



House of Commons
Treasury Committee

The 2006 Budget

Fourth Report of Session 2005–06

Volume I



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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 HM Treasury and its associated public bodies.

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A list of Reports of the Committee in the present Parliament is at the back of this volume.

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The current staff of the Committee are Colin Lee (Clerk), Fiona McLean (Second Clerk and Clerk of the Sub-Committee), Dominic Lindley, Andrew Staines and Adam Wales (Committee Specialists), Lis McCracken (Committee Assistant), Mandy Sullivan (Secretary) and James Clarke (Senior Office Clerk)

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Summary

The economy

The overall economic outlook has not changed greatly since the 2005 Pre-Budget Report. Rising gas and oil prices are an important feature of that outlook, and we recommend that the Government report to Parliament later this year on progress in its efforts to secure independent investigation of European gas markets. We propose further Government work to examine the economic effect of migration, both high- and low-skilled, as well as further Treasury monitoring of the performance of business investment.

The public finances

We re-state the view expressed in our Report on the 2005 Pre-Budget Report that it would be appropriate to review the fiscal rules in order to put any improved formulation of the rules in place at the start of the next economic cycle. We remain concerned at the possible constraint on fiscal policy towards the end of the economic cycle arising from the golden rule. The sustainable investment rule needs to be taken forward in the context of the information that will emerge from Whole of Government Accounts. We identify some of the spending pressures that will affect the conduct of the Comprehensive Spending Review and identify a role for departmental select committees of the House of Commons in relation to that review.

Other issues

The Government's efficiency agenda in central and local government could be further strengthened in the context of the Comprehensive Spending Review, including by placing greater emphasis on net savings and on reductions in departmental administration budgets. We recommend that, as part of its report due in mid-2006 on the challenges for the Comprehensive Spending Review, the Government set out in greater detail assessments and possible additional measures to meet its target to halve child poverty by 2010–11. We urge the Government to re-examine whether it is making the fullest possible use of taxation instruments as a mechanism to achieve the Government's environmental targets. We find the Government's attempt to justify freezing air passenger duty (APD) for the fifth year running to be incoherent and unconvincing, and recommend that the Government give serious consideration to increasing rates of APD.

1 Introduction

1. The 2006 Budget was delivered on 22 March.¹ We have decided to follow the practice of our predecessors by examining the Budget and by aiming to conclude our inquiry in time to report to the House before the debate on the Second Reading of the Finance Bill.² We accordingly took oral evidence in the week following the Budget from outside experts³ on Monday 27 March, from Treasury officials on Wednesday 29 March and from the Rt Hon Gordon Brown MP, Chancellor of the Exchequer, on Thursday 30 March. We also received a range of written evidence, some of which is being published in Volume II of this Report and the remainder of which has been reported to the House and is available for public inspection.⁴ We are most grateful to all those who gave evidence to the Committee, and to Professor David Heald of Sheffield University for his specialist advice. In the course of this inquiry we have also benefited from oral evidence taken and written evidence received in the course of March 2006 in connection with the Bank of England February 2006 Inflation Report, evidence which is being published separately.⁵

2. In this Report we examine the state of the United Kingdom economy and then matters concerning the public finances, before turning to consideration of selected individual Budget measures. We have also taken the opportunity to explore some issues arising from our Report on the 2005 Pre-Budget Report and the Government's response to that Report which we received on the day of the Budget.⁶

1 HC Deb, 22 March 2006, cols 287–302. The accompanying Economic and Fiscal Strategy Report and Financial Statement and Budget Report was published as *Budget 2006: A strong and strengthening economy: Investing in Britain's future*, HC (2005–06) 968 (hereafter *Budget 2006*)

2 For the Committee's commitment to Budget inquiries, see Treasury Committee, Second Report of Session 2005–06, *The 2005 Pre-Budget Report*, HC 739 (hereafter HC (2005–06) 739), para 1.

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

4 For a list of published written evidence, see p 73; for a list of unpublished written evidence, together with details about how such evidence may be inspected, see p 74.

5 Treasury Committee, *Bank of England February 2006 Inflation Report: Oral and Written Evidence*, HC (2005–06) 973–i–ii

6 Treasury Committee, Third Special Report of Session 2005–06, *The 2005 Pre-Budget Report: Government Response to the Committee's Second Report of Session 2005–06*, HC 1013 (hereafter HC (2005–06) 1013)

2 The economy

The economic outlook

3. The Red Book stated that the overall forecast for GDP had not changed between the 2005 Pre-Budget Report and the 2006 Budget, although there were small changes around the composition of the drivers of future GDP growth.⁷ These changes are discussed in the remainder of this section. The Red Book then analysed the balance of risks around the forecast, saying “the balance of risks has shifted a little, with domestic risks having receded while global uncertainties have increased somewhat. Globalisation means that the United Kingdom economy shares ever increasingly in the risks affecting the world economy, and that domestic risks are harder to differentiate.”⁸

4. Professor David Miles, from Imperial College and Morgan Stanley, in response to this statement told us that “I think it may be a little premature to conclude that some of the domestic risks have become much less important”.⁹ However, Treasury officials defended their position, saying that, on the domestic side, consumer confidence appeared to be coming back and inflation had remained stable despite recent rises in the oil price. On the international side, while the risk from global imbalances had remained roughly the same, rising interest rates in the USA and the euro-area, meant that the risk of a rise in global yields had increased.¹⁰

Energy prices

5. Recent rises in oil and gas prices have led to some concern over their effect on inflation, and on economic growth. On the energy price rises, the Red Book stated that “The price of Brent crude oil, the European standard, rose from a low of \$10 a barrel in 1999 to a peak of over \$67 a barrel in September 2005. Prices declined from this peak towards the end of 2005, but have risen again in early 2006 to average \$62 a barrel for the year to date, compared to an average of \$55 a barrel during 2005.”¹¹ The Governor of the Bank of England, referring to the recent movements in gas prices, said that “the size of the changes in gas prices is clearly very striking and it reflects the fact that the gas market is very much a spot market”.¹² On the future path of oil prices, Mr Jon Cunliffe, Second Permanent Secretary, Macroeconomic Policy and International Finance, HM Treasury, observed that “most forecasters have them remaining at a level of \$60 a barrel over the next 12 months and staying high in the medium term”.¹³

7 *Budget 2006*, para B53 and Tables B9 and B6, pp 232, 247, 240; *Pre-Budget Report 2005*, Tables A9 and A6, pp 204, 198

8 *Budget 2006*, para B109, p 246

9 Q 4

10 Q 143

11 *Budget 2006*, para B21, p 225

12 HC (2005–06) 973-i-ii, Q 63

13 Q 143

6. Rising energy prices, as well as having a direct impact on prices such as the cost of petrol, pose the risk of second-round effects on inflation. Second-round effects are where consumers begin to push for higher wages to counter their rising utility bills and motoring costs, and if they attain them, this then leads to greater demand which feeds through to higher prices. The Chancellor of the Exchequer acknowledged this risk, telling us that "...if people are trying to catch up for the rise in energy prices and that were to have a second round effect in wage rises that were inflationary, then the Bank of England would take note of this, as the Governor has said".¹⁴

7. Another aspect of the recent rise in gas prices has been whether the United Kingdom has been detrimentally affected by a lack of competition in European gas markets. The Governor noted "It is true that there is the inter-connector with Belgium through which it had been hoped that gas would flow into the United Kingdom when prices were higher here than on the Continent, but I am not sure whether it was entirely reasonable to expect that, given that the gas market on the other side of the Channel is not exactly reminiscent of the group of atomistic competitors of textbook theory".¹⁵ The Chancellor of the Exchequer went further, saying that:

the failure to complete the single market and the lack of liberalisation in some of the key industries is damaging, not just to industries across Europe but is obviously hitting consumers as well. The most obvious example ... is gas prices and the fact that it is probably costing us £10 billion more for gas than it should. I believe that the way forward has got to lie beyond simply setting political timetables, and that is why I have been suggesting (and we will discuss this at the meeting of finance ministers in Vienna in only a few days time) that we need independent investigations into particular sectors where we are worried about the limits of liberalisation, and we need, therefore, also powers to act on these investigations when they reveal that practices that are being pursued in certain countries are not beneficial to the completion of the single market.¹⁶

The rise in energy prices appears, so far, to have had muted second-round effects. We note the Government's proposed actions to encourage an "independent investigation" into European gas markets (and energy markets in general) and we recommend that the Government provide an update on the outcome in the 2006 Pre-Budget Report.

The output gap

8. The Treasury uses estimates of the output gap to assess the growth potential of the economy in the future. A negative gap means that there is spare capacity, and economic growth can be above trend, and non-inflationary. As Chart B3 in the Red Book shows, the Treasury currently believes there to be a significant negative output gap, forecast to increase over 2006, before closing by 2009.¹⁷ However, the International Monetary Fund's (IMF) Article IV report on the United Kingdom suggests that the output gap may not be as

¹⁴ Q 323

¹⁵ HC (2005–06) 973-i-ii, Q 63

¹⁶ Q 322

¹⁷ *Budget 2006*, Chart B3, p 230

great as the Treasury's forecast.¹⁸ Mr Martin Weale, of the National Institute for Economic and Social Research, told us that "my own best guess ... is that the Treasury is overstating the trend growth rate in that period with the two peaks and that actually we have only a small output gap, considerably lower than they show".¹⁹ Ms Bridget Rosewell, of Volterra Consulting, supported this notion that the output gap may be smaller than the Treasury indicates, saying "the internal evidence suggests that the Bank of England would concur with that analysis in that they have focused quite a lot on the resource take that is going on in the economy and have suggested themselves that the output gap is smaller than the Treasury suggest".²⁰ Professor Miles agreed, considering the Treasury's estimate to be "at the high end of estimates of the output gap".²¹ Treasury officials said they justified the Red Book's forecast in two ways, first using an arithmetic process based around where the economy would have been had it grown at trend growth, a process which suggested an output gap, but also from looking at capacity indicators, such as employment and manufacturing capacity, which also suggested a gap existed.²² Mr Cunliffe defended the Treasury's forecasts, saying "The main point I would make, though, is we do not calculate the output gap by reference to other people's forecasts; we calculate it by reference to the methodology that we have always used. We have published the cyclical indicators, we are transparent in what we do. Obviously it is a judgment but making that sort of judgment lies at the heart of fiscal policy."²³

9. We also heard evidence on the difficulties of defining and measuring the output gap. The Governor of the Bank told us that the output gap "is an abstract concept that economists find useful but it does not correspond to anything you could go and measure". He went on to say "I would throw in labour migration as something that makes even the concept somewhat dubious".²⁴ Other witnesses added to the concerns over the measurement of the output gap. Mr Weale observed that "it is also true that estimates of the output gap are subject to substantial revision because you really need a considerable element of hindsight to assess it, and that raises a question about how useful it is as a tool for policy analysis".²⁵ Mr Robert Chote, of the Institute for Fiscal Studies, also picked up on this point, saying "It is clearly a good idea that you have a framework that allows you to borrow more when the economy is weak, but judging whether the framework is passed or failed in some sense based on precise estimates of the output gap is putting more rhetorical weight on this than its foundations can bear".²⁶ Rising labour migration may mean that there is always spare capacity in the economy, rendering the measurement of the output gap less meaningful. Mr Cunliffe acknowledged that "the concept of an infinitely elastic labour force, if that is what we had, that proved that the supply side of the economy could

18 United Kingdom: 2005 Article IV Consultation – Staff Report: IMF, para 10, page 11

19 Q 5

20 Q 6

21 Q 6

22 Q 144

23 Q 144

24 HC (2005–06) 973-i-ii, Q 117

25 Q 5

26 Q 6

grow just to meet any level of demand, would make it more difficult to run fiscal policy around an output gap”.²⁷

10. **There are some differences between the Treasury’s forecast for the size of the output gap going forward, and the forecasts of independent observers and some members of the Bank of England Monetary Policy Committee.**²⁸ We note that the concept of the output gap has significant, and possibly insuperable, measurement and definitional problems, particularly given the growing economic importance of migration and its potential influence on the output gap, but we recommend that the Treasury publish a technical note on its methodology for measuring the output gap.

Household consumption and saving

Consumer spending

11. Consumer spending has in recent times been the most important driver of economic growth. The Red Book reported little change to the profile of household consumption since the 2005 Pre-Budget Report, although the forecast for private consumption growth in 2006 is slightly higher than in that Pre Budget Report.²⁹ Commenting on this increase in the forecast, Ms Rosewell said “I would not myself do that, no. If anything, I would have weakened it rather than strengthened it.”³⁰ And acknowledging that the consumer was an important part of the economy, she went on to say that “what worries me about the picture that we have got here [in the Budget] is there does not seem to be much else except the consumer”.³¹ Mr Weale also expressed reservations, saying that “I am slightly more pessimistic about consumer spending growth than the Budget”.³² In earlier evidence to the Committee, Mr John Butler of HSBC, said “My forecast is one in which the consumer rally you saw at the end of last year will not persist and you will revert back to the similar story you saw from most of last year with the consumers weak”.³³

12. Concerns were also raised about the underlying strength of household consumption, in the face of changes to the economic environment such as a rise in interest rates. Mr Butler told us that, despite a lack of “bad news”, recent movements in consumer spending and house prices appeared to show “an increased sensitivity on the household sector to smaller and smaller shocks and that increased sensitivity is in a backdrop in which debts are at record heights”.³⁴ External Monetary Policy Committee member Professor Stephen Nickell noted that “in some sense, when people take out mortgages ... they generally think in terms of life carrying on as it is today. Touch wood, they are right to do so, but there is always this risk, which even the greatest monetary policy in the world could not eliminate.

27 Q 157

28 HC (2005–06) 973-i-ii, Qq 113, 114

29 *Budget 2006*, para B86, p 239 and para B62, p 234

30 Q 12

31 Q 16

32 Q 15

33 HC (2005–06) 973-i-ii, Q 26

34 HC (2005–06) 973-i-ii, Q 17

There is always that kind of danger around, and the economy is a more dangerous place than a lot of people now think.”³⁵ However, Mr Cunliffe presented the more positive view that “on the domestic side I would say that, at the time of the Pre-Budget Report, we were looking at what seemed to be a sharp contraction in household consumption in the United Kingdom. The issue was, was that likely to level off, or was consumption likely to continue contracting? Since the Pre-Budget Report, there has been evidence on consumption and evidence on retail sales that it is flattening off and consumer confidence is coming back. So I would say that the greater downside risk around household consumption is less than we saw at the Pre-Budget Report.”³⁶

13. Some witnesses expressed concern about the lack of timely data on consumer spending on services as opposed to retail sales. Ms Rosewell felt this to be important because consumer spending was “a lot more than retail sales, and indeed retail sales have been falling as a proportion of total consumer spending for some years now as people moved into buying services and holidays and all of those sorts of things as much as they buy things”.³⁷ Mr Charles Bean, Chief Economist of the Bank of England, highlighted the disparity, saying “There is a great swathe of consumer spending on consumer services which we have much less information on and there we often rely on what our agents are telling us...”³⁸ The Governor of the Bank of England said “This is a major issue for us and it is not easy for the ONS (Office of National Statistics) to know how to develop this, but they are certainly working on it”.³⁹ **While the forecasts of the Budget do not suggest that consumer spending growth will reach the previously high levels seen in the recent past, several outside observers note significant downside risks to these forecasts. We recommend that the Treasury provide all necessary assistance to the ONS in its task of understanding and measuring consumer spending, such as on services rather than retail sales, to help improve the quality of consumer spending forecasts.**

The household saving rate

14. According to the Red Book, the household saving rate was 5¼% in 2005, and is then forecast to rise to 5¾% in 2006, before falling slightly to 5½% in 2007 and 2008.⁴⁰ However, the IFS Green Budget states that the average household saving rate since 1963 was 7.8%.⁴¹ Mr Weale stated that the framework ought to “be one which allows the Chancellor of the Exchequer, Parliament and everyone else to address the question in aggregate; is the country saving enough or not?”.⁴² Commenting on the Treasury’s forecast for the household saving rate, Professor Miles said “I would be somewhat concerned if that is how the United Kingdom economy played out given that we are probably saving too little and it would be good to save more”.⁴³ When asked whether this low saving rate could be

35 HC (2005–06) 973-i-ii, Q 111

36 Q 143

37 Q 10

38 HC (2005–06) 973-i-ii, Q 93

39 HC (2005–06) 973-i-ii, Q 95

40 *Budget 2006*, Table B5, p 238

41 *The IFS Green Budget: January 2006*, p 50

42 Q 3

43 Q 16

mitigated by using the international savings glut, Mr Weale replied “Living off other people’s saving in retirement is a trick that I cannot quite see working”.⁴⁴ Mr Cunliffe had reservations on whether the saving rate was low, telling us that “If you look at its rate, say, over the 1960s, which was a fairly even period, it is roughly where it is now. If I looked at it historically does it look to me as if it is greatly out of line with history? No, in that sense.”⁴⁵ Another reason why the saving rate may be low was suggested by Mr Cunliffe, in that easier access to finance meant that the precautionary motive for saving was less important now.⁴⁶ The Chancellor of the Exchequer, as well as identifying the Government’s pilot schemes with low-income households and Child Trust Funds as means employed by the Government to encourage household saving, said “The savings ratio is around about 5% at the moment, but, if I may say so, it is higher than it was at certain peak periods under the previous government, and, of course, it is a lot higher than the American savings ratio, and I think that has to be borne in mind as we look at the economy”.⁴⁷ He had already highlighted in his Budget speech that under the Government’s Individual Savings Accounts, “I can report that £190 billion has already been invested by 16 million people”.⁴⁸

The labour market and migration

The strength of the labour market

15. Discussing the current state of the labour market, and its recent weakness, the Red Book comments that “having remained broadly stable for the first three quarters of 2005, the employment rate has subsequently fallen back by 0.4 percentage points to 74.5% in late 2005 and early 2006, while the unemployment rate rose by ¼ percentage point to around 5% over the same period. Moreover, average earnings growth has continued to track down. However, it is unclear thus far to what degree the labour market has undergone an underlying softening and to what extent some of the recent weakening may be temporary and erratic.”⁴⁹ Professor Miles, when asked by the Committee whether he thought the recent weakness in the labour market stemmed from rising labour availability or job losses, told us “I do not think that one can point to the unemployment figures that have been moving up now for six months or more and say it is self-evident that job losses are driving unemployment up. The actual number of people employed, until very recently I believe, has continued to rise.”⁵⁰

The impact of migration

16. In the February 2006 Inflation Report, there was discussion of the potential impact of migration on sectoral pay and overtime.⁵¹ The Committee sought evidence on the impact

44 Q 17

45 Q 151

46 Q 151

47 Q 331

48 HC Deb, 22 March 2006, col 297

49 *Budget 2006*, para B40, p 228

50 Q 26

51 *February 2006 Inflation Report*, Bank of England, Charts 3.6 and 3.7, p 21

this would have on productivity. Professor Miles suggested that “it may well have an adverse effect on measured productivity” as more unskilled jobs are filled in the United Kingdom, and that this would be “a positive interpretation of lower productivity”.⁵² But Ms Rosewell disagreed with the premise of the argument, saying “I read the Bank of England piece, but I was not completely sure I agreed with the conclusion that you could draw a general conclusion from those particular results. After all, there have always been quite high levels of migrants and temporary workers involved in the hotel and restaurant sectors at low wages and now we have just got different groups involved in it. I am not convinced that this is really a big story.”⁵³ Mr Cunliffe also pointed out that “There is some very high-skilled migration into the United Kingdom”,⁵⁴ a point also raised by Mr Weale.⁵⁵ Treasury officials took up this point, saying “a fairly large proportion of migration is still quite highly skilled and essentially if you are talking about outside the EU, the gateway can be applied and you could really only come in if you were earning more than the average salary, so that would be higher productivity”.⁵⁶ However, the impact of migration, whether skilled or unskilled, on the United Kingdom economy still seems unclear. Mr Weale pointed out that “...is that in terms of flows of migration we know very little about it. The ONS has very major difficulties in collecting migration statistics.”⁵⁷ Mr Cunliffe said “I think we need to try and understand this better [the effect of migration] and I think it will take us some time to do that as we become used to it and yes, we are trying to do that”.⁵⁸ In the Government’s response to the Committee’s Report on the 2005 Pre-Budget Report, the Treasury said that “the Department for Work and Pensions has also started a research project with Dr Sara Lemos from Leicester University to build on this earlier work [into the effects of migration from countries that have recently joined the European Union]. Initial results are expected to be published soon. As part of its ongoing assessment of the United Kingdom economy, the Treasury closely analyses developments in the United Kingdom labour market and their wider economic implications.”⁵⁹ **We note the recent slight weakening in the labour market, and recommend that the Treasury monitor the situation closely. We also note the recent publication of research by the Department for Work and Pensions into migration effects of people moving into the United Kingdom from the new European Union countries and the Home Secretary’s statement on a points-based immigration system. However, we recommend that the Government now undertake a more wide-ranging study of the effects of all migration, both high- and low-skilled, looking at areas such as wages, productivity, business investment and the effect on aggregate labour supply overall.**

52 Q 24

53 Q 26

54 Q 163

55 Q 26

56 Q 165

57 Q 26

58 Q 166

59 HC (2005–06) 1013, pp 10–11

The role of women in the labour market

17. On 27 February 2006, the Women and Work Commission published its report *Shaping a Fairer Future*. The Government has the aspiration “to achieve an employment rate equivalent to 80% of working age population”.⁶⁰ The female employment rate currently stands at nearly 70%.⁶¹ The Women and Work Commission’s report contains 40 recommendations, some of which are designed to encourage greater female labour participation. The report also highlights that, by increasing both female labour mobility and participation, the economy may benefit by up to £23 billion, about 2% of GDP.⁶² The Red Book contains several measures to respond to the Women in Work Commission’s recommendations, including funding for Sector Skills Councils to develop new ways to recruit and train women with low skills.⁶³ The Chancellor of the Exchequer told us that “What we have tried to do in the Budget is to provide more funds for training women who have low skills to encourage them to get higher skills”.⁶⁴ The Women and Work Commission’s recommendations, however, are also concerned with the wage gap, and the additional costs on small businesses of part-time or flexible workers. **We welcome the moves in the Budget to encourage a higher rate of female labour participation, but note that these only form part of the way in which the Government will be expected to respond to the recommendations in the report of the Women in Work Commission.**

Productivity

18. According to the Red Book, “The United Kingdom is experiencing the longest sustained period of productivity and employment growth since the 1950s when records began”.⁶⁵ And the Chancellor of the Exchequer in his Budget speech said that “In the cycle that ended in 1997, productivity growth averaged 2% a year. In the current cycle, it is 2.3%, which is a rate of productivity growth higher than at any time since the 1960s ... Britain has caught up with Germany in productivity, is ahead of Japan and has halved the gap with France”.⁶⁶ The international comparisons were based on output per worker. The Institute for Fiscal Studies (IFS) Green Budget however, using a different measure of productivity based on real GDP per hour worked, suggested that gap has not closed with France, and that the United Kingdom is not on a par with Germany.⁶⁷ There has recently been a softening in productivity growth, although the figures for fourth quarter of 2005 are stronger.⁶⁸ This may have been the result of labour hoarding, where firms retain labour in times of slowing demand just to maintain a skill base. Mr Weale thought that two reasons for the recent poor performance in productivity were businesses being taken by surprise by

60 *Budget 2006*, para 4.1, p 75

61 *Budget 2006*, Box 4.2, p 88

62 *Shaping a Fairer Future*, Women and Work Commission, p vii

63 *Budget 2006*, Box 4.2, p 88

64 Q369

65 *Budget 2006*, Box 3.1, p 43

66 HC Deb, 22 March 2006, col 291

67 *IFS Green Budget*, Table 3.2, p 52

68 ONS Press Release, Productivity 4th Quarter 2005, 30 March 2006

the recent fall in output, leading to labour hoarding, and the large expansion in the public sector.⁶⁹

19. On the point of the recent weakening in the figures, Treasury officials suggested that it was misleading to focus on productivity growth over the last couple of years, and said it should be looked at over the cycle.⁷⁰ However, Ms Rosewell had earlier contested the Treasury's comparative measurements of productivity over the cycle, saying that the Treasury had compared the previous full cycle with only the recent upswing, and that this was not "really comparing like with like, so it seems to me that it is certainly premature and rather misleading to say that the performance of the United Kingdom economy has improved in that respect".⁷¹ The Chancellor of the Exchequer told us: "We obviously wish to see even greater productivity growth. In a period when you have lower growth, as we had last year, and people retain employment, then your productivity growth will be slower than in previous years, but the fact of the matter is that productivity growth in the previous cycle was 2%, productivity growth in this cycle so far is 2.3% and, therefore, we have increased the rate of productivity growth in the British economy and we will do better, in my view, in the years to come."⁷²

20. Measuring the productivity of the public sector has always been difficult. Mr Weale, commenting on recent attempts to improve the public sector productivity statistics, told us that "the work does have a lot more to be done to make sure it has logical coherence".⁷³ Mr Cunliffe said the Treasury was "currently in the middle of trying to get a better grip of public sector productivity by ONS by trying to quantify and measure those outputs, so the picture is, I think, quite difficult".⁷⁴ **We note the closing of the productivity gap (on certain measures) with international competitors. However, we also note the debate on the productivity figures, and recommend that the Treasury monitor those figures closely to ascertain the effect of labour hoarding. We also note the work being done to improve the public sector productivity figures, and recommend that the Treasury and the ONS ensure that there is significant public consultation before the new official statistical standards are disseminated.**

Business investment

21. Business investment, and its recent performance, were a major theme in our hearings on the 2005 Pre-Budget Report.⁷⁵ According to the Red Book, business investment grew 1½% in 2005, and is forecast to grow 1% to 1½% in 2006, rising to 4½% to 5¼% in both 2007 and 2008.⁷⁶ Mr Butler said "One of the biggest disappointments the Bank of England faced last year was not necessarily on the consumer side; it was the lack of investment coming through—which shows a degree of uncertainty and almost a savings glut out

69 Q 28

70 Q 168

71 Q 35

72 Q 347

73 Q 34

74 Q 167

75 HC (2005–06) 739, para 24

76 *Budget 2006*, Table B6, p 240

there”.⁷⁷ The Governor of the Bank of England, commenting on the growth of business investment, said that “there is no doubt it has been very weak in the last year or two and weaker than we had expected and weaker than we find it entirely easy to explain”.⁷⁸ But the Governor went on to say that “The growth rates have been very weak, but the level relative to GDP has not been”.⁷⁹ Mr Cunliffe told us that “We have not seen business investment come back as strongly as forecast, particularly last year where, under the pressure of higher oil prices and also weaker export markets, business investment was more subdued than we thought. The way we see the evolution of the economy is that next year business investment will stay quite muted.”⁸⁰ Discussing the forecast for 2007 and 2008, Mr Cunliffe said that “4½% is not a very big increase in investment”.⁸¹ The Chancellor of the Exchequer though, seemed less concerned by the recent weakness, telling us that “business investment has risen. It has risen substantially since 1997. There was a particular building investment in IT in the late 1990s in almost every country around the world. When the IT boom came to an end there was a retrenchment for a time. We expect business investment rates to rise again.”⁸²

22. We received evidence on the recent movements in business investment in other countries, providing a comparator for the United Kingdom’s position. It appears that other industrialised countries have faced a similar puzzle of business investment appearing unduly weak, but some of those countries have recently seen increases in investment. The Governor of the Bank of England told the Committee that “this was something which a year ... ago the US and the euro-area were also seeing and they really did not understand why investment looked weak either, and there were stories from the US and elsewhere that maybe generalised business caution explained weak investment, but there was no more compelling or explicit explanation than that. In the last year business investment has picked up in the US and the euro-area so that puzzle has gone away.”⁸³ Mr Cunliffe told us that “internationally there has been for a number of years the issue that businesses were not investing as much at this stage of the cycle as they had at previous stages. In the US that investment has started. In Germany and some places in the eurozone it has started and other places it has not.”⁸⁴

23. We heard evidence on the implications of data revisions and definitions on the measurement of business investment. The Red Book notes that “expenditure on R&D, organisational change, training and some elements of branding and software investment are all currently recorded as current expenditure in the national accounts, whereas firms might reasonably consider them investments aimed at future capacity and efficiency”.⁸⁵ The Red Book then goes on to discuss how changes to the measurement of computer

77 HC (2005–06) 973-i-ii, Q 16

78 HC (2005–06) 973-i-ii, Q 83

79 HC (2005–06) 973-i-ii, Q 84

80 Q 147

81 Q 154

82 Q 333

83 HC (2005–06) 973-i-ii, Q 84

84 Q 153

85 *Budget 2006*, Box B6, p 241

software investment might see total software investment in 2003 rise from £8 billion to £21 billion.⁸⁶ The problems with measuring business investment were also commented on by Professor Miles, who questioned whether the data fully took into account the effects of training: “If I take a day away from the desk and go and learn how to use a computer better, it seems to me that is investment. Nobody in National Statistics is going to measure that as investment.”⁸⁷ Mr Cunliffe also questioned the accuracy of the current data, telling us that “I am always a bit careful with business investment because the figures get revised and often very heavily revised as we go along. In 2002 we were looking at a 10% reduction and that was revised to a 1% increase, so it is a very volatile series and one has to be a bit careful in drawing conclusions”.⁸⁸ The Chancellor of the Exchequer reiterated this point, telling us that “we have been notoriously poor in our official statistics in reflecting the scale of investment in software, in IT, which, of course, is difficult to quantify and to record.”⁸⁹

24. Issues with measurement aside, most commentators agreed that the current economic environment for business investment appeared to be supportive. The Governor also told us that “there is no simple or easy explanation for that because cash flow and profitability are high and the cost of capital is at an all time low”⁹⁰ and Mr Butler said “a lot of the conditions for investment have been fairly supportive”.⁹¹ The Red Book states that “with corporate fundamentals relatively sound, liquidity high and the cost of capital historically low, within the context of sustained domestic macroeconomic stability, the corporate sector should be relatively well placed to undertake somewhat stronger business investment growth as domestic growth picks up and stronger underlying export growth becomes established”.⁹² Mr Weale stated that “I am rather mystified why with a nicely rising stock market, high profits and low interest rates we have such a depressed investment performance”.⁹³

25. Several reasons for the recent weak performance of investment growth have been suggested. The Red Book argues that “cyclical factors are likely to have contributed: subdued private consumption growth alongside weak growth in key United Kingdom exports over much of 2005 will have tended to discourage companies from raising physical capacity. High oil prices have also probably contributed to the recent reluctance to step up capital expenditure”.⁹⁴ Ms Rosewell thought that “the instabilities in the world economy are relevant here”.⁹⁵ There was disagreement over the relative importance of the effect of pension deficits on the growth of business investment, with Ms Rosewell commenting that “I think the importance of that feature should not be underestimated, certainly from discussions that I have had with company directors”.⁹⁶ Professor Miles, in contrast, was

86 *Budget 2006*, Box B6, p 241

87 Q 21

88 Q 147

89 Q 338

90 HC (2005–06) 973-i-ii, Q 84

91 HC (2005–06) 973-i-ii, Q 28

92 *Budget 2006*, para B95, pp 240–241

93 Q 19

94 *Budget 2005*, para B91, p 240

95 Q 19

96 Q 19

“very sceptical about the pensions part of this story” because, “although it sounds superficially plausible, the evidence is not really consistent with it being a big factor”.⁹⁷ **The statistics on business investment are prone to revision, and may also under-report investment. We recommend that the Treasury, in conjunction with the Bank of England as a prime user of these statistics, work with the Office of National Statistics to refine both the methodology and definitions of the business investment statistics, especially given the greater proportion of service sector activity in the United Kingdom. We further recommend that the Treasury continue to monitor the performance of business investment (including any effects from under-reporting as a result of weaknesses in the official statistics), including by international comparisons.**

External demand and United Kingdom trade

26. The balance between export and import growth has, in recent times, been a drag on economic growth. The Red Book says, that in the forecast period, this may change, “with export growth expected to be a little above that of imports over the forecast horizon, despite some assumed further loss of export market share, net trade is forecast to make a broadly neutral contribution to GDP growth throughout”.⁹⁸ Ms Rosewell broadly agreed with this assessment.⁹⁹ However, Mr Butler, commenting on the Bank of England’s similar forecast for net trade, disagreed: “On the export side, we are probably more concerned about the global growth picture. A lot of the issues that are highlighted as risks in the Bank of England’s forecasts we would probably incorporate more as a central projection, such as that the US consumer starts to slow, and, with it, United Kingdom exports soften.”¹⁰⁰ His position was supported by Mr Roger Bootle, of Capital Economics.¹⁰¹ The Governor of the Bank of England confirmed that the Bank expected “some less negative contribution of net trade to growth than we have seen in the past decade where net trade has subtracted from growth every single year for ten years”.¹⁰² This position was supported by Mr Cunliffe, who said “Net trade, exports minus imports, contributes zero to GDP, whereas in the past it has been a drag and was a negative contribution because we have imported more than we have exported. Personally I think there is an upside around that forecast.”¹⁰³ The Chancellor of the Exchequer said that “the key to this is to expand your exports. You have got to expand your exports into new areas and into new industries”, and went on to describe how the United Kingdom does and should foster links with emerging economies such as China and India.¹⁰⁴ **Should the Treasury’s forecast of the zero input to GDP growth from net trade be achieved, we recognise that this would be a positive break from the recent trend.**

97 Q 20

98 *Budget 2006*, para B104, p 245

99 Q 37

100 HC (2005–06) 973-i-ii, Q 34

101 HC (2005–06) 973-i-ii, Q 36

102 HC (2005–06) 971-i-ii, Q 81

103 Q 147

104 Q 351

Global economic imbalances

27. The imbalances in the world economy have continued to grow and the United States' current account deficit exceeded 6% in 2005.¹⁰⁵ Professor Miles told us “that the longer the US runs current account deficits at an extraordinarily large level the more likely it is you see some potentially rather sharp adjustment at some point in the future”.¹⁰⁶ Ms Rosewell also suggested that Japan's staunching of the flow of liquidity into its financial system may have an effect on the ability of the US to finance its current account deficit.¹⁰⁷ Mr Cunliffe said the Bank of Japan would move “... into a period in which I would expect to see monetary policy tightening”.¹⁰⁸ However Mr Cunliffe said that “On the international side, the risk of global imbalances, which this Committee has asked about before, has probably remained the same.”¹⁰⁹ The Chancellor of the Exchequer reaffirmed the risk of any unwinding of these global imbalances to the United Kingdom economy, saying that “I think the risks to the British economy are internationally from an unwinding of current account balances in a way that was deleterious to the European and to the British economy”.¹¹⁰

105 *Budget 2006*, Box B1, p 221

106 Q 41

107 Q 41

108 Q 143

109 Q 143

110 Q 329

3 The public finances

The golden rule

Meeting the golden rule in the current cycle

28. Since 1997 the Government has put in place and sought to adhere to a new fiscal policy framework set out in the *Code for fiscal stability*. The Code requires the Government to state the rules through which fiscal policy be operated. There are currently two fiscal rules, the sustainable investment rule, which is discussed further below, and the golden rule. The golden rule states that, over the economic cycle, the Government will borrow only to invest and not to fund current spending. The golden rule is evaluated using the current budget balance, which represents the difference between current receipts and current expenditure, including depreciation. The rule measures the degree to which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of intergenerational fairness.¹¹¹

29. The 2006 Budget states:

The average surplus on the current budget since the start of the current cycle in 1997–98 is in balance or surplus in every year of the projection period. The economy is projected to return to trend in 2008–09, which means that the average annual surplus on the current budget would be 0.1% of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £16 billion in this cycle, including the AME margin, the same as at the 2005 Pre-Budget Report.¹¹²

However, by definition, a fiscal forecast cannot be wholly certain. Mr Martin Weale told the Committee that “the chances of hitting the fiscal rules are clearly less than 100% certainty”.¹¹³ The IFS has estimated that, based on Treasury forecasts and the Treasury's past forecasting performance, there is a 55% to 60% chance of meeting the golden rule in the absence of further policy changes over the remaining three years of the economic cycle.¹¹⁴ This compares to an estimated 75% chance of meeting the golden rule as at the time of Budget 2003, which was then estimated to be three years ahead of the projected end of the cycle.¹¹⁵ Based on the IFS forecasts and the fiscal forecasts in the 2006 Budget, the IFS estimate that the Treasury has an equal chance of meeting the golden rule or missing the golden rule.¹¹⁶ In calculating these estimated probabilities, the IFS are assuming that the distribution of forecasting errors is symmetrical, in other words, there is equal chance of underachievement or overachievement. However, in giving evidence on the 2005 Pre-Budget Report, Mr Cunliffe told us that “There is a tendency for forecast errors to be

111 *Budget 2006*, para 2.56, p 33

112 *Budget 2006*, para 2.58, p 34

113 Q 71

114 IFS press release on *Budget 2006*, 22 March 2006

115 *Post Budget Briefing*, Institute for Fiscal Studies, 23 March 2006

116 Qq 137, 140

correlated with the economic cycle, so when you have a positive output gap there is a tendency for forecast errors to be one way and when you have a negative output gap there is a tendency for forecast errors to be the other way.”¹¹⁷ If taken into account, this would tend to reduce slightly the estimated probabilities of meeting the golden rule as stated above.

30. The actual or forecast surplus or deficit on the current account for each year of the current economic cycle is set out in the table below.

Table 1: Current account balances over most recent economic cycle

	Public sector current budget as % of GDP	Average since 1997–98 (estimated start date of current cycle as at Budget 2006)
1997–98 outturn	-0.15%	-0.15%
1998–99 outturn	1.20%	0.53%
1999–00 outturn	2.20%	1.08%
2000–01 outturn	2.23%	1.37%
2001–02 outturn	1.02%	1.30%
2002–03 outturn	-1.23%	0.88%
2003–04 outturn	-1.91%	0.48%
2004–05 outturn	-1.62%	0.22%
2005–06 estimate	-0.90%	0.09%
2006–07 estimate	-0.60%	0.02%
2007–08 estimate	0.10%	0.03%
2008–09 estimate (estimated end date of current cycle as at Budget 2006)	0.50%	0.07%
2009–10 estimate	0.70%	0.12%
2010–11 estimate	0.80%	0.17%

Data sources: public sector current budgets from 1997–98 to 2004–05 from Public sector finances, National Statistics, February 2006; and public sector current budgets from 2005–06 to 2010–11 from The 2006 Budget, Table C5, p 259

31. The table above demonstrates that, based on projections in the Budget, the Government is forecast to meet its golden rule over the current cycle, by a margin of approximately 0.07% of GDP in each year of the cycle (or approximately £800 million based on GDP in 2005). This equates to approximately £10 billion in total over the course

of the cycle, or £16 billion if it is assumed that the AME margin of £1 billion in 2006–07, £2 billion in 2007–08 and £3 billion in 2008–09 is not needed.¹¹⁸

Taking forward the golden rule

32. In our Report on the 2005 Pre-Budget Report we recommended that the focus of the golden rule should be on ensuring that fiscal policy is sustainable on a forward-looking basis, rather than on encouraging changes to tax levels or spending now as a consequence of data revisions relating to levels of growth several years ago. The Government's response to that Report notes that:

Fiscal policy is made in a forward looking way, as is made clear by the extensive use of projections in the 2005 Pre-Budget Report, covering the five years to 2010–11. For example, the Government reports on whether the golden rule, using cautious assumptions, is set to be met after the current cycle ends on the assumption that the economy is on trend. It reports on projected performance against the golden rule in a cautious case of trend output being lower by 1 percentage point to stress test the projections.¹¹⁹

33. Indeed, the Budget states that “With the economy assumed to be on trend in 2008–09, Budget projections show, based on cautious assumptions, that the average surplus on the current budget over the period 2008–09 to 2010–11 is 0.7% of GDP. At this early stage and based on cautious assumptions ... the Government is therefore on course to meet the golden rule after the end of this economic cycle”.¹²⁰ However, under the golden rule, fiscal policy today is constrained by historical and forecast fiscal policy over the complete period from 1997–98 to 2008–09. As the economy moves closer to the end of a cycle, the constraint becomes even more ‘backwards-looking’, with fiscal policy today depending more and more on historical outcomes rather than the future fiscal and economic outlook. Furthermore, historical data can be subject to subsequent revisions which may force sudden changes in spending or tax around the end of an economic cycle, in order to show the golden rule having been met, despite there having been no change in the underlying performance of the economy. If the Treasury would not contemplate missing the golden rule, regardless of the timing or circumstances, the other alternative would be to redefine the golden rule at that time to take account of any developments late in the cycle.

34. Mr Chote told that Committee that the golden rule should be framed “in a more forward-looking way which does not rely on you being able to judge the output gap with any great precision”.¹²¹ The Governor of the Bank of England told our predecessors in March 2005 that “looking back [over the economic cycle] is not entirely helpful”. He thought that “what is significant is the need to look forward, and that is to look at the rules

118 The AME margin is an unallocated margin on total Annually Managed Expenditure and is included as a measure of caution against AME expenditure exceeding its forecast levels.

119 HC (2005–06) 1013, p 13

120 *Budget 2006*, para 2.59, p 34

121 Q 106

in terms of whether it is plausible in a forward-looking sense that the rules will be met”.¹²² Moreover, the IMF said in March 2006 that:

the precise dating of the cycle might be undermining the objective of the golden rule. Staff supported the rule as a means of protecting investment spending and guarding against procyclical fiscal policy, but noted two problems with its current application. First, different methodologies yield different interpretations of the economic cycle, so the attempt to be precise about dating the cycle inevitably leads to controversy. Second, meeting the rule could require procyclical policy toward the end of a cycle. Staff suggested that an exclusively forward-looking interpretation of the golden rule—for example, a rolling target of balance 3-years hence for the current budget—would reduce these drawbacks. However, to preserve credibility, a new interpretation of the golden rule should not be introduced until the current budget is back in balance.¹²³

Changes to the timing of the cycle

35. The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability.¹²⁴ As we discussed in our Report on the 2005 Pre-Budget Report,¹²⁵ the Treasury has adjusted its estimated start date and end date of the current cycle during the first year of the current Parliament. In July 2005, the Chancellor of the Exchequer announced that, following “the significant historical updating by the Office of National Statistics ... all the evidence now points to the conclusion that the economic cycle started in 1997–98”.¹²⁶ In the 2005 Pre-Budget Report, the Treasury announced that it expected the economy to return to its trend level, ending the current cycle, in 2008–09.¹²⁷ Accordingly, the Budget projects that the economic cycle will run from 1997–98 to 2008–09, compared to 1999–2000 to 2005–06 at the time of Budget 2005.

36. In July 2005 the Chancellor of the Exchequer told the Committee that he considered that the Government would meet the golden rule over the present cycle even without the revision to the start date of the current cycle announced at that time.¹²⁸ However, the IFS has calculated that, based on projections in the 2005 Pre-Budget Report, the golden rule would be narrowly missed over the period defined as the cycle in Budget 2005, with a cumulative deficit over the seven year cycle estimated at £1.9 billion.¹²⁹ The minor revisions to the historical and projected budget surpluses over the cycle shown in the 2006 Budget compared with the 2005 Pre-Budget Report do not change this conclusion of the IFS. This is not necessarily cause for fiscal concern. In evidence to the Committee on the 2005 Pre-Budget Report, Mr Chote cautioned that “the golden rule at best was only ever a reasonable

¹²² Treasury Committee, *Bank of England February 2005 Inflation Report: Oral and Written Evidence*, HC (2004–05) 500-i, Q 22

¹²³ *IMF Article IV Report on the United Kingdom*, March 2006, para 22

¹²⁴ *Budget 2006*, para 2.57, p 33

¹²⁵ HC (2005–06) 739, paras 40–47

¹²⁶ HC (2005–06) 399, Qq 1, 7–8

¹²⁷ *Pre-Budget Report 2004*, Box A3, p 170

¹²⁸ HC (2005–06) 399-i, Q 8

¹²⁹ *Green Budget 2006*, Institute of Fiscal Studies, p 25

rule of thumb ... The idea that over a period of seven or twelve years if you beat it by one billion that is terrific and you miss it by one billion that is a disaster just is not sustainable on any analytical grounds.”¹³⁰ Furthermore, although the golden rule is not framed in a symmetrical way, given that one of the objectives of the golden rule is intergenerational fairness, it could be considered appropriate for the Government to run an approximately balanced budget over the course of an economic cycle. It is also important to note that forecasts of the fiscal balance, the balance between current spending and investment and GDP can be subject to significant revision. As we noted in our Report on the 2005 Pre-Budget Report, the IMF concluded in December 2005: “The fiscal rules are playing an important role in disciplining fiscal policy, although at times this role is overshadowed by peripheral controversies. We strongly endorse the objectives of the golden rule ... However, the current form of the golden rule requires a precise dating of the cycle. Not only is this difficult, but the adjustments in the definition of the cycle have proved an unhelpful distraction from the more important considerations of what a sustainable fiscal policy is and how it should be achieved.”¹³¹

37. The Chancellor of the Exchequer told the Committee that the changes to the timing of the golden rule had enhanced the credibility of the approach, because “Credible economic policy depends on going with the evidence” and the data indicated that there was no economic cycle between 1997 and 1999.¹³² Asked whether it would be possible for the Treasury to prepare calculations to show whether that the golden rule would have been met over the period from 1999–2000 to 2005–06, the Chancellor of the Exchequer did not view it as the Treasury’s role to carry out what he viewed as “hypothetical exercises”, because he had seen no evidence that there was a complete economic cycle between 1997 and 1999. He challenged the Committee to produce an argument that there had been a cycle in this period.¹³³

Conclusions

38. We note the Treasury’s projections which show that the Government is on course to meet the golden rule after the end of this economic cycle. We remain concerned that fiscal policy towards the end of a cycle may be constrained unnecessarily by spending levels or data classifications from, say, 12 years earlier, at the start of the cycle. In particular, revisions to data might be held to require sudden and undesirable changes to tax or spending in the final years of the cycle for the sole purpose of meeting the mechanical calculation implicit in the golden rule. We remain of the view that it would be appropriate to review the fiscal rules now such that any improved formulation of the rule could be introduced at the start of the next cycle.

130 HC (2005–06) 739, Q 50

131 IMF: United Kingdom—2005 Article IV Consultation, Concluding Statement of the IMF Mission, 19 December 2005, para 10

132 Qq 372, 373

133 Qq 454–459

Excessive deficit procedure

39. On 11 January 2006, subsequent to our oral evidence sessions on the 2005 Pre-Budget Report, but prior to publication of our Report on that subject, the European Commission recommended that the United Kingdom deficit be declared excessive and the United Kingdom asked to correct the situation.¹³⁴ Accordingly, in our Report on the 2005 Pre-Budget Report, we noted that we would examine the United Kingdom's 'excessive deficit' further in our inquiry into the 2006 Budget.¹³⁵

40. The Stability and Growth Pact (SGP) is designed to ensure budgetary discipline as a permanent feature of European countries forming an Economic and Monetary Union (EMU). Under the SGP, countries are required to observe the two reference values laid down in the Maastricht Treaty: government budget deficits should not exceed 3% of GDP; and public debt should not exceed 60% of GDP. Our predecessor Committee concluded that a Treaty interpretation allowing countries with relatively low overall debt levels to exceed the 3% limit during a cyclical downturn was essential.¹³⁶ Indeed, during March 2005, the European Council adopted certain changes to the SGP, retaining the current 'rules-based' system, but allowing for a wider range of relevant factors to be taken into account when considering the importance of a member state breaking a rule.¹³⁷ However, if, other than for temporarily or for exceptional reasons, a country has a deficit that exceeds the 3% of GDP threshold, then the 'excess deficit procedure' is launched. Countries such as the United Kingdom that remain outside the eurozone are also subject to the SGP but only 'endeavour' to avoid excess deficits and are not subject to sanctions if they fail to do so.

41. Economic and Monetary Affairs Commissioner Mr Joaquin Almunia said in January 2006 that, "although the United Kingdom budgetary position is less worrying than that of others in the EU, in particular as far as its debt position is concerned, the Commission recommends that the United Kingdom deficit be declared excessive and the United Kingdom asked to correct the situation".¹³⁸ The Council therefore recommended that "the United Kingdom authorities should put an end to the present excessive deficit situation as soon as possible and by the financial year 2006–07 at the latest ... and ... the United Kingdom authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner and to this end ensure an improvement of the structural balance by at least 0.5 percentage points of GDP between the 2005–06 and 2006–07 financial years. The Council establishes the deadline of 24 July 2006 for the United Kingdom authorities to take effective action to this end."¹³⁹

42. On 22 February 2006, the European Commission released its assessment of the December 2005 update (in the Pre-Budget Report) of the convergence programme of the

134 European Commission, 11 January 2006, *Commission opinion on the existence of an excessive deficit in the United Kingdom*

135 HC (2005–06) 739, para 12

136 Treasury Committee, Sixth Report of Session 2002–03, *The UK and the Euro*, HC 187-I, para 34

137 European Council Regulation No 1056/2005 of 27 June 2005

138 European Commission Press Release, 11 January 2006, *Commission recommends correction of United Kingdom budget deficit*, (IP/06/17).

139 Council of the European Union, 24 January 2006, *Council Recommendation to the United Kingdom with a view to bringing an end to the situation of an excessive government deficit—Application of Article 104(7) of the Treaty*, (5367/06), page 6.

United Kingdom. The 2005 Pre-Budget Report estimated that the fiscal deficit will be 3.0% in 2005–06 and 2.7% in 2006–07. However, the Commission believed that the United Kingdom’s budgetary strategy did not seem to provide a sufficient safety margin against breaching the 3% of GDP reference value and suggest that the United Kingdom’s adjustment path could be strengthened. The Commission’s updated assessment also noted that “over the last decade, United Kingdom macroeconomic performance has been impressive in terms of improved stability, growth, low inflation and labour market outturns”.¹⁴⁰

43. The 2006 Budget shows that the Treaty deficit is forecast to be 3.2%, 3.0% and 2.4% of GDP in 2005–06, 2006–07 and 2007–08 respectively, and cyclically-adjusted Treaty deficits are forecast at 2.5%, 2.0% and 1.8% in these years on a Maastricht basis. Accordingly, the estimated treaty deficit is forecast to be temporarily above the 3% threshold value for 2005–06, but is forecast to fall below the threshold during 2006–07 and remain below thereafter throughout the forecast period. The United Kingdom’s debt levels remain well below the 60% reference value in the Stability and Growth Pact and compare favourably to other countries in the G7.¹⁴¹ The Budget states that “the public finance projections set out ... are fully consistent with a prudent interpretation of the Pact”.¹⁴²

The sustainable investment rule, public sector pension liabilities and the Whole of Government Accounts programme

Sustainable investment rule

44. The sustainable investment rule is designed to ensure sound public sector finances in the medium term. This rule states that public sector net debt should be maintained below 40% of GDP in each and every year of the current economic cycle.¹⁴³ The Budget states that net debt is expected to stabilise at 38.4% of GDP from 2009–10, which indicates that the Government continues to expect to meet its sustainable investment rule in the current cycle. The 2006 Budget forecast for the stable level of net debt in the medium term of 38.4% is slightly above the maximum forecast net debt at 38.2% in the 2005 Pre-Budget Report.¹⁴⁴

45. Mr Duncan Melville from GLA Economics noted that, under their projections, the Government will continue to meet its sustainable investment rule, although he forecasts public sector net debt reaching 39.7% of GDP by 2010–11—the last year of spending allocations under the 2007 Comprehensive Spending Review. Ms Rosewell told the Committee that there was no “objective meaning” to choosing 40% of GDP as the limit, rather than picking 30% or 50%.¹⁴⁵ **As we noted in our Report on the 2005 Pre-Budget Report, while criticisms of the arbitrary level of the limit imposed by the sustainable investment rule have some merit, these do not outweigh the essential role that the rule**

¹⁴⁰ European Commission, 22 February 2006, *Commission’s assessment of the December 2005 update of the convergence programme of the United Kingdom*, paras 3 and 10.

¹⁴¹ *Budget 2006*, chart 2.3, p 24 and Table 2.5, p 33

¹⁴² *Budget 2006*, para 2.71, p 39

¹⁴³ *Budget 2006*, para 2.60, p 34

¹⁴⁴ *Budget 2006*, para 2.61, p 34; *Pre-Budget 2005*, para 2.5, p 28

¹⁴⁵ Q 51

plays in ensuring that Government expenditure and investment today do not lead to an unfair or unsustainable burden on future generations. However, looking forward, the sustainable investment rule will need to be considered in the context of the Government's balance sheet to be prepared under the Whole of Government Accounts (WGA) programme, which is discussed further below.

Whole of Government Accounts

46. The Government Resources and Accounts Act 2000 (GRAA) implemented full accruals based accounts for the whole of the public sector and required the Government to introduce WGA. WGA will be a single set of consolidated financial accounts based on generally accepted accounting practice (GAAP) for the whole of the public sector reporting as a single entity. In the 2003 Pre-Budget Report, the Chancellor of the Exchequer set out a timetable to publish a set of WGA for 2006–07 onwards. The 2005 Pre-Budget Report stated that “good progress was being made” and the Government re-affirmed its commitment to publish information for the year ended 31 March 2007.¹⁴⁶

47. The 2000 Pre-Budget Report stated: “Central Government Accounts (CGA) are a necessary first step towards WGA. The plan is to produce ‘dry-run’ CGA for 2001–02 and 2002–03, with the first CGA published for 2003–04. However the full benefits for fiscal policy will only be achieved when WGA covering the entire public sector are available. The aim is to produce ‘dry-run’ WGA for 2003–04 and 2004–05, with the first WGA published for 2005–06.”¹⁴⁷ As at the date of the Budget, the timetable for publication of WGA has slipped by one year due to methodological issues as announced in the 2003 Pre-Budget Report.¹⁴⁸ For example, the Comptroller and Auditor General, Sir John Bourn, told the Public Accounts Commission on 28 February 2006 that the delay in publication of CGA would damage public confidence in the WGA programme.¹⁴⁹ Ms Rosewell advised the Committee that the complexity of the accounting issues around producing a set of accounts encompassing the whole of government “means that inevitably [preparation of WGA] will take some time”.¹⁵⁰ Treasury officials told the Committee that the Treasury was still on target to meet its timetable for publishing and having a fully audited set of WGA available for 2006–07, although there were “some challenging issues to be tackled along the way”.¹⁵¹ Furthermore, Sir John Bourn told the Public Accounts Commission on 28 February 2006 that the whole of central government accounts would not be audited because it was “just a dry run” and not the “real thing”, but that the “first set of definitive accounts will be the Whole of Government Accounts for 2006–07 and that will have [his] certificate on them”.¹⁵²

48. Sir John Bourn also told the Public Accounts Commission that he would have to qualify the whole of government accounts on the basis that a significant number of private

¹⁴⁶ *Pre-Budget Report 2005*, para B5, p 208

¹⁴⁷ *Pre-Budget Report 2000*, Box 2.4

¹⁴⁸ *Pre-Budget Report 2003*, para 2.17, p 18

¹⁴⁹ Uncorrected transcript of oral evidence taken before the Public Accounts Commission on 28 February 2006, p 28

¹⁵⁰ Q 45

¹⁵¹ Q 219

¹⁵² Uncorrected transcript of oral evidence taken before the Public Accounts Commission on 28 February 2006, p 29

finance initiative (PFI) schemes for local government and health bodies have been treated as off-balance sheet, which is not in accordance with accepted accounting practice. Sir John noted that “too many [PFI schemes] which are off balance sheet relate to projects where the risk still lies with the local authority or national health service trust...and if the majority still lies with the local authority, it should be recognised as on balance sheet”.¹⁵³ Ms Rosewell told the Committee that achieving transparency around the financing arrangements for Government projects is important, rather than concentrating on the accounting treatment, saying that “A lot of the discussion about who bears the risk is quite arcane and not very realistic in many respects”.¹⁵⁴ Ms Rosewell also told the Committee that, in her opinion, qualification of the Whole of Government Accounts would not impact on confidence in the accounts because the “intractable” problems in preparing accounts for public sector bodies meant that such accounts were frequently qualified.¹⁵⁵

49. The publication of the Whole of Government Accounts in 2006–07 will be an important development in helping to demonstrate the Government’s stewardship of public finances across central government, local government and public corporations. Whilst we note the myriad of technical difficulties to be overcome—once complete, WGA will represent one of the most complex financial consolidations in the world—it is important that the Treasury meets its timetable to publish a set of Whole of Government Accounts (WGA) for 2006–07 onwards.

Estimating the present value of the public sector pension liabilities

50. The Government Actuary’s Department estimated the total accrued liability of unfunded pension schemes for public sector employees at £530 billion as of 31 March 2005.¹⁵⁶ However, this estimate is sensitive to the discount rate used. The measured pensions liability increases substantially if a lower discount rate is applied and likewise, the liability falls significantly if a higher discount rate is used. Professor Miles told the Committee that the choice of discount rate was not important: “Whatever number you use as a discount rate arguably one could use the same number to discount future receipts of revenues for the Government”.¹⁵⁷ **Future public sector pensions can be paid from future tax revenues and therefore long-term forecasts of cash payments are directly relevant when considering fiscal sustainability. We recommend that the estimated present value of the Government’s public sector pension liabilities today, which is useful for the purposes of comparing the pensions provision for public sector employees with that for employees in the private sector, be published regularly.**

153 Uncorrected transcript of oral evidence taken before the Public Accounts Commission on 28 February 2006, p 30

154 Q 50

155 Q 47

156 HC Deb, 2 March 2006, col 388

157 Q 53

Taking forward the sustainable investment rule in light of the WGA programme

51. The rigorous application of accounting standards used in the private-sector may lead to new or increased liabilities, for example, a greater element of the liabilities associated with PFI projects or public-sector pensions, appearing on the Government's balance sheet. Mr Chote told the Committee that he would be "quite happy" with showing the public-sector pensions liability on the Government's balance sheet, but noted "The idea that that means that you then stick with the same target [for the sustainable investment rule] is obviously absurd, the numbers are completely different".¹⁵⁸ The Chancellor of the Exchequer told the Committee that tripling the stated value of the public debt, but retaining the sustainable investment rule in its current guise would mean that you could never meet the rule and the Government "would have to be cutting public investment not just in hospitals and schools but in transport and every other area".¹⁵⁹ We have previously concluded that a review of the fiscal rules in the near future would be timely.¹⁶⁰ **The publication of WGA is likely broadly to coincide with the end of the current economic cycle, although estimates in WGA may be volatile over the first few sets of accounts as valuation issues are ironed out. However, once any valuation concerns have been resolved, it may be timely to revisit the sustainable investment rule to ensure that estimates of public sector liabilities included in the Government's accounts are borne in mind in any review of the sustainable investment rule.**

The overall level of taxation

52. The 'burden of taxation' is an expression of the proportion of income which is paid in taxes. The overall level of taxation is important to the management of the economy because taxes can distort economic behaviour and lead to sub-optimal outcomes. Furthermore, in an increasingly globalised economy, labour and capital is more mobile and so there may be greater potential for tax competition from countries otherwise similar to the United Kingdom. There are two main ways of expressing the United Kingdom's tax to output ratio: the public finances basis, used by the Treasury in Budget documentation, and the national accounts basis, based on data from the Office for National Statistics. The United Kingdom's historical and forecast tax ratio using each of these measures is shown in the graph below.¹⁶¹

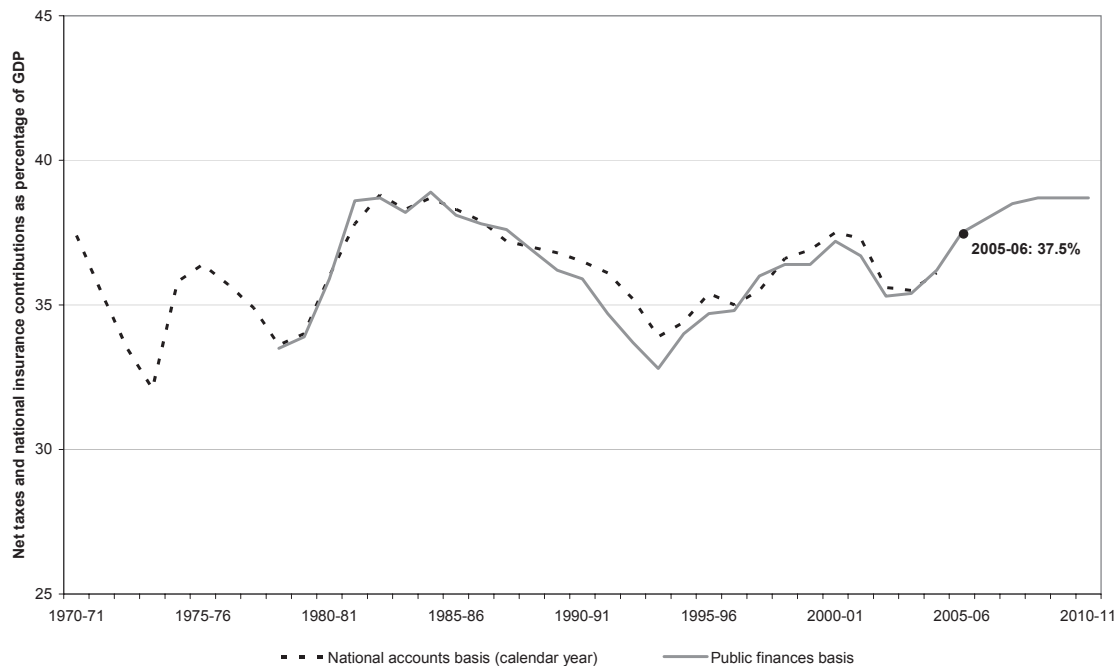
158 Q 52

159 Q 420

160 HC (2005–06) 739, para 55

161 See the House of Commons Library Research Paper 05/68, *The Burden of Taxation 2005*, for further details on the differences between these two measures of the tax burden

Figure 1: Tax to GDP ratio in the United Kingdom



Source: Budget 2006 and Office for National Statistics

53. As the chart shows, the tax to GDP ratio rose sharply in the early 1980s, reflecting recession and attempts to reduce the public sector deficit. The tax ratio, using the public finances basis, peaked at 38.9% of GDP in 1984–85, a period when revenues were also boosted by receipts from North Sea oil production¹⁶². However, these declined rapidly after world oil prices fell sharply in 1986. The late 1980s saw a period of rapid economic growth and reductions in income tax rates. The tax burden fell steadily to 36.2% of GDP by the end of the 1980s. The recession of the early 1990s saw real GDP in 1992–93 fall below its 1989–90 level, and the tax burden decreased further because tax revenues fell faster than GDP. Increases in taxation revenues from the ‘dot com’ boom led the tax burden ratio to peak at 37.2% in 2000–01. The latest figures, published in the Budget, show the total tax take increasing from 37.5% of GDP in 2005–06 to 38.7% from 2008–09 onwards. The Budget states that from 2006–07 onwards, “the rise in the tax-GDP ratio is driven by rises in the income tax and corporation tax to GDP ratios. The rise in income tax largely arises from the normal fiscal forecasting convention on tax allowances and fiscal drag. The buoyant growth in non-North Sea corporation tax is expected to persist into 2006–07, but is expected to stabilise at 3.4% of GDP from 2007–08 onwards”.¹⁶³ In historical terms, a forecast stable tax to GDP ratio of 38.7% is equal to that in 1982–83 and only slightly below the tax ratio of 38.9% reached in 1984–85. Mr Chote told the Committee that, in 1997, the United Kingdom “would have been about a third of the way up” a table comparing tax burdens across industrial countries, “and we are now approaching half way”.¹⁶⁴ The Chancellor of the Exchequer said that “we have cut the rates of income tax and we have cut the rates of business tax when we have been able to do so over the last few years”.¹⁶⁵ He said

162 Budget 2006, Table C25, p 286

163 Budget 2006, para C64, p 266

164 Q 64

165 Q 367

that the Government had managed to keep tax rates low, “with the basic income tax rate at 22 pence, the 10p starting rate of tax introduced by us and with the Tax credit that helps seven million families in this countries and Corporation Tax reduced from 33 to 20 pence, is because we have been able to finance the development of public services and these relatively low rates of tax on business and on income because we have got 2.4 million more people in work. Once we have more people in work and an economy that is growing, you will inevitably generate more tax revenues, but it is tax revenues based not on higher rates of income tax or higher rates of Corporation Tax but based on there being more economic activity in your economy.”¹⁶⁶

Expenditure plans and the Comprehensive Spending Review

Introduction

54. The levels of public expenditure in the years up to 2007–08 have been determined by the 2004 Spending Review. That Review provided for an annual average growth rate of 4.2% in real terms, with expenditure on the National Health Service and international development increasing at an annual rate of more than 7% in real terms.¹⁶⁷ In July 2005, the Government announced that expenditure plans for the period from 2008–09 to 2010–11 would be determined following a new Comprehensive Spending Review which would consider expenditure plans from a zero base.¹⁶⁸ The 2005 Pre-Budget Report contained projections of public expenditure for the period to be covered by the Review. The Chancellor of the Exchequer emphasised to us in December 2005 that these were simply “working assumptions”, although, during the same inquiry, Mr Cunliffe told us that “clearly public spending cannot grow indefinitely faster than the rate of growth of the economy”.¹⁶⁹ When we put Mr Cunliffe’s observation to the Chancellor of the Exchequer during the current inquiry, he referred to the assumptions in the Red Book, under which public sector current expenditure is forecast to grow by 2.0% in real terms in 2008–09 and by 1.9% in 2009–10 and 2010–11, growth levels which are below the trend growth rate of the economy.¹⁷⁰

55. Although the figures for public spending from 2008–09 to 2010–11 set out in the Red Book are only planning assumptions, the overall fiscal situation and the projections for an increasing tax burden in coming years would suggest that the Treasury will have every incentive to see overall spending allocations at broadly the same level as those contained in its current planning assumptions. However, although the Comprehensive Spending Review is intended to examine departmental expenditure from a zero base, there are certain commitments, aims and pressures which may shape the overall distribution of expenditure. We discuss spending commitments, aims and pressures in five areas—education, international development, health, assistance concerning occupational pension

166 Q 330

167 *2004 Spending Review: New Public Spending Plans 2005–2008*, July 2004, Cm 6237, Table 1.2, p 12

168 HC Deb, 19 July 2005, cols 54–56WS

169 HC (2005–06) 739, Qq 206, 389–391

170 Q 424; *Budget 2006*, para C27, p 255

schemes and net contributions to the European Union—before turning to the conduct of the Comprehensive Spending Review.

Education expenditure

56. In the Budget the Chancellor of the Exchequer announced that the Government would increase the investment in public sector schools per pupil to the current levels of private sector per pupil capital investment—estimated at £975 per pupil in 2005–06, excluding spend specifically linked to boarding accommodation—by the end of the period of the Comprehensive Spending Review. To fulfil this commitment, the Budget announced that school capital investment would rise from £6.4 billion in 2007–08 to £8.0 billion by 2010–11.¹⁷¹ The Chancellor of the Exchequer told us that capital expenditure per pupil would have increased by about ten-fold between 1997 and 2010–11.¹⁷² The increased capital investment in schools will itself have implications for current expenditure, as the Secretary of State for Education has acknowledged.¹⁷³ In addition to the specific commitments relating to capital expenditure in the period up to 2010–11, the Chancellor of the Exchequer also announced in the Budget a “long-term aim” for all pupils to have access to the same level of support and opportunities that are currently available to pupils in the independent sector so that schools spending per pupil would rise to the current average of £8,000 per pupil in private sector day schools.¹⁷⁴ Treasury officials described this as a “pledge”, but one with “no timetable attached”.¹⁷⁵ The Chancellor of the Exchequer also indicated that the aim would be met “over a period of time”.¹⁷⁶ Robert Chote told the Committee that, if education spending per pupil were to remain constant as a share of GDP, it would take 16 years for this pledge to be fulfilled. If education spending is to be raised in line with the level under Labour to date, the pledge would be fulfilled in about seven years.¹⁷⁷ With a higher increase, it could be done even faster. The Government has commissioned a review of “personalisation”—tailoring teaching and wider support to the needs of individual pupils—to report to the Secretary of State for Education by the end of 2006 and the Chancellor of the Exchequer told us that he was keen to see the outcome of this review and examine the resources available before determining the speed of increase in expenditure to meet the long-term objective.¹⁷⁸

International development

57. One area where public expenditure is certain to rise in real terms is on international development. The Government has previously announced that it wishes to continue to raise official development assistance at the annual rate of growth achieved in 2007–08 so that total official development assistance would reach the United Nations target of 0.7% of

171 *Budget 2006*, paras 6.55–6.56, p 145

172 Q 425

173 HC Deb, 27 March 2006, col 585

174 HC Deb, 22 March 2006, col 301; *Budget 2006*, para 6.56, p 145

175 Qq 243, 249

176 Q 425

177 Q 68

178 *Budget 2006*, para 6.53, p 145; Q 425

Gross National Income by 2013.¹⁷⁹ The IFS has calculated that, in order to reach the United Nations target by 2012–13, international development expenditure will need to increase by 10.5% a year in real terms during the period covered by the Comprehensive Spending Review, equating to a £3 billion cash increase in annual spending over the period.¹⁸⁰ Separately, and since the Budget, the Chancellor of the Exchequer and the Secretary of State for International Development have announced that the Department for International Development will spend £8.5 billion on aid for education in the period from 2006–07 to 2015–16 in support of the Millennium Development Goal that, by 2015, every one of the world’s children is able to go to school although there is no indication of the extent to which this will be achieved by additional expenditure or by redistribution of expenditure.¹⁸¹

The National Health Service

58. The Wanless Review of health needs which reported in 2002 assisted in setting the agenda for substantial increases in spending on the National Health Service in the period up to 2007–08. That review foresaw that the United Kingdom would need to devote a substantially larger share of its national income to health care over a 20 year period. In order to deliver a high quality health service, the Wanless Review envisaged total National Health Service spending increasing at an average of between 4.2% and 5.1% a year in real terms over that period.¹⁸² The sustained and substantial real terms increases in expenditure on the National Health Service envisaged in the Wanless Review provide part of the context in which health spending for the years covered by the Comprehensive Spending Review will be determined.

Assistance concerning occupational pensions schemes

59. On 16 March 2006, the Secretary of State for Work and Pensions, Mr John Hutton MP, made a statement to the House of Commons about occupational pension schemes.¹⁸³ This followed the publication on the previous day of a report by the Parliamentary Ombudsman on the security of final salary occupational pensions. That report had concluded that there had been maladministration by government bodies with regard to: official information; the response of the Department for Work and Pensions to the actuarial profession’s recommendations that disclosure should be made to pensions scheme members of the risks of wind-up; and the decision in 2002 by the Department to approve a change to the Minimum Funding Requirement basis. The Ombudsman had made four recommendations concerning the restoration of the lost pension rights of affected scheme members, the making of consolatory payments and the provision of apologies to scheme trustees.¹⁸⁴ In his statement, the Secretary of State for Work and Pensions told the House in

179 *2004 Spending Review*, p 135

180 *IFS Green Budget*, p 85

181 HM Treasury press notice 29/06, *Government announces \$15 billion to deliver education for all*

182 *Securing our Future Health: Taking a Long-Term View: Final Report*, April 2002, para 5.10, p 77

183 HC Deb, 16 March 2006, cols 1620–24

184 *Trusting in the pensions promise: government bodies and the security of final salary occupational pensions*, Sixth Report of the Parliamentary and Health Service Ombudsman, HC (2005–06) 984

relation to the recommendations for recompense that he did “not consider that it would be in the wider public interest for Government to accept that very substantial liability on behalf of taxpayers. We calculate the liability as being in the range of £13 billion and £17 billion in cash terms over the next 60 years.” In addition, “administration costs would be in the region of a further £20 million each year”.¹⁸⁵ However, the Secretary of State did indicate that the Government was prepared to look again at all aspects of the Financial Assistance Scheme “as part of the current spending review”.¹⁸⁶ The Financial Assistance Scheme was established to help those who had lost the most and were in greatest need as a result of the failure of occupational pension schemes, with £400 million of public money.¹⁸⁷

60. We are not examining in this Report the merits of the Parliamentary Ombudsman’s Report on final salary occupational pensions and of the Government response. Our examination is limited to consideration of the possible costs of certain actions arising from that Report in the context of the forthcoming Comprehensive Spending Review. The Ombudsman has made clear that she does not view the Financial Assistance Scheme as presently constituted as an adequate and appropriate remedy.¹⁸⁸ The Government has confirmed its willingness to re-examine the Scheme, and presented an estimate of the costs of full implementation of the Ombudsman’s recommendations in cash terms. The Pensions Commission has noted that there are a number of ways of presenting the future cost of pensions, but expressing them in cash terms is “the least useful because it exaggerates how expensive something will feel”.¹⁸⁹ Treasury appraisal guidance indicates that costs should be expressed in present value terms, using an appropriate discount rate.¹⁹⁰ There have also been no figures put forward by the Government for the possible costs of expanding the Financial Assistance Scheme by, for example, aligning the benefits of the Scheme to those available under the Pension Protection Fund. We asked the Chancellor of the Exchequer whether he agreed with the Prime Minister that it would cost £15 billion to comply with the Ombudsman’s recommendations. The Chancellor of the Exchequer told us that “The figure is one that the Department for Work and Pensions is dealing with ... There have been a number of recommendations from this report and the Department for Work and Pensions is looking at it. There will be a fuller reply at a later stage.”¹⁹¹ **A full understanding of the costs associated with policy options arising from the recent Report of the Parliamentary Ombudsman on final salary occupational pensions is essential to a proper public and parliamentary debate on that report in the context of the Comprehensive Spending Review. We recommend that the Government publish estimates of the cost of various options for compensating affected pensioners in net present value terms as part of the Department for Work and Pensions’ further reply to the Report of the Parliamentary Ombudsman, including options for expanding the Financial Assistance Scheme.**

185 HC Deb, 16 March 2006, col 1623

186 Ibid

187 Ibid

188 HC (2005–06) 984, para 5.174, p 166

189 Pensions Commission, *Sanity in Numbers*, press release, 1 December 2005

190 HM Treasury, *The Green Book: Approval and Evaluation in Central Government*, 2003

191 Q 412

Net contributions to the European Union

61. The Financial Perspectives represent major overhauls of the EU budget, which are negotiated at five- or seven-year intervals. The European Council unanimously agreed the perspective for the period from 2007 to 2013 on 17 December 2005, at the end of the United Kingdom Presidency of the Council of the European Union, which ran from June to December. The Perspectives were drawn up for a European Union comprising 27 Member States on the working assumption that Bulgaria and Romania will join the Union in 2007. The maximum total expenditure for the EU 27 for the period 2007–2013 represented 1.045% of EU Gross National Income. As part of the agreement, the European Commission will also undertake a comprehensive review of the EU budget, looking at all areas of the budget from 2008 onwards.¹⁹² The extra costs to the United Kingdom following the agreement on the European Financial Perspective for 2007–13 have been estimated by the Treasury at £500 million (0.09% of public spending) in 2007–08, zero (0%) in 2008–09, £1.0 billion (0.16% in 2009–10, and between £1.6 billion and £1.9 billion (0.23% and 0.26%) each year between 2010–11 and 2012–13.¹⁹³ Mr Cunliffe noted that the EU budget settlement had not yet passed into legislation and this process “could change the numbers a bit at the margins”.¹⁹⁴

62. The Chancellor of the Exchequer told us that “a very substantial part” of the additional cost was going to finance the development of eastern Europe. He thought that “the enlargement of the European Union is to the benefit both of the economies of these countries but also Europe as a whole, but it is also to the benefit of democracy in Europe where we have encouraged nascent democracies in these countries which are now flourishing as a result of the support which comes from the European Union”. He also believed that the review which was going to take place into the Common Agricultural Policy would be “quite fundamental” in changing that Policy for the future.¹⁹⁵

Overall approach and initial settlements

63. The Comprehensive Spending Review will be conducted at a time when the Government may well be seeking to reduce the overall rate of growth of public expenditure, but when there will be upward pressure on expenditure, not least in the individual areas of spending we have just considered. To illustrate the likely pressures, the IFS Green Budget published in January 2006 calculated that, on the basis of the overall spending assumptions contained in the 2005 Pre-Budget Report, if health spending were increased by 4.4% a year, education spending by 2.4% a year and official development assistance by 10.5% a year, then spending on all other items would be constrained to grow by an average of just 0.8% a year in real terms over the period of the Review. However, if public spending remained constant as a share of national income and expenditure on health, education and international development were to increase at the rates just referred

192 Council of the European Union, *Financial Perspective 2007–2013*, 19 December 2005

193 HC Deb, 20 December 2005, col 2796W

194 Q 176

195 Qq 452, 453

to, other areas of public spending would increase by 1.7% in real terms over the period covered by the Review.¹⁹⁶

64. The Chancellor of the Exchequer has already indicated to us in evidence last December that “public investment will continue to rise right throughout the course of this Parliament”.¹⁹⁷ In evidence during the current inquiry he signalled his overall approach to the Comprehensive Spending Review when he said that “we wish to release resources from certain areas to enable us to do what we need to do for health, education and other additional priorities”.¹⁹⁸

65. This overall approach was signalled in the Budget when the Chancellor of the Exchequer announced that the Department for Work and Pensions, HM Revenue and Customs, HM Treasury and the Cabinet Office had already agreed outline spending settlements for the period to be covered by the Comprehensive Spending Review with Departmental Expenditure Limits (DEL) that would fall by 5% in real terms per year in 2008–09, 2009–10 and 2010–11. These early settlements are intended to embed efficiency savings into the departments’ medium-term expenditure planning and release £1.8 billion in total over the three years of the Comprehensive Spending Review period for reallocation to front-line services. To meet the transitional costs of transforming these departments, the Government will set aside a modernisation fund of over £800 million.¹⁹⁹ Some evidence we received was sceptical about whether these reductions in expenditure could be delivered without a deleterious effect on service provision.²⁰⁰ However, Treasury officials were confident that the efficiency savings could be achieved without an adverse impact on the quality of service.²⁰¹ They acknowledged the importance of the modernisation fund as part of these settlements, enabling the departments concerned to invest in their businesses while delivering spending savings.²⁰² **It is important that the Government clarifies at an early stage whether the “modernisation fund” proposed as part of the spending settlements for the Department for Work and Pensions, HM Revenue and Customs, the Treasury and the Cabinet Office is included within the new totals for those departments or is to be accounted for separately and provides a breakdown of the proposed expenditure between the departments.**

66. Alongside the settlements for these four departments incorporating reductions in real terms throughout the period to be covered by the Comprehensive Spending Review, the Chancellor of the Exchequer also announced in the Budget a settlement for the Home Office for the same period:

196 *IFS Green Budget*, January 2006, pp 85–86

197 HC (2005–06) 739, para 63

198 Q 447

199 *Budget 2006*, Box 6.3, p 136

200 Qq 118–119

201 Q 255

202 Q 256

The Home Secretary has agreed that we can invest more in priorities like policing and security, while making savings in other areas within a three-year budget at its 2007–08 real-terms level.²⁰³

The Red Book did not furnish much detail regarding this settlement, referring only to the decision to “lock in the large real increases in resources since 1999, providing the long-term funding certainty needed to lead the fight against crime and terrorism and realise the benefits of police force restructuring and reform”.²⁰⁴ Treasury officials confirmed that these announcements meant that Home Office expenditure would remain flat in real terms between 2007–08 and 2010–11.²⁰⁵ **The early announcement of a decision on the overall spending levels of the Home Office provides an opportunity to focus on the distribution of expenditure within that total and the savings to be expected in specified areas of the Home Office budget, although it does also constrain the forthcoming national debate on spending priorities in relation to services funded through the Home Office.**

The conduct of the Review

67. In December 2005, the Chancellor of the Exchequer told us that a report would be published in the summer of 2006 which would clarify some of the issues about the resources available during the period to be covered by the Comprehensive Spending Review before final decisions would be announced in 2007.²⁰⁶ In January we recommended that that report be framed so as to maximise opportunities for parliamentary consideration of the spending challenges and options.²⁰⁷ The Budget announced that the Government planned to initiate a national debate on the future priorities for public spending and public services, to inform the Comprehensive Spending Review.²⁰⁸ Treasury officials indicated that this national debate would be in two stages, with an initial debate on the long-term challenges followed by a wider debate on the implications of those challenges for future spending priorities.²⁰⁹ The Chancellor of the Exchequer told us that the Government “will be taking measures over the next few months to stimulate” the national debate, and provided instances of the way such a debate might be presented, for example in terms of the weekly cost to an average family of the provision of particular services.²¹⁰

68. It has been pointed out that the Treasury’s account of the national debate makes no specific reference to the role to be played by Parliament.²¹¹ When we asked whether the report promised in mid-2006 would be published sufficiently far in advance of the Summer recess to permit prompt and effective parliamentary consideration, we were assured by

203 HC Deb, 22 March 2006, col 300

204 *Budget 2006*, p 127

205 Q 248

206 HC (2005–06) 739, Qq 390–391

207 HC (2005–06) 739, para 70

208 *Budget 2006*, Box 6.1, p 131

209 Q 237

210 Q 462

211 Q 140; see also Ev 79

Treasury officials that “we and Ministers always take Parliament into account”.²¹² We were also told that departments are likely to consult about their targets under new Public Service Agreements before the outcome of the Comprehensive Spending Review is published.²¹³ **We welcome the Government’s decision to initiate a national debate as part of the Comprehensive Spending Review. It is important that this debate is set in a context which enables it to amount to an opportunity for full consideration of options and priorities, rather than simply providing an opportunity for departments to canvass for public support for their bids for increased expenditure. In this context, it is vital that departmental select committees of the House of Commons ensure that they are fully engaged with the process. As a first step, we expect to hold an initial inquiry on spending matters following the publication of the report expected in mid-2006 on the spending challenges. To assist with timely parliamentary scrutiny of matters arising from that report, we urge the Government to ensure that this document is published no later than the end of June 2006.**

Debt management

69. The real rate of return on long-dated gilts has fallen to historically low levels over the past year. The fall in long-term real rates may have been driven by the behaviour of pension funds, because holding long-dated government bonds is an effective way for pension funds to match their assets and their liabilities.²¹⁴ Accordingly, it has been argued that the Government, through the Debt Management Office (DMO) should increase its supply of long-dated and index-linked bonds to take advantages of the low yields at present and to help meet the demand of pension funds attempting to match the assets that they hold to their liabilities to pay out future pensions. For example, the IFS considers that

“real yields on bonds issued by the United Kingdom government are significantly more likely to be higher in the future than to stay at current low levels or fall further. Yields on long-dated index-linked bonds have fallen well under 1%. The United Kingdom government may look back in 10 years and regret that it issued anything other than long-dated index-linked bonds at yields under 1%. We believe that issuing long-dated inflation-proof debt represents a good deal for future taxpayers ... the scale of the fall in real yields is so great that the risks have now become asymmetric—the chances of real yields going higher from here are greater than their going lower. Locking in at today’s low real yields by issuing long-dated indexed debt is therefore sensible”.²¹⁵

70. The Red Book notes that “During 2006–07, the DMO will increase the amount of long-maturity and index-linked gilt issuance, with up to two-thirds of total issuance at long maturities”.²¹⁶ In addition, the Debt and Reserves Management Report 2006–07 notes that “The gilt market has experienced very low and sometimes volatile yields at the longest maturities particularly during the final quarter of 2005–06. These unusual conditions may

212 Q 241

213 Q 242

214 *Inflation Report*, Bank of England, February 2006, p 5

215 *IFS Green Budget*, January 2006, p 132

216 *Budget 2006*, para 2.70, p 37

continue next year. To help both the DMO and the gilt market more generally to deal with a potentially challenging environment in 2006–07, the DMO’s remit for next year contains temporary changes intended to allow greater responsiveness in gilt issuance by the DMO during 2006–07 whilst retaining the Government’s firm commitment to transparency and predictability in debt management policy”.²¹⁷ However, whilst there is some movement towards greater use of long-maturity and index-linked gilts, this announcement does not appear to signal a major change to the remit of the DMO towards locking in a lower cost of Government borrowing through taking advantage of relatively low yields. Mr Cunliffe told us that there was “no free lunch” from refinancing the national debt, because “refinancing the debt portfolio at lower cost does not work”. He noted that the Debt Management Office has an objective “to minimise cost subject to risk and it is not an objective of debt policy to help out particular sectors of the economy”, although this could be an objective of government policy.²¹⁸ Mr Cunliffe also noted that you sometimes need to pay a refinancing penalty on debt currently held in the market. However Mr Cunliffe did agree that there “could be reasons” to increase the amount of long index-linked debt, in order to meet demand from pension funds. The Chancellor of the Exchequer told us that the Government makes a decision on the quantum of debt issuances at different maturities and types on a “year to year” basis.²¹⁹

217 *Debt and Reserves Management Report 2006–07*

218 Q 212

219 Q 423

4 Other issues

Efficiency savings and the public sector workforce

The Efficiency Programme

71. The Gershon Review of public sector efficiency was published at the time of the 2004 Spending Review. It identified £21.48 billion of efficiency savings to be delivered by the end of 2007–08 from central and local government; the savings were incorporated in the spending plans announced at that time, were to be delivered as part of a unified Efficiency Programme and were to be retained by departments and local authorities.²²⁰ In the 2005 Pre-Budget Report the Government announced annual efficiency gains totalling £4.7 billion reported by the end of September 2005.²²¹ In our review of that document we viewed the progress reported as encouraging, but considered that confidence in the process would be enhanced if future Budgets and Pre-Budget Reports included a breakdown of reported savings by department and financial year.²²²

72. The 2006 Budget provides an update on the progress of the Efficiency Programme. It indicates that annual efficiency gains of £6.4 billion had been reported by the end of December 2005 and provides some examples of progress by individual departments.²²³ The Government has rejected our recommendation for Budgets and Pre-Budget Reports to include breakdowns of expenditure by department and by financial year, contending that it is a matter for departments to report on their own progress.²²⁴ The lack of detail in the Budget documentation about progress of the Programme was criticised by Professor Talbot and Professor Heald.²²⁵ In some ways, the quality of information provided has declined in the 2006 Budget compared with that provided at the time of the 2005 Pre-Budget Report. For example, it is known that just under half of the savings reported in the 2005 Pre-Budget Report were cashable.²²⁶ The divide between cashable and non-cashable savings can be a useful indicator of the type of changes that are giving rise to savings.²²⁷ However, the 2006 Budget does not give any indication of how the savings reported there are divided between cash and non-cash savings, and Treasury officials were unable to shed light on the matter in oral evidence.²²⁸ Also, the 2006 Budget documentation does not follow the 2005 Pre-Budget Report in indicating what proportion of the reported savings are attributable to local government.²²⁹

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

221 *Pre-Budget Report 2005*, paras 6.11–6.13 and Box 6.1, pp 129–130

222 HC (2005–06) 739, para 74

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

224 HC (2005–06) 1013, pp 16–17; Q 288

225 Q 73; Ev 80–81

226 Ev 67

227 Q 74

228 Q 284

229 *Pre-Budget Report 2005*, para 6.12, p 129

73. Since we last reported on the Efficiency Programme, the National Audit Office has published the results of a detailed examination of the Programme.²³⁰ The National Audit Office study highlights several innovative aspects of the Programme, and was welcomed by the Treasury.²³¹ That study indicates that the savings of £4.7 billion reported at the time of the 2005 Pre-Budget Report “should be regarded as provisional and subject to further verification, given the degree of risk that efficiencies may not be measured accurately”.²³² The study also points out that lags in reporting data mean that further gains may have been achieved beyond what is already reported.²³³ The National Audit Office found that returns provided by departments to the Office of Government Commerce—which has a central, coordinating role in relation to the Programme—at December 2005 did not include information on the baselines for 108 of the top 300 projects within the Programme.²³⁴ It is difficult to measure the gains from a project without a full understanding of the inputs, outputs and service quality prior to the efficiency initiative.²³⁵ Treasury officials told us that some projects were still without baselines, but that 85% of projects in the Programme by value now had baselines.²³⁶ They also indicated that progress reported so far only related to those projects with an established baseline.²³⁷

74. The establishment of agreed, meaningful and measurable baselines is important, in part because one of the central principles of the Efficiency Programme is that the savings identified can be delivered without affecting the quality of service provided. There have been suggestions that the Programme has impacted adversely on service delivery, for example in the recent Report by the Work and Pensions Committee on the failings of Jobcentre Plus in the Summer of 2005.²³⁸ The National Audit Office has concluded that “the biggest risk is that efficiency gains are accompanied by unintended falls in the quality of service delivery”.²³⁹ Professor Talbot was sceptical about the capacity of the Government to measure service delivery effectively, in part because of the problems with data systems used for Public Service Agreements recently highlighted by the National Audit Office.²⁴⁰ Treasury officials acknowledged that further work was needed to ensure that there were measures in place to ensure that quality of service was not affected and indicated an intention to undertake such work.²⁴¹

75. The National Audit Office study of the Efficiency Programme notes that the overall target of around £21.5 billion excludes most investment costs, in part because much of the

230 National Audit Office, *Progress in improving government efficiency*, HC (2005–06) 802–I

231 Qq 250, 430

232 HC (2005–06) 802–I, para 10, p 5

233 Ev 67

234 Ev 68

235 Q 76; Ev 68

236 Qq 281, 279

237 Q 278

238 Work and Pensions Committee, Second Report of Session 2005–06, *The Efficiency Savings Programme in Jobcentre Plus*, HC 834–I

239 Ev 66

240 Qq 76, 73; National Audit Office, *Second Validation Compendium Report: 2003–06 PSA data systems*, HC (2005–06) 985

241 Q 250

up-front capital investment was begun before the Programme began.²⁴² The study concludes:

To gain a complete picture of the success of the Programme, the additional costs should be matched against the efficiency gains delivered in each financial year. Without such matching of capital costs against gains, the £21.5 billion target overestimates the efficiency gains that will actually be achieved by 2007–08.²⁴³

In response, Treasury officials indicated that the Gershon Efficiency Programme had been constructed on the basis of gross rather than net savings, although they agreed to “look at” a request for figures on net savings.²⁴⁴

76. Both Treasury officials and the Chancellor of the Exchequer told us that they were keen to work closely with the National Audit Office on the issues identified in the recent study, including those surrounding verification, and the Chancellor of the Exchequer confirmed that one aim of such work was to establish a basis on which savings can be agreed.²⁴⁵ **We welcome the contribution made by the recent National Audit Office study to understanding of the Efficiency Programme. We also welcome the Treasury’s commitment to work closely with the National Audit Office on the issues identified in that study. We continue to believe that public and parliamentary confidence in the Programme, and in the effectiveness of the central coordinating role played by the Office of Government Commerce, would be enhanced by the provision of more information about measurement systems and data in a single source in Red Books and Pre-Budget Reports. We recommend that such documents contain further analysis of progress of the Efficiency Programme as a whole, including an indication of the proportions of the overall reported savings that are attributable to central and local government and that are cashable and non-cashable, as well as analysis of savings in relation to the themes identified in the Gershon review—back office functions, transactional services, procurement, policy, funding and regulation, and productive time. We further recommend that such documents include an update on verification, in cooperation with the National Audit Office, of previously reported savings.**

77. Although it is too early to reach an overall assessment of the effectiveness of the Efficiency Programme, there are some encouraging signs that it may prove to be a step-change in the way efficiency is promoted within central and local government. There nevertheless remains room for improvement both in the reporting mechanism for efficiency savings and in their delivery more generally. The Confederation of British Industry, for example, believed that there was much greater potential for the use of shared services to drive efficiency and the Comptroller and Auditor General has observed that the potential for reform goes well beyond the £21.5 billion target.²⁴⁶ The Government is keen to embed efficiency in departmental expenditure planning and this is part of the reason for the early spending settlements for the period 2008–09 to 2010–11 which were considered

242 HC (2005–06) 802–I, para 1.15, p 19

243 Ibid, Figure 10, p 20

244 Qq 285–287

245 Qq 250, 430–431

246 Ev 95, Ev 70

above.²⁴⁷ The Chancellor of the Exchequer told us that the Government would be providing further information about the future of the Efficiency Programme as part of the Spending Review.²⁴⁸ **We welcome the Government's determination to embed the efficiency agenda as part of the process for spending allocations during the Comprehensive Spending Review. We recommend that the initial report as part of that Review to be published in mid-2006 contain initial proposals for consultation on how an Efficiency Programme for the period from April 2008 onwards can be monitored and reported on. As part of such proposals, we expect the Government to give consideration to ensuring that efficiency projects are designed and measured using net as well as gross savings in order that the investment necessary to secure efficiency savings can be properly measured and assessed.**

Civil Service workforce and administration budgets

78. As part of the 2004 Spending Review, the Government announced targets for reductions in Civil Service numbers resulting from efficiency savings. That Spending Review included a gross target of 84,150 posts and a net target of 70,600 to be achieved between April 2004 and April 2008.²⁴⁹ In our Report on the 2005 Pre-Budget Report we noted that differing starting dates were used by departments as baselines to measure such workforce reductions.²⁵⁰ In its response, the Government confirmed that different starting dates were used so that not all the reductions would take place between April 2004 and April 2008. They considered that “it would have been illogical to penalise departments who have made early progress in delivering their Gershon efficiency gains and workforce reductions”.²⁵¹ The departments who have benefited from flexibility about starting points include the Department for Work and Pensions, in respect of which a baseline of 1 March 2004 has been used to take account of early progress in reducing staff.²⁵² We have also noted previously that the targets arising from the Gershon Review are for workforce reductions directly attributable to the Efficiency Programme; they are not intended as targets for overall reductions in Civil Service numbers.²⁵³ The National Audit Office's recent study of the Programme contains a helpful analysis of some of the differences between the reductions reported as part of the Efficiency Programme and statistics on Civil Service numbers prepared by the ONS.²⁵⁴ An added difficulty in assessing the significance of the reported reductions is that “the headcount numbers reported by departments are not subject to the kind of formal review and challenge that the Office of Government Commerce applies to reported efficiency gains”.²⁵⁵

247 *Budget 2006*, Box 6.3, p 136; and see para 65

248 Q 436

249 *2004 Spending Review*, Table 2.2, p 20

250 HC (2005–06) 739, para 75

251 HC (2005–06) 1013, p 17

252 HC (2005–06) 802–I, para 2.9, p 32

253 HC (2005–06) 739, para 75

254 HC (2005–06) 802–I, para 2.9, pp 32–33

255 *Ibid*, para 2.8, p 32

79. Some evidence we received was anyway sceptical about the importance of Civil Service headcount as a measure of progress in efficiency. Professor Talbot said that there had been a general consensus across most OECD countries to move away from using headcounts as a way of managing public sector activity 10 to 15 years ago.²⁵⁶ Mr Weale noted that a stress on headcount could simply encourage a shift from direct employment to the use of consultants without necessarily saving money; he saw more value in using a financial target.²⁵⁷ The 2004 Spending Review included targets for reductions in the administration budgets of most departments.²⁵⁸ Progress against these targets is not reported on as prominently in the context of the drive for increased efficiency in government as is progress in relation to workforce reductions. We have received evidence suggesting that departmental administration budgets may be a more revealing indicator about efficiency than Civil Service headcount. **We recommend that, in seeking to embed a culture of efficiency in Government departments during the period covered by the Comprehensive Spending Review, the Government places greater emphasis on delivering and reporting on targets for continued reductions in departmental administration budgets rather than on workforce reductions attributed to efficiency projects.**

Public sector pay and pensions

80. In the 2005 Pre-Budget Report the Government announced the establishment of a new Public Sector Pay Committee, known as the Pay Gateway. Reporting to the Chief Secretary to the Treasury, the Pay Gateway was intended to ensure that all new pay structures were evidence-based, represented value for money and were financially sustainable over the long run, including taking account of the pensions implications of new pay decisions.²⁵⁹ The Red Book states that the Pay Gateway has met on several occasions and “has made good progress in strengthening the consistency and quality of the information base used to underpin pay decisions”.²⁶⁰ Professor Talbot considered that the establishment of the Pay Gateway was a centralising measure and represented a significant reversal of the trend towards greater pay delegation to departments since the early 1990s.²⁶¹ Mr Weale was concerned that it might inhibit the development of regional flexibility in public sector pay.²⁶² Treasury officials rejected the implication of centralisation, pointing out that the Pay Gateway was “not a Treasury body, but ... is actually made up of officials from across Whitehall who have an interest in pay”.²⁶³ They also considered that the work of the Pay Gateway was consistent with support for local pay flexibility.²⁶⁴

256 Q 94

257 Q 82

258 *Spending Review 2004*, Table 2.3, p 21

259 *Pre-Budget Report 2005*, para 6.19, p 132

260 *Budget 2006*, para 6.18, p 134

261 Q 88

262 Ibid

263 Q 257

264 Q 258

81. Following the 2002 Budget, when the Chancellor of the Exchequer announced significant increases in health spending up to 2007–08 in advance of that year’s Spending Review, concern was expressed that the benefits of funding increases might be mitigated by pay increases.²⁶⁵ At that time, the Chancellor of the Exchequer cautioned that “a sustained commitment to better public services demands responsibility in setting public sector pay”.²⁶⁶ This year, very shortly after the Budget, the Chancellor of the Exchequer announced the Government’s response to the pay review bodies and indicated that, while accepting the recommendations of the pay review bodies, the Government would stage the awards for judges and senior public servants—including Ministers, MPs and consultants—with an initial award of just 1% from 1 April 2006 and the remainder paid in November.²⁶⁷ The Chancellor of the Exchequer told us that this staging would “have the effect of saving considerable money in allowing resources to go to other front-line services, but, equally, at the same time, it is sending out a very powerful message that we will not tolerate rising inflation”.²⁶⁸ The staging does not apply to the pay settlement for nurses: the typical salary rise for a nurse will be 5.2% and the average nurse will see their salary rise from £27,000 to £28,400.²⁶⁹

82. Another way in which the Government is seeking to release resources for front-line services is to secure savings from reforms of public sector pensions. In December last year the Chancellor of the Exchequer expressed confidence that these reforms would secure savings of around £13 billion. He also did not rule out the possibility of sector-by-sector negotiations leading to consideration of the age of retirement for serving public servants: “I think it is possible that all things will be looked at in the sector-by-sector negotiations”.²⁷⁰ Treasury officials told us that they still expected to recoup the level of savings set out in the original proposal.²⁷¹ However, Treasury officials told us that the pension age for existing members of schemes was “not under discussion”.²⁷²

Poverty and the tax system

High marginal deduction rates

83. What is known as the poverty trap occurs when those in work have limited incentives to move up the earnings ladder because it may leave them little better off. Marginal deduction rates measure the extent of the poverty trap by showing how much of each additional pound of gross earnings is lost through higher taxes and withdrawn benefits or tax credits.²⁷³ The number of households facing varying high marginal deduction rates, as estimated in recent Budgets, are shown in the figure below.

265 Treasury Committee, Second Report of Session 2001–02, *2002 Budget*, HC 780–I, para 47

266 *Ibid*

267 HC Deb, 30 March 2006, col 1025; Qq 323, 348

268 Q 323

269 Q 348

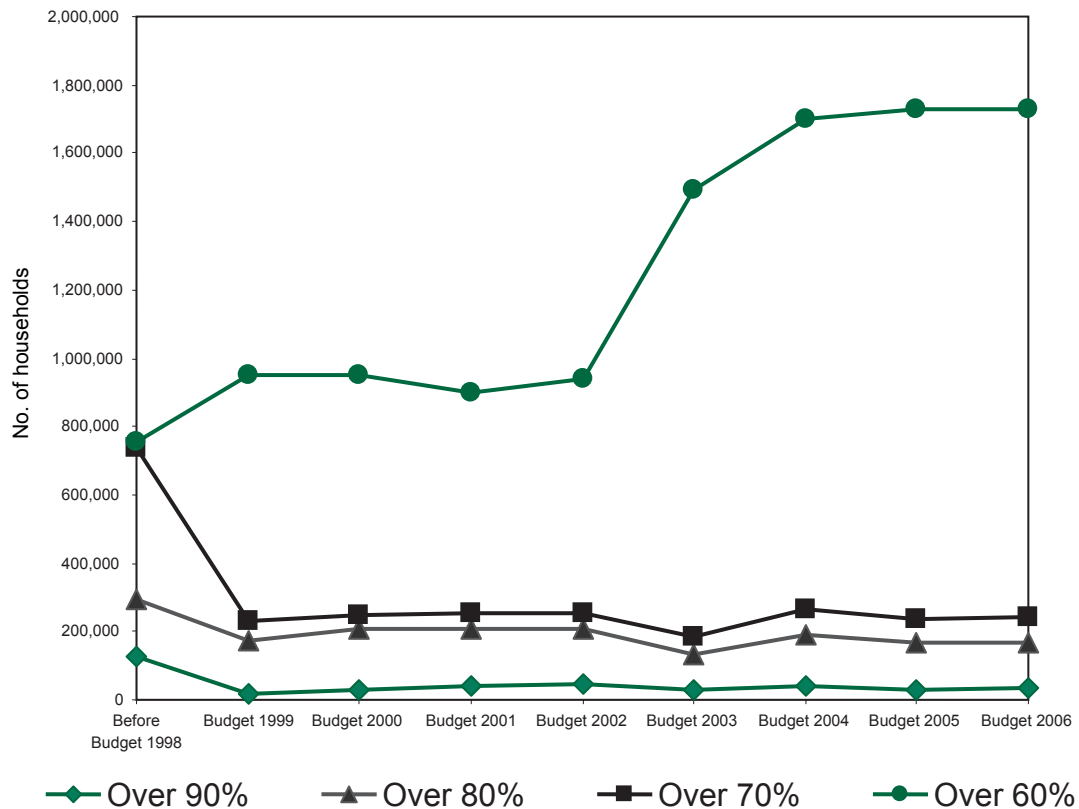
270 HC (2005–06) 739, para 98

271 Q 259

272 Q 260

273 *Budget 2006*, para 4.63, p 93

Figure 2: Numbers of households facing high marginal deduction rates



Source: Various Budgets, including table 4.2, p 94 in Budget 2006

84. The chart shows that the number of households facing marginal deduction rates of 70% or higher has fallen, with no households facing a marginal deduction rate in excess of 100%, compared to 5,000 households (just prior to Budget 1998). However, the number of households facing marginal deduction rates in excess of 60% increased significantly following the introduction of new child and working tax credits from April 2003. The OECD has suggested that:

While in-work tax credits help to boost labour force participation, their means-tested withdrawal leads to high marginal effective tax rates which reach 70% for families with children at below average income. This attenuates market signals for intermediate skills, because even though gross earnings are considerably higher for people with intermediate skills than for the low-skilled, net earnings are not very different for households with children ... While the tax credit reforms over recent years have successfully reduced child poverty while maintaining incentives to work and removing the worst peaks of high marginal effective tax rates, the effect for the average person in a couple with children has been to push up marginal effective tax rates by 5 percentage points. It would therefore be useful to better understand how much taxation of subsequent earnings matters for the propensity of teenagers and adults to make use of the improved education and training on offer.²⁷⁴

85. In 2004 Mike Brewer and Andrew Shephard from the IFS noted that the impact of changes to personal taxes and benefits since 1997 on the financial work incentives faced by parents is mixed. Whilst low-earning lone parents now keep more of any increase in earnings they achieve than was the case in 1997, overall more working parents now face means-testing which withdraws benefits or tax credits as their earnings rise, compared with 1997. The IFS considers that this reduces their incentive to seek pay rises or work longer hours. The Chancellor of the Exchequer told the Committee that the increase in the number of people facing marginal deduction rates of over 60% was a consequence of “more people going into work and more people claiming the child tax credit or the working tax credit”. He noted that he “would like to do more, and we will do more over time”, but emphasised that he had succeeded in “eliminating the highest marginal tax rates”.²⁷⁵ **The introduction of tax credits has contributed to the reduction in the number of households facing the highest marginal deduction rates of 70% or more from 740,000 before Budget 1998 to 240,000 under the 2006–07 system of tax and benefits.. However, the number of households facing marginal deduction rates in the region of 60% to 70% has increased since 1997 and now appears to have levelled off at around 1.5 million households. We recommend that the Treasury analyse the characteristics and income distributions of households facing marginal tax rates in the region of 60% to 70% and the extent to which these high marginal tax rates are discouraging people from entering the workforce, from working longer hours or from acquiring additional skills. We further recommend that the Treasury publish the findings of such analysis at the time of the 2006 Pre-Budget Report.**

Child poverty

86. The Government has set itself an ambitious series of PSA targets with the aim of ending child poverty. The targets are joint between HM Treasury and the Department of Work and Pensions and were set in the 2004 Spending Review:

- between 1998–99 and 2010–11, to halve the number of children in relative low-income households
- by 2020, to end child poverty.

In the 2002 Spending Review, HM Treasury and the Department for Work and Pensions were set the target of reducing the number of children in low-income households by at least a quarter between 1998–99 and 2004–05. Data published recently by the Department for Work and Pensions showed that, although significant steps had been made towards meeting this target, a 25% reduction in child poverty had not been achieved. As summarised by the IFS, the data showed:

- “Child poverty fell 700,000 after housing costs between 1998/99 and 2004/05, from 4.1 million to 3.4 million. This was a drop of approximately 17%—to meet the target, it would have needed to fall by a further 400,000 to 3.0 million.

- Child poverty also fell 700,000 before housing costs between 1998/99 and 2004/05, from 3.1 million to 2.4 million. To meet the target, it would have needed to fall by a further 100,000 to 2.3 million.²⁷⁶

A press notice accompanying the Budget stated that “the Government remains firmly committed to meeting its targets to reduce child poverty and eradicate it by 2020”.²⁷⁷

87. The Budget contained two announcements which the Chancellor of the Exchequer has indicated were intended to contribute towards achieving the Government’s child poverty targets. First, the Government will continue to increase the child element of the child tax credit at least in line with earnings until the end of this Parliament. The Chancellor of the Exchequer stated that, over the next 3 years, this would mean a 14% improvement in the child element of the child tax credit.²⁷⁸ The Government believes that this measure will “provide a solid foundation for meeting the target to halve child poverty”.²⁷⁹ Secondly, from April 2007, the Government will extend the existing work focused interview (WFI) initiative. Since October 2005, lone parents who have been claiming income support for 12 months or more, and whose youngest child is aged 14 years or over, are required to attend a WFI once every three months. The Red Book announced that “all lone parents” who have been on benefit for at least a year “will benefit from a WFI at least every six months”—that is, all lone parents, regardless of the age of their youngest child.²⁸⁰ According to the Red Book, “helping lone parents move into, remain in, and progress in work, is one of the key elements in achieving the Government’s commitment to ... eradicate [child poverty] by 2020”.²⁸¹ The Government has set what it refers to as the “challenging target” of achieving a 70% lone parent employment rate by 2010; the Red Book estimates that meeting this target would lift at least a further 200,000 children out of poverty.²⁸²

88. In his Budget statement to the House, the Chancellor of the Exchequer indicated that he had examined “which tax decision could do most for families in the future”:

We are raising the personal tax allowance from £4,895 to £5,035. One option would be to raise that personal tax allowance further. Spending £500 million on a family tax cut in this way would give a two child family on median earnings of £24,000 a year, £22 a year more, 40p a week. However, using the same resources to raise the child tax credit will give that same family a family tax cut worth £140 a year more, over six times as much, £2.70 a week. So the best way to do most to help low and middle income families, the best family tax cut, is—as I will do today—raising the child element of the child tax credit.²⁸³

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

277 HM Treasury, PN01, *A strong and strengthening economy: investing in Britain’s future*, 22 March 2006

278 HC Deb, 22 March 2006, col 296

279 *Budget 2006*, para 5.6, p 98

280 *Budget 2006*, para 4.31, p 85

281 *Budget 2006*, para 4.27, p 84

282 *Ibid.*

283 HC Deb, 22 March 2006, col 295

89. Both Mr Chote and Mr Whiting considered that the current tax system offered the Chancellor of the Exchequer “three levers” with which to address child poverty: tax allowances, child tax credit and child benefit.²⁸⁴ Both felt that, if the aim was to address child poverty, the Chancellor of the Exchequer’s decision to use the child element of child tax credit was the most effective use of these levers, because it was the most targeted measure.²⁸⁵ Mr Chote added a caveat to this:

... looking at the longer term ... the Chancellor of the Exchequer has managed to increase the child element of the child tax credit by quite a degree without there being visibly serious consequences for work incentives. The one danger is if you continue to pump money through that particular method, the impact on work incentives will become more of a problem and, obviously, worklessness is an important component as well as income to the degree to which you are likely to be in child poverty or not. So there could be an argument for saying in the future, to the degree you try to pursue lower child poverty through transfer payments, you might want to go to a working tax credit, which is less precisely focused on the families in need but would have less of a damaging effect on work incentives.²⁸⁶

The Chancellor of the Exchequer told us that tax credits had “made work pay” for “the lowest paid families in this country” and that, as a result, “there are more people who find it worth their while to work, as well as reducing child poverty. I just do not accept ... that somehow the system of child tax credits has made it less attractive for people to work; it has made it more attractive for people to work.”²⁸⁷

90. The IFS expected the child tax credit initiative to benefit roughly the poorest half of families with children but described it as “relatively inexpensive—only costing £400m a year by 2010 compared to the £8bn increase in total financial support for children since 1997”.²⁸⁸ Mr Chote told us that although, in the absence of the announcement, rates of child poverty would have increased, the initiative would do no more than preserve current levels of child poverty.²⁸⁹ Given that the Government “need[ed] to accelerate progress on child poverty, moving half as quickly again” if it was to meet its PSA targets, “there is nothing in that decision which will achieve that”.²⁹⁰ Earlier analysis by the IFS had shown that it was “already too late for the Government to influence child poverty rates in 2005/06 and 2006/07 by changing benefit and tax credit rates, so a third of the next target period has in effect already elapsed—and we do not know if progress will have improved or worsened over this period.”²⁹¹

284 Q 112

285 Qq 108, 109 and 112

286 Q 109

287 Q 360

288 IFS press notice, *Analysis of today’s Budget*, 22 March 2006

289 Q 107

290 *Ibid.*

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

91. We asked both the Chancellor of the Exchequer and his officials what other measures they proposed to enable the Government to meet its targets to reduce child poverty. Officials told us:

We keep progress towards the child poverty target under a continuing review ... Looking forward, achievement of the target obviously depends on quite a wide range of factors, it will depend how incomes grow in the economy generally, how the incomes of people towards the lower end of the income distribution grow and it will depend on what happens in the labour market. I think it is too early to say now exactly what other measures may be needed to reach the target.²⁹²

Officials also considered that it was not possible to project precisely what progress individual measures would deliver in reducing child poverty targets, “because much depends on how the underlying economy is performing and how incomes are moving in the economy”.²⁹³ The Chancellor of the Exchequer told us that “there is a real chance here” that “the combination” of the two measures outlined above “can move us towards the target we really want to achieve”, but he did not specify any additional measures which the Government plans to deploy in its initiative to end child poverty.²⁹⁴

92. We welcome the announcements in the Budget that the child element of the child tax credit will increase at least in line with earnings until the end of this Parliament and that, from April 2007, the work focused interview initiative will be extended to all lone parents who have been on benefit for at least a year. These initiatives represent a positive step towards achieving the Government’s PSA targets of halving child poverty by 2010–11, and ending it by 2020. The Budget contained no clear indication of exactly how the Government propose to meet its challenging target of halving child poverty by 2010–11. The Government took significant steps towards meeting its target to reduce the number of children in low-income households by at least a quarter between 1998–99 and 2004–05. However, the Government missed meeting this target. The IFS has calculated that the increase in the child element of child tax credit will do no more than maintain current levels of child poverty and that, if the Government is to meet its PSA targets, it needs to in fact accelerate progress on child poverty, moving half as quickly again. **We recommend that, as part of its report, due to be published in mid-2006 on the challenges for the Comprehensive Spending Review, the Government set out in greater detail what existing measures it has in place to meet its target of halving child poverty by 2010–11, what additional measures it is considering, and what assessment it has made of the current likelihood that the 2010–11 target will be met. In particular, given that about one million more children are defined as living in poverty after housing costs are taken into account, as opposed to before housing costs are taken into account, we recommend that the Government set out how it intends to address further the issue of housing costs in order to reduce levels of child poverty.**

292 Q 291

293 Q 295

294 Q 451

Tax measures

Environmental taxation

93. The Government set out its objectives for using environmental taxation in its *Statement of intent on environmental taxation*, released in July 1997. In issuing this statement, the Government undertook, “over time”, to “aim to reform the tax system to increase incentives to reduce environmental damage”.²⁹⁵ Such reform would “shift the burden of tax from ‘goods’ to ‘bads’; encourage innovation in meeting higher environmental standards; and deliver a more dynamic economy and a cleaner environment, to the benefit of everyone.”²⁹⁶ The Government endorsed the principles set out in the 1997 statement of intent in a document published alongside the Pre-Budget Report 2002, which concluded that taxes and other economic instruments had a central role to play in improving the environment and delivering sustainable development.²⁹⁷

94. The Budget contained several announcements about existing environmental taxes, the most significant of which included:

- From 1 April 2007, an increase in climate change levy (CCL) rates in line with current inflation, “to ensure the United Kingdom continues to make progress in tackling climate change”.²⁹⁸ CCL rates have not been raised since the introduction of the levy in 2001. The Red Book states that the CCL “is playing a crucial role in enabling the United Kingdom to meet its Kyoto targets”.²⁹⁹
- A continuing freeze in air passenger duty (APD) rates, a tax levied on almost every passenger on flights taking off from United Kingdom airports; APD rates have not changed since April 2001. Although the Government recognised that “its focus on including aviation in the EU ETS [Emissions Trading Scheme] should not preclude further work on other policy instruments, including APD, to tackle emissions from aviation”, it considered that “decisions on APD rates need to be considered in the context of wider social and economic factors, particularly the current volatile oil market.”³⁰⁰ The Red Book also announced that Croatia, “as an applicant country to the EU”, will be reclassified so that it qualifies for the European (or short-haul) rate of APD.³⁰¹ This means that the APD rate for economy-class flights to Croatia will drop by £15, to £5.

95. The Commons Environmental Audit Committee recently reviewed the 2005 Pre-Budget Report in order to assess “the progress made by the Treasury in placing environmental objectives at the heart of its fiscal policies”.³⁰² The Committee

295 HM Treasury news release, *Tax Measures to Help the Environment*, 2 July 1997

296 HM Treasury news release, *Tax Measures to Help the Environment*, 2 July 1997

297 HM Treasury, *Tax and the environment: using economic instruments*, November 2002, chapter 8

298 *Budget 2006*, para 7.33, p 159

299 *Ibid.*

300 *Budget 2006*, para 7.84

301 *Ibid.*

302 Environmental Audit Committee, Fourth Report of Session 2005–06, *Pre-Budget 2005: Tax, economic analysis, and climate change*, HC 882

acknowledged that, following the 1997 statement of intent, “the Treasury has introduced a number of important environmental policy instruments—the Climate Change Levy, the Aggregates Levy, and the United Kingdom Emissions Trading Scheme being notable examples—and modified other instruments the Government inherited, such as the Landfill Tax”.³⁰³ However, the Committee considered that, since 1999 the Government’s overall impact on shifting the burden of taxation from ‘goods’ to ‘bads’ had “gone into reverse, with latest figures showing the proportion of tax revenues gained from environmental taxes to be at its lowest for over a decade”.³⁰⁴ The Committee cited data on environmental taxes published by the Office for National Statistics (ONS) showing that, since 1999, the proportion of revenue gained from environmental taxes had fallen “almost year on year (the single exception being 2002), from a peak of 9.8% in 1999 down to 8.3% in 2004”.³⁰⁵ The Committee also noted that the ONS figures are based on a much broader classification of what constitutes an environmental tax than that used by the Treasury and that, if the Treasury’s classification was used, “then the proportion of total taxes made up by environmental taxes in 2004 plummets to 0.4%”.³⁰⁶

96. The Environmental Audit Committee commented on the specific example of APD. It stated that, between 2000 and 2004:

- the annual number of chargeable passengers rose by some 25 million, or 35%;
- annual greenhouse gas emissions from United Kingdom aviation increased by some 0.8 million tonnes of carbon equivalent, or 10%;
- yet tax receipts from APD fell by 8%, from £931 million to £856 million.³⁰⁷

The Committee attributed this fall in APD revenue to the reforms to APD announced in Budget 2000, which included the introduction of lower APD rates for short-haul economy flights. At the time, the Chancellor of the Exchequer acknowledged that the result of the “new, fairer and lower” APD would be an overall cost to the Exchequer of £80 million a year.³⁰⁸ The Committee concluded that, “as the recent expansion in aviation has overwhelmingly been in short-haul budget flights, so the introduction of the new lower [APD] rate has more than cancelled out the revenue gained from the extra 25 million passengers”.³⁰⁹

97. We questioned both the Chancellor of the Exchequer and Treasury officials about the fall in the proportion of revenue gained from environmental taxes since 1999, as calculated by the ONS, and asked what measures the latest Budget contained to address this downward trend. Treasury officials thought that the effectiveness of environmental taxation ought to be measured “in terms of behavioural change and the savings we make

303 Environmental Audit Committee, para 2

304 Environmental Audit Committee, para 36

305 Environmental Audit Committee, para 37; ONS, *United Kingdom Environmental Accounts Autumn 2005*, pp 41–2

306 *Ibid.*; the Treasury classifies only the Climate Change Levy, the Aggregates Levy and the Landfill Tax as environmental taxes.

307 Environmental Audit Committee, para 17

308 HC Deb, 21 March 2000, col 869

309 Environmental Audit Committee, para 17

on greenhouse gas and carbon emissions”, rather than in terms of the revenue yielded to the Exchequer.³¹⁰ Officials considered that the fall in the proportion of revenue gained from environmental taxes could be a sign of the success of environmental taxes, “in the sense that business and households are moving away from energy intensive consumption”, and said that they analysed tax instruments on the basis of which instrument would have the biggest impact on people’s behaviour.³¹¹ The Chancellor of the Exchequer pointed to the effect of the CCL, claiming that “a large number of climate change agreements have been signed as a result of the [CCL]; so the effect of the [CCL] ... is way beyond the impact of the tax itself. It is in the change of behaviour that has happened in companies, and it is responsible for 40% of the cuts in emissions by 2010.”³¹²

98. We took up with the Chancellor of the Exchequer and Treasury officials the specific case of APD, and suggested that the 35% rise in annual numbers of air passengers between 2000 and 2004 indicated that APD was not currently set at a level sufficient to achieve behavioural change of the type referred to by the Chancellor of the Exchequer and his officials. We also asked them to provide evidence for the suggestion in the Red Book that APD rates had been frozen because of volatile oil prices. Officials considered that APD had had “an impact on [greenhouse gas] emissions” and argued that “you need to look at the counterfactual situation—i.e. what the level of air travel would have been without an air passenger duty.”³¹³ They maintained that “the cost of air travel has risen as a result of the rise in oil prices and that will have had an impact on people’s behaviour”.³¹⁴ The Chancellor of the Exchequer thought that the changes to APD announced in Budget 2000 were “if I am right ... a cost neutral change rather than an overall cut in the amount of duties that we intended to receive”.³¹⁵ He defended the decision to hold APD at April 2001 rates:

We have got to make a judgment year to year on air passenger duty as to whether what is happening to oil prices or what is happening to usage should lead us to make a different fee for the [APD]... I do not think at this stage, when we have a doubling of oil prices and people are having to pay the price for that, that [raising APD] is entirely the right thing to do if we are going to get the balance between environmental care and the needs of the economy right.³¹⁶

Both the Chancellor of the Exchequer and his officials argued that the most effective way of dealing with the environmental implications of aviation was to bring it within the EU Emissions Trading Scheme; the Treasury told us that the United Kingdom Civil Aviation Authority had been “taking the lead in the EU” in trying to achieve this objective.³¹⁷

310 Qq 296–97

311 Qq 297–98

312 Q 325

313 Qq 299–300

314 Q 304

315 Q 326

316 Q 328

317 Qq 299, 302 and 327

99. We are concerned by the apparently limited assessment the Treasury has made of the reasons for the drop in the proportion of revenue yielded to the Exchequer from environmental taxes, from a peak of 9.8% in 1999 to 8.3% in 2004. We accept that one important measure of the effectiveness of environmental taxation is the extent to which it brings about behavioural change which results in reductions in greenhouse gas emissions. However, the amount of revenue flowing to the Exchequer from environmental taxes as a proportion of overall tax revenue yield also gives an indication of the priority Government places on using the tax system to achieve environmental ‘goods’. **We urge the Government to re-examine whether it is making the fullest possible use of taxation instruments as a mechanism to achieve the Government’s environmental targets.**

100. **In particular, we are puzzled by the Government’s justification of its decision to freeze air passenger duty (APD) for the fifth year running.** Between 2000 and 2004, the annual number of passengers liable to pay APD rose by some 25 million, or 35%. Treasury officials appeared to argue that, although air passenger numbers had admittedly increased, they would have increased more, were it not for the increases in oil prices, and that increasing APD would result in a decrease in passenger numbers. The United Kingdom is currently lagging behind on its domestic CO₂ targets—CO₂ emissions in fact increased in 2004, the most recent year for which data is available; furthermore, according to European Commission figures, greenhouse gas emissions in the EU from international aviation rose 73% between 1990 and 2003.³¹⁸ **In the context of the challenges facing the United Kingdom in reducing its greenhouse gas emissions, we find the Government’s attempt to justify freezing air passenger duty (APD) for the fifth year running to be incoherent and unconvincing. It is telling that the only aviation-specific taxation measure contained in the Budget is to widen the scope of the European APD to include Croatia—meaning that it is now £15 cheaper to fly economy class to Croatia.**

101. **Consequently, we recommend that the Government give serious consideration to increasing rates of APD. In the context of the wider problem of climate change, we consider it entirely inappropriate that, between 2000 and 2004, tax receipts from APD should have fallen by 8% whilst passenger numbers have risen by 35%. If this trend continues, the Government risks allowing APD to become an ineffective policy instrument which does nothing to recognise or address the contribution made by aviation to greenhouse gas emissions.** In this context, we note the Chancellor of the Exchequer’s statement to us that the changes to APD announced in Budget 2000 were “if I am right ... a cost neutral change rather than an overall cut in the amount of duties that we intended to receive”.³¹⁹ We remind the Chancellor of the Exchequer of his statement to the House on Budget 2000, when he announced “a new, fairer and lower air passenger duty—at an overall cost to the Exchequer of £80 million a year”.³²⁰

102. **We accept the point made by both the Chancellor of the Exchequer and officials that it is important to bring aviation within the EU Emissions Trading Scheme (ETS).**

318 Defra statistical release, ‘2004 United Kingdom climate change sustainable development indicator and greenhouse gas emissions final figures’, 23 January 2006; Communication from the Commission to the Council, the European Parliament, the European Economic And Social Committee and the Committee of the Regions, *Reducing the Climate Change Impact of Aviation*, COM(2005) 459 final

319 Q 326

320 HC Deb, 21 March 2000, col 869

However, we are mindful that, to be included in phase 2 of the EU ETS (which runs from 2008 to 2012), aviation will have to be included in the ETS by 30 June 2006.³²¹ Member states have until this date to submit their national allocation plans for phase 2; if aviation is not included in those national allocation plans, aviation emissions are unlikely to be included in any ETS-type scheme until after 2012. **Time is running out for aviation emissions to be subject to the ETS before 2012. Consequently, for the Government to say that it is seeking to bring aviation within the ETS is only a partial response to the pressing issue of climate change currently facing the United Kingdom. In addition to continuing to press for action at the EU level, the Government must also act at a domestic level. We refer the Government to its undertaking, in its Statement of intent on environmental taxation, to “aim to reform the tax system to increase incentives to reduce environmental damage”. We recommend that the Government give urgent consideration to how it can best use the tax system to increase incentives to reduce the harmful environmental effects of aviation.**

Changes to the tax treatment of trusts

103. The Budget announced changes to the tax treatment of two types of trusts, known as accumulation and maintenance trusts, and interest in possession trusts. The Red Book recognised that “trusts have a positive role to play in assisting people to manage their affairs”, then stated that “the inheritance tax exemptions which presently apply to some types of trust will [now] only be available in certain prescribed circumstances. Where this is not the case, inheritance tax charges will apply in the same way as for all other trusts, preventing these trusts from being used to shelter wealth from inheritance tax.”³²² The new rules came into effect on 22 March 2006, although existing trusts will not be affected until April 2008. The Government has announced that inheritance tax thresholds will rise as follows: in 2006–07, £285,000; in 2007–08, £300,000; in 2008–09, £312,000; and, in 2009–10, £325,000.³²³ The Government expects the new tax treatment of trusts to yield the Exchequer £15 million in 2007–08, and another £15 million in 2008–09.³²⁴

104. On 24 March, *The Times* published a letter from the Paymaster General, Dawn Primarolo MP, setting out an estimate of how many people the Government expects to be affected by the new measure. The Paymaster General disputed an earlier report in *The Times* that the measure would affect “at least 100,000 families”, and concluded:

To be affected by the new measure, individuals would have to have placed assets into a trust, excluding their homes and over and above any savings that they would need access to, in excess of £275,000 and be seeking to avoid [inheritance tax]. Such individuals make up only a tiny fraction of the wealthiest top 1% of the population.³²⁵

321 European Commission press notice, *Emissions trading: Commission sets out guidance on national allocations for 2008–2012*, 9 January 2006

322 *Budget 2006*, para 5.102, p 118

323 *Budget 2006*, para 5.100, p 117

324 *Budget 2006*, Table 1.2, p 14

325 Letter to *The Times* from the Paymaster General, 24 March 2006

105. Mr Whiting considered the Treasury was “entirely wrong” to suggest that the changes affected only a very few, very wealthy, people.³²⁶ On the contrary, he believed the changes affected “an awful lot of everyday arrangements ... arrangements on the break-down of marriage, on grandparents leaving money in trust for their grandchildren”.³²⁷ He described the accumulation and maintenance trust as “frequently used” and said that, since 1984, inheritance tax legislation had effectively encouraged the use of such trusts.³²⁸ He stressed that such arrangements were “ordinary management devices”, not “trusts being used as avoidance devices” and suggested that the announcement amounted to the Government instructing people “to give the money to their children direct rather than protecting it with a trust”.³²⁹ Mr Whiting described as “outrageous” the fact that “there has been absolutely no mention of [this measure] in two and a half years of the consultation [which] has been [underway] on trust reform ...”, especially given that he felt consultation had been “such a good feature” of the review of trust law.³³⁰

106. Treasury officials rejected Mr Whiting’s characterisation of the absence of consultation as “outrageous”. They did not claim to have consulted on the measure, but said that the Government did “not generally consult on Budget measures where there is a potential behavioural impact and the risk of forestalling, and that would certainly have been the case in this case”.³³¹ Officials repeated the point made to *The Times* by the Paymaster General, arguing that the new rules would affect only a small number of trusts:

We estimate that there are about 100,000 discretionary trusts and only a small minority of those are accumulation and maintenance trusts of the kind that are caught by this Budget measure. Of that small minority of accumulation and maintenance trusts, only those containing assets above the inheritance tax threshold will be caught, so it is a minority of a minority.³³²

Officials were unable to provide an estimate of the number of wills that will be affected.³³³ Finally, officials confirmed that the new rules were intended to create a situation in which the only way to avoid taxation will be to allow beneficiaries to take control of a trust’s assets by age 18: “the purpose of this measure is to ensure that trusts remain available for the wholly legitimate purpose of protecting the interests of vulnerable people including children, but ... we regard childhood as ending at age 18”.³³⁴ Currently, many trusts do not pass control to beneficiaries until they turn 25.

107. Since Budget day, there have been reports in the media that professionals who work with the affected trusts believe that the changes are likely to affect many more trusts than

326 Q 136

327 Qq 136, 138

328 Ev 77

329 Q 138, Ev 77

330 Qq 136, 139

331 Q 308

332 Q 309

333 Q 305

334 Q 306

the Government expects.³³⁵ Edward Nugee QC, in a letter to *The Times*, suggested that the reason why the Treasury considered so few trusts would be affected by the changes was that “there has been no reason until now to report them to the Revenue for the purposes of inheritance tax”.³³⁶ Media reports also made it clear that practitioners were concerned that the new rules would affect not only accumulation and maintenance and interest in possession trusts, but also life insurance policies written into trust.³³⁷

108. The new rules were published in the Finance Bill on 7 April.³³⁸ HM Revenue and Customs published a note alongside the Bill, intended to provide guidance on the new rules.³³⁹ This stated:

The Finance Bill makes absolutely clear that there is no retrospective tax charge. In particular, no one who wrote a life insurance policy into trust before Budget Day will have to pay an inheritance tax charge. All of these continue to be exempt from inheritance tax as they were before the Budget. This means that statements about millions of people being affected by the change remain simply incorrect ... As the Government has repeatedly made clear ... this measure will affect only a very small number of very wealthy people.³⁴⁰

109. With respect to the new rules on the tax treatment of accumulation and maintenance and interest in possession trusts, we are concerned that estimates of the expected numbers of affected trusts vary so widely between Government and practitioners. If the Government’s estimate, that the new rules will affect “only a very small number of very wealthy people” is correct, then the Government needs to provide much more detailed information about its estimates, in order to allay taxpayer and industry concerns. **We are concerned that a legitimate measure designed to reduce tax avoidance may penalise trusts established to protect family members and consider that the issue merits further consideration. We recommend that the Government provide detailed information about how it has arrived at its estimate that the new rules on the tax treatment of certain trusts will affect only “a minority of a minority” of 100,000 discretionary trusts. This information should be provided prior to consideration in Committee of the House of Commons of Clause 57 of, and Schedule 20 to, the Finance Bill.**

110. The Government has presented this measure as a tax avoidance measure, and has justified its lack of consultation on this basis. Mr Whiting told us that the affected trusts are used as “ordinary management devices”, not “avoidance devices”.³⁴¹ **In future, we suggest that the Treasury considers the benefits of undertaking appropriate consultation on measures such as those changing the tax treatment of certain trusts, where there is a strong argument that people have been quite properly planning their affairs on the basis of explicit exemptions in tax legislation.**

335 For example, *Financial Times*, ‘Tax on trusts set to affect ‘millions of wills’’, 4 April 2006.

336 Letter to *The Times* from Edward Nugee QC, 27 March 2006

337 For example, *Financial Times*, ‘Chancellor of the Exchequer’s crackdown has wide impact’, 4 April 2006.

338 Clause 157 and Schedule 20

339 HMRC guidance note, ‘Clause 157 and schedule 20–Rules for trusts’, 7 April 2006; available at www.hmrc.gov.uk.

340 *Ibid.*

341 Q 138

Planning gain supplement

111. The 2005 Pre-Budget Report announced a consultation into a planning-gain supplement (PGS), based on a recommendation made by Kate Barker in her study of housing supply.³⁴² The PGS is designed to help finance the infrastructure needed to stimulate and service proposed housing growth and ensure that local communities better share in the benefits that growth brings. The introduction of PGS would be accompanied by a scaling back of planning obligations to make the planning system more efficient and transparent. In its report on the Pre-Budget Report, the Committee recommended that the Treasury consults fully and appropriately on the proposals, to ensure that the optimum balance is struck between raising revenues to improve local infrastructure, whilst not deterring landowners from selling their land for housing development or compromising appropriate planning safeguards. In particular, the Committee noted that it expects the Treasury to give full consideration to applying lower rates (or a total exemption) for PGS applied to brownfield sites. Mr Whiting told the Committee that the consultation on the PGS, which closed on 27 February 2006, had “been good because it has been open and in very early stages ... the next step should be some broad proposals and we can carry on the consultation loop again”.³⁴³ Mr Weale noted that the key issue surrounding the success of the PGS is “whether the tax is expected to be permanent or temporary. If in the run-up to the next general election, opposition parties were to say they would abolish the tax, there is obviously quite a strong incentive on landowners to withhold land until after the tax has been abolished. On the other hand, if there is a cross-party consensus, then the tax is much more likely to be successful”.³⁴⁴ The Budget noted that further announcements on PGS implementation will be made by the end of the year.³⁴⁵

The Private Finance Initiative

112. The Private Finance Initiative (PFI) was announced in 1992, with the aim of increasing the involvement of the private sector in the provision of public services. PFI entails transferring the risks associated with public service projects to the private sector in part or in full. Where a private sector contractor is judged best able to deal with risk, such as construction risk, then these responsibilities should be transferred to the private sector contractor. Where the private sector is deemed less able to manage the project’s risks, such as whether demand will be high enough, then at least some of the responsibility must remain within the public sector.³⁴⁶ Our predecessor Committees have undertaken three inquiries into PFI:

- a general inquiry in Session 1995–96 which highlighted a number of issues relating to value for money and the transfer of risk which the then Committee considered could only be resolved when PFI projects were more widespread and more developed;³⁴⁷

342 *Review of housing supply*, Final Report—recommendations, March 2004, para 32, p 8

343 Q 120

344 Q 121

345 *Budget 2005*, Para 3.109, p 69

346 See *The Private Finance Initiative*, Research Paper 03/79, House of Commons Library, 21 October 2003

347 Treasury Committee, Sixth Report of Session 1995–96, *The Private Finance Initiative* HC 146

- a further inquiry into the PFI during the 1999–2000 Session, which noted that PFI projects would be likely to be successful where they genuinely combine capital and service requirements, where the risks are primarily commercial, where scope for innovation exists, and with skilled and committed public sector management;³⁴⁸ and
- an inquiry specifically into the handling of the joint Inland Revenue and HM Revenue and Customs STEPS PFI project in 2002–03, which looked at the administration of the transaction to transfer ownership and responsibility for some 600 properties to the Mapeley Group. In particular, this inquiry investigated the implications for the administration of the transaction of Mapeley’s decision to adopt an offshore structure to minimise its tax liabilities ensuing from the transaction.³⁴⁹

113. The PFI has meant that more capital projects have been undertaken for a given level of public expenditure and public service capital projects have been brought on stream earlier. To the date of the Budget, there have been over 700 PFI projects agreed, with a total value of over £46 billion. This includes 500 projects which have been completed and are operational, including 185 new or refurbished health facilities, 230 new or refurbished schools and 43 transport projects. The total PFI deal pipeline over the next five years is around 200 projects worth £26 billion in capital value.³⁵⁰

114. In evidence to the Committee, Professor Talbot said that he believed there were “some obvious managerial problems” arising from PFI projects. For example, he noted that the Government had entered into contracts where companies are required to provide both property development services and facilities management services, despite there being clear differences in the skills and experience needed to successfully deliver in each of these areas. Professor Talbot was also concerned that the Government was tied into long contracts, even though Government policy needs to react to the changing environment. For example, “GCHQ had major problems because of the sudden change post-9/11, they suddenly had to expand what they were doing, so there were major structural problems because of that”. Professor Talbot told the Committee that the Treasury was moving to separate out “soft services” from contracts and that this made “an awful lot of sense”, but that the long length of PFI contracts was “always going to cause problems”, given that public policy is likely to change over time.³⁵¹ Treasury officials told the Committee that “overall PFI continues to provide a useful vehicle for procurement in some circumstances. It is a small proportion of overall procurement in the public sector. We have adapted and modified the system as we have learnt lessons from experience. For example, we are no longer recommending PFI projects for IT systems”.³⁵² Mr Martin told the Committee that there “is a challenge around the sort of management of these contracts ... We have put in place a number of things to improve the skill and quality of management both in the contracting process and then in the actual management of the contracts”.³⁵³ **We note Professor Talbot’s concerns at the**

348 Treasury Committee, Fourth Report of Session 1999–2000, *The Private Finance Initiative* HC 147

349 Treasury Committee, Fourth Report of Session 2002–03, *The handling of the joint Inland Revenue/Customs and Excise STEPS PFI project* HC 184

350 *PFI: strengthening long-term partnerships*, HM Treasury, March 2006, p 13

351 Q 129

352 Q 229

353 Q 230

length, terms and scope of some PFI contracts. We welcome publication of the Treasury document entitled *PFI: strengthening long-term partnerships at the time of the Budget*, which examines issues to which we will return in due course.

Additional payments to pensioners

115. The Government has made a number of winter fuel payments and additional “one-off” payments to pensioners over the past 10 years. In Budget 2005, the Government stated that it understood “the position of older people on fixed incomes facing pressures such as council tax bills. Alongside Council Tax Benefit for the poorest pensioners, the Government believes that it is right to help elderly households with their council tax. This Budget announces an additional payment to all council tax paying households with someone over 65”.³⁵⁴ This meant that “some 4.7 million council tax paying households with someone over 65 will receive £200”.³⁵⁵ We asked the Chancellor of the Exchequer why the Government did not propose to repeat the £200 payment in Winter 2006. The Chancellor of the Exchequer told us that “we said in the last Budget that this was for the year and we made no commitment for it beyond that”.³⁵⁶

116. The Chancellor of the Exchequer told us that “it is because we understand the difficulties that people have faced in relation to the council tax that we have put in this extra money from central government direct to local authorities...[and we have] had a special allocation this year which was decided only a few weeks ago that enabled local authorities to have a lower rate of increase of the council tax.”³⁵⁷ The rise in council tax bills in 2006/07 has been announced as 4.5%.³⁵⁸ In combination with the rise of 4.1% in 2005/06, the past two years represent the slowest rise in the council tax since 1997. The latest figures available from the Department for Work and Pensions indicate that in 2003/04 (the latest year for which figures are available) pensioner households received £1.47 billion in council tax benefit, but that between £880 million and £1,140 million remained unclaimed. In line with the rising oil and gas prices, household utility bills have risen by 13.3% over the past twelve months.³⁵⁹ With regard to the rise in heating bills faced by pensioners, the Chancellor of the Exchequer told us that “to keep heating bills down there is an offer of free central heating for large numbers of pensioners, support for the installation of central heating...free insulation for many pensioners and financial support for every pensioner to be able to insulate their homes and these will bring down energy bills”.³⁶⁰ He also told that “every pensioner still has the winter allowance of £200 and £300 for the over-80s” and that this was guaranteed over this Parliament.³⁶¹ **We note that the rise in council tax over 2005–06 and 2006–07 is forecast to be the lowest since 1997. However, it is important that the Government understands the effect of rises in council**

354 HM Treasury, *Budget 2005*, para 5.66, p 115

355 *ibid*

356 Q 402

357 Q 438

358 ODPM news release, 27 March 2006, *Council tax increases for 2006 announced*

359 ONS, Consumer price indices, press release, 21 March 2006

360 Q 451

361 Q 405

tax and household utility bills on pensioners and others on fixed incomes. We note that the Government does not propose to repeat the £200 council tax rebate for pensioners. The Government should take action to improve the take-up of council tax benefit amongst pensioner households. We welcome the guarantee of the higher winter fuel payment of £200 and £300 for the over 80s for the rest of this Parliament, alongside the support for insulation and central heating for pensioner households. In the light of continued volatility in energy markets and announcements of future gas and electricity price rises, we recommend that the Government re-assess the situation at the time of the 2006 Pre-Budget Report and take further action if necessary.

Independence for statistics

117. Following recommendations from the Statistics Commission, the Royal Statistical Society, the Treasury Committee and others, the Chancellor of the Exchequer announced to Parliament on 28 November 2005 that the Government intended to publish plans early in 2006 “to legislate to make the Office for National Statistics independent of Government, making the governance and publication of official statistics the responsibility of a wholly separate body at arm’s length from Government and fully independent of it”.³⁶² The Government published a consultation paper alongside the Budget, *Independence for statistics*, setting out its proposals to “build on earlier reforms, reinforcing the independence, integrity and quality of statistics produced in government”.³⁶³ The consultation process is due to end on 14 June 2006.

118. The Government proposes to “legislate for the creation of an independent governing board, with responsibility for meeting an overall objective for statistical quality and integrity”. The board would:

- be responsible for assessing and approving all National Statistics against a statutory-based code of practice;
- report directly to, and be accountable to, Parliament;
- be established as a Non-Ministerial Department, with special funding arrangements outside the normal Spending Review process;
- be appointed through fair and open competition.³⁶⁴

The Government “intends to retain the current decentralised system of statistical production”, whereby statistics are produced within individual government departments. Ministers would remain “wholly responsible” for statistics produced by their departments which are not National Statistics, and Ministers will decide whether these statistics should become National Statistics, subject to the board’s approval.”³⁶⁵ The proposals would result in the Statistics Commission being wound up, as its “roles and responsibilities ... will be

362 HC Deb, 28 November 2005, col 78W

363 HM Treasury, *Independence for statistics: a consultation document*, March 2006, p 1

364 *Independence for statistics*, para 4.6

365 *Independence for statistics*, para 4.15

subsumed within the new board”.³⁶⁶ The consultation paper states that “it will be a matter for the devolved administrations to decide what action they might take with respect to their own responsibilities given the Government’s proposed reforms”.³⁶⁷

119. At this stage, we do not propose to comment on the substance of the Government’s consultation paper, *Independence for statistics*. We expect that the Treasury Sub-Committee will shortly undertake an inquiry into the Government’s proposals, which will result in a much fuller analysis than we are able to give here. We note only that, in terms of the timetable for progressing the proposals, the Government expects to publish its response to the consultation process after the summer break, and then to seek to introduce a Bill to Parliament in Autumn 2006.³⁶⁸

366 *Independence for statistics*, para 4.48

367 *Independence for statistics*, para 4.47

368 Q 310

Conclusions and recommendations

Energy prices

1. The rise in energy prices appears, so far, to have had muted second-round effects. We note the Government's proposed actions to encourage an "independent investigation" into European gas markets (and energy markets in general) and we recommend that the Government provide an update on the outcome in the 2006 Pre-Budget Report. (Paragraph 7)

The output gap

2. There are some differences between the Treasury's forecast for the size of the output gap going forward, and the forecasts of independent observers and some members of the Bank of England Monetary Policy Committee. We note that the concept of the output gap has significant, and possibly insuperable, measurement and definitional problems, particularly given the growing economic importance of migration and its potential influence on the output gap, but we recommend that the Treasury publish a technical note on its methodology for measuring the output gap. (Paragraph 10)

Consumer spending

3. While the forecasts of the Budget do not suggest that consumer spending growth will reach the previously high levels seen in the recent past, several outside observers note significant downside risks to these forecasts. We recommend that the Treasury provide all necessary assistance to the ONS in its task of understanding and measuring consumer spending, such as on services rather than retail sales, to help improve the quality of consumer spending forecasts. (Paragraph 13)

The labour market and migration

4. We note the recent slight weakening in the labour market, and recommend that the Treasury monitor the situation closely. We also note the recent publication of research by the Department for Work and Pensions into migration effects of people moving into the United Kingdom from the new European Union countries and the Home Secretary's statement on a points-based immigration system. However, we recommend that the Government now undertake a more wide-ranging study of the effects of all migration, both high- and low-skilled, looking at areas such as wages, productivity, business investment and the effect on aggregate labour supply overall. (Paragraph 16)
5. We welcome the moves in the Budget to encourage a higher rate of female labour participation, but note that these only form part of the way in which the Government will be expected to respond to the recommendations in the report of the Women in Work Commission. (Paragraph 17)

Productivity

6. We note the closing of the productivity gap (on certain measures) with international competitors. However, we also note the debate on the productivity figures, and recommend that the Treasury monitor those figures closely to ascertain the effect of labour hoarding. We also note the work being done to improve the public sector productivity figures, and recommend that the Treasury and the ONS ensure that there is significant public consultation before the new official statistical standards are disseminated. (Paragraph 20)

Business investment

7. The statistics on business investment are prone to revision, and may also under-report investment. We recommend that the Treasury, in conjunction with the Bank of England as a prime user of these statistics, work with the Office of National Statistics to refine both the methodology and definitions of the business investment statistics, especially given the greater proportion of service sector activity in the United Kingdom. We further recommend that the Treasury continue to monitor the performance of business investment (including any effects from under-reporting as a result of weaknesses in the official statistics), including by international comparisons. (Paragraph 25)

External demand and United Kingdom trade

8. Should the Treasury's forecast of the zero input to GDP growth from net trade be achieved, we recognise that this would be a positive break from the recent trend. (Paragraph 26)

The golden rule

9. We note the Treasury's projections which show that the Government is on course to meet the golden rule after the end of this economic cycle. We remain concerned that fiscal policy towards the end of a cycle may be constrained unnecessarily by spending levels or data classifications from, say, 12 years earlier, at the start of the cycle. In particular, revisions to data might be held to require sudden and undesirable changes to tax or spending in the final years of the cycle for the sole purpose of meeting the mechanical calculation implicit in the golden rule. We remain of the view that it would be appropriate to review the fiscal rules now such that any improved formulation of the rule could be introduced at the start of the next cycle. (Paragraph 38)

Sustainable investment, liabilities and Whole of Government Accounts

10. As we noted in our Report on the 2005 Pre-Budget Report, while criticisms of the arbitrary level of the limit imposed by the sustainable investment rule have some merit, these do not outweigh the essential role that the rule plays in ensuring that Government expenditure and investment today do not lead to an unfair or unsustainable burden on future generations. However, looking forward, the

sustainable investment rule will need to be considered in the context of the Government's balance sheet to be prepared under the Whole of Government Accounts (WGA) programme, which is discussed further below. (Paragraph 45)

11. Future public sector pensions can be paid from future tax revenues and therefore long-term forecasts of cash payments are directly relevant when considering fiscal sustainability. We recommend that the estimated present value of the Government's public sector pension liabilities today, which is useful for the purposes of comparing the pensions provision for public sector employees with that for employees in the private sector, be published regularly. (Paragraph 50)
12. The publication of WGA is likely broadly to coincide with the end of the current economic cycle, although estimates in WGA may be volatile over the first few sets of accounts as valuation issues are ironed out. However, once any valuation concerns have been resolved, it may be timely to revisit the sustainable investment rule to ensure that estimates of public sector liabilities included in the Government's accounts are borne in mind in any review of the sustainable investment rule. (Paragraph 51)

The Comprehensive Spending Review

13. A full understanding of the costs associated with policy options arising from the recent Report of the Parliamentary Ombudsman on final salary occupational pensions is essential to a proper public and parliamentary debate on that report in the context of the Comprehensive Spending Review. We recommend that the Government publish estimates of the cost of various options for compensating affected pensioners in net present value terms as part of the Department for Work and Pensions' further reply to the Report of the Parliamentary Ombudsman, including options for expanding the Financial Assistance Scheme. (Paragraph 60)
14. It is important that the Government clarifies at an early stage whether the "modernisation fund" proposed as part of the spending settlements for the Department for Work and Pensions, HM Revenue and Customs, the Treasury and the Cabinet Office is included within the new totals for those departments or is to be accounted for separately and provides a breakdown of the proposed expenditure between the departments. (Paragraph 65)
15. The early announcement of a decision on the overall spending levels of the Home Office provides an opportunity to focus on the distribution of expenditure within that total and the savings to be expected in specified areas of the Home Office budget, although it does also constrain the forthcoming national debate on spending priorities in relation to services funded through the Home Office. (Paragraph 66)
16. We welcome the Government's decision to initiate a national debate as part of the Comprehensive Spending Review. It is important that this debate is set in a context which enables it to amount to an opportunity for full consideration of options and priorities, rather than simply providing an opportunity for departments to canvass for public support for their bids for increased expenditure. In this context, it is vital that departmental select committees of the House of Commons ensure that they are

fully engaged with the process. As a first step, we expect to hold an initial inquiry on spending matters following the publication of the report expected in mid-2006 on the spending challenges. To assist with timely parliamentary scrutiny of matters arising from that report, we urge the Government to ensure that this document is published no later than the end of June 2006. (Paragraph 68)

Efficiency savings and the public sector workforce

17. We welcome the contribution made by the recent National Audit Office study to understanding of the Efficiency Programme. We also welcome the Treasury's commitment to work closely with the National Audit Office on the issues identified in that study. We continue to believe that public and parliamentary confidence in the Programme, and in the effectiveness of the central coordinating role played by the Office of Government Commerce, would be enhanced by the provision of more information about measurement systems and data in a single source in Red Books and Pre-Budget Reports. We recommend that such documents contain further analysis of progress of the Efficiency Programme as a whole, including an indication of the proportions of the overall reported savings that are attributable to central and local government and that are cashable and non-cashable, as well as analysis of savings in relation to the themes identified in the Gershon review—back office functions, transactional services, procurement, policy, funding and regulation, and productive time. We further recommend that such documents include an update on verification, in cooperation with the National Audit Office, of previously reported savings. (Paragraph 76)
18. We welcome the Government's determination to embed the efficiency agenda as part of the process for spending allocations during the Comprehensive Spending Review. We recommend that the initial report as part of that Review to be published in mid-2006 contain initial proposals for consultation on how an Efficiency Programme for the period from April 2008 onwards can be monitored and reported on. As part of such proposals, we expect the Government to give consideration to ensuring that efficiency projects are designed and measured using net as well as gross savings in order that the investment necessary to secure efficiency savings can be properly measured and assessed. (Paragraph 77)
19. We recommend that, in seeking to embed a culture of efficiency in Government departments during the period covered by the Comprehensive Spending Review, the Government places greater emphasis on delivering and reporting on targets for continued reductions in departmental administration budgets rather than on workforce reductions attributed to efficiency projects. (Paragraph 79)

Poverty and the tax system

20. The introduction of tax credits has contributed to the reduction in the number of households facing the highest marginal deduction rates of 70% or more from 740,000 before Budget 1998 to 240,000 under the 2006–07 system of tax and benefits.. However, the number of households facing marginal deduction rates in the region of 60% to 70% has increased since 1997 and now appears to have levelled off at around 1.5 million households. We recommend that the Treasury analyse the characteristics

and income distributions of households facing marginal tax rates in the region of 60% to 70% and the extent to which these high marginal tax rates are discouraging people from entering the workforce, from working longer hours or from acquiring additional skills. We further recommend that the Treasury publish the findings of such analysis at the time of the 2006 Pre-Budget Report. (Paragraph 85)

21. We recommend that, as part of its report, due to be published in mid-2006 on the challenges for the Comprehensive Spending Review, the Government set out in greater detail what existing measures it has in place to meet its target of halving child poverty by 2010–11, what additional measures it is considering, and what assessment it has made of the current likelihood that the 2010–11 target will be met. In particular, given that about one million more children are defined as living in poverty after housing costs are taken into account, as opposed to before housing costs are taken into account, we recommend that the Government set out how it intends to address further the issue of housing costs in order to reduce levels of child poverty. (Paragraph 92)

Environmental taxation

22. We urge the Government to re-examine whether it is making the fullest possible use of taxation instruments as a mechanism to achieve the Government's environmental targets. (Paragraph 99)
23. In particular, we are puzzled by the Government's justification of its decision to freeze air passenger duty (APD) for the fifth year running. In the context of the challenges facing the United Kingdom in reducing its greenhouse gas emissions, we find the Government's attempt to justify freezing air passenger duty (APD) for the fifth year running to be incoherent and unconvincing. It is telling that the only aviation-specific taxation measure contained in the Budget is to widen the scope of the European APD to include Croatia—meaning that it is now £15 cheaper to fly economy class to Croatia. (Paragraph 100)
24. Consequently, we recommend that the Government give serious consideration to increasing rates of APD. In the context of the wider problem of climate change, we consider it entirely inappropriate that, between 2000 and 2004, tax receipts from APD should have fallen by 8% whilst passenger numbers have risen by 35%. If this trend continues, the Government risks allowing APD to become an ineffective policy instrument which does nothing to recognise or address the contribution made by aviation to greenhouse gas emissions. (Paragraph 101)
25. We accept the point made by both the Chancellor of the Exchequer and officials that it is important to bring aviation within the EU Emissions Trading Scheme (ETS). Time is running out for aviation emissions to be subject to the ETS before 2012. Consequently, for the Government to say that it is seeking to bring aviation within the ETS is only a partial response to the pressing issue of climate change currently facing the United Kingdom. In addition to continuing to press for action at the EU level, the Government must also act at a domestic level. We refer the Government to its undertaking, in its Statement of intent on environmental taxation, to “aim to reform the tax system to increase incentives to reduce environmental damage”. We

recommend that the Government give urgent consideration to how it can best use the tax system to increase incentives to reduce the harmful environmental effects of aviation. (Paragraph 102)

Changes to the tax treatment of trusts

26. We are concerned that a legitimate measure designed to reduce tax avoidance may penalise trusts established to protect family members and consider that the issue merits further consideration. We recommend that the Government provide detailed information about how it has arrived at its estimate that the new rules on the tax treatment of certain trusts will affect only “a minority of a minority” of 100,000 discretionary trusts. This information should be provided prior to consideration in Committee of the House of Commons of Clause 57 of, and Schedule 20 to, the Finance Bill. (Paragraph 109)
27. In future, we suggest that the Treasury considers the benefits of undertaking appropriate consultation on measures such as those changing the tax treatment of certain trusts, where there is a strong argument that people have been quite properly planning their affairs on the basis of explicit exemptions in tax legislation. (Paragraph 110)

The Private Finance Initiative

28. We note Professor Talbot’s concerns at the length, terms and scope of some PFI contracts. We welcome publication of the Treasury document entitled *PFI: strengthening long-term partnerships* at the time of the Budget, which examines issues to which we will return in due course. (Paragraph 114)

Additional payments to pensioners

29. We note that the rise in council tax over 2005–06 and 2006–07 is forecast to be the lowest since 1997. However, it is important that the Government understands the effect of rises in council tax and household utility bills on pensioners and others on fixed incomes. We note that the Government does not propose to repeat the £200 council tax rebate for pensioners. The Government should take action to improve the take-up of council tax benefit amongst pensioner households. We welcome the guarantee of the higher winter fuel payment of £200 and £300 for the over 80s for the rest of this Parliament, alongside the support for insulation and central heating for pensioner households. In the light of continued volatility in energy markets and announcements of future gas and electricity price rises, we recommend that the Government re-assess the situation at the time of the 2006 Pre-Budget Report and take further action if necessary. (Paragraph 116)

Formal Minutes

Thursday 20 April 2006

Members present:

Mr John McFall, in the Chair

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

The 2006 Budget

The Committee considered this matter.

Draft Report (The 2006 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 9 read and agreed to.

Paragraph 10 read, amended and agreed to.

Paragraphs 11 to 15 read and agreed to.

Paragraph 16 read, amended and agreed to.

Paragraph 17 read and agreed to.

Paragraphs 18 and 19 read, amended and agreed to.

Paragraphs 20 to 35 read and agreed to.

Paragraph 36 read, as follows:

“In July 2005 the Chancellor of the Exchequer told the Committee that he considered that the Government would meet the golden rule over the present cycle even without the revision to the start date of the current cycle announced at that time. However, the IFS has calculated that, based on projections in the 2005 Pre-Budget Report, the golden rule would be narrowly missed over the period defined as the cycle in Budget 2005, with a cumulative deficit over the seven year cycle estimated at £1.9 billion. The minor revisions to the historical and projected budget surpluses over the cycle shown in the 2006 Budget compared with the 2005 Pre-Budget Report do not change this conclusion. This is not necessarily cause for fiscal concern. In evidence to the Committee on the 2005 Pre-Budget Report, Mr Chote cautioned that ‘the golden rule at best was only ever a reasonable rule of

thumb ... The idea that over a period of seven or twelve years if you beat it by one billion that is terrific and you miss it by one billion that is a disaster just is not sustainable on any analytical grounds.’ Furthermore, although the golden rule is not framed in a symmetrical way, given that one of the objectives of the golden rule is intergenerational fairness, it could be considered appropriate for the Government to run an approximately balanced budget over the course of an economic cycle. It is also important to note that forecasts of the fiscal balance, the balance between current spending and investment and GDP can be subject to significant revision. As we noted in our Report on the 2005 Pre-Budget Report, the IMF concluded in December 2005: ‘The fiscal rules are playing an important role in disciplining fiscal policy, although at times this role is overshadowed by peripheral controversies. We strongly endorse the objectives of the golden rule ... However, the current form of the golden rule requires a precise dating of the cycle. Not only is this difficult, but the adjustments in the definition of the cycle have proved an unhelpful distraction from the more important considerations of what a sustainable fiscal policy is and how it should be achieved.’”

An Amendment made.

Another Amendment proposed, in line 8, after the words last inserted, to insert the words “The figures contained in Table 3 above, based on figures contained in the public sector finances, National Statistics and the 2006 Budget, further confirm that the golden rule would have been narrowly breached had not the dates of the economic cycle been reassessed.”—(*Mr David Gauke*.)

Question put, That the Amendment be made.

The Committee divided.

Ayes, 4

Mr Michael Fallon
Mr David Gauke
Mr Brooks Newmark
Peter Viggers

Noes, 7

Jim Cousins
Angela Eagle
Ms Sally Keeble
Mr Andrew Love
Kerry McCarthy
Mr George Mudie
Mr Mark Todd

Paragraph, as amended, agreed to.

Paragraphs 37 and 38 agreed to.

A paragraph—(*Mr David Gauke*)—brought up and read, as follows:

“Given that the Chancellor of the Exchequer has previously given evidence to the Committee that the golden rule would have been met over the period from 1999–2000 to 2005–06, we consider that his reasons for not providing his current assessment to the Committee were unsatisfactory. Nonetheless, it would appear that the golden rule would have been breached over this period.”

Question put, That the paragraph be read a second time.

The Committee divided.

Ayes, 4

Mr Michael Fallon
Mr David Gauke
Mr Brooks Newmark
Peter Viggers

Noes, 7

Jim Cousins
Angela Eagle
Ms Sally Keeble
Mr Andrew Love
Kerry McCarthy
Mr George Mudie
Mr Mark Todd

Paragraphs 39 to 49 read and agreed to.

Paragraph 50 read, amended and agreed to.

Paragraphs 51 to 55 read and agreed to.

Paragraph 56 read, amended and agreed to.

Paragraphs 57 to 59 read and agreed to.

Paragraph 60 read, as follows:

“We are not examining in this Report the merits of the Parliamentary Ombudsman’s Report on final salary occupational pensions and of the Government response. Our examination is limited to consideration of the possible costs of certain actions arising from that Report in the context of the forthcoming Comprehensive Spending Review. The Ombudsman has made clear that she does not view the Financial Assistance Scheme as presently constituted as an adequate and appropriate remedy. The Government has confirmed its willingness to re-examine the Scheme, and presented an estimate of the costs of full implementation of the Ombudsman’s recommendations in cash terms. The Pensions Commission has noted that there are a number of ways of presenting the future cost of pensions, but expressing them in cash terms is ‘the least useful because it exaggerates how expensive something will feel’. Treasury appraisal guidance indicates that costs should be expressed in present value terms, using an appropriate discount rate. There have also been no figures put forward by the Government for the possible costs of expanding the Financial Assistance Scheme by, for example, aligning the benefits of the Scheme to those available under the Pension Protection Fund. We asked the Chancellor of the Exchequer whether he agreed with the Prime Minister that it would cost £15 billion to comply with the Ombudsman’s recommendations. The Chancellor of the Exchequer told us that ‘The figure is one that the Department for Work and Pensions is dealing with ... There have been a number of recommendations from this report and the Department for Work and Pensions is looking at it. There will be a fuller reply at a later stage.’ **A full understanding of the costs associated with policy options arising from the recent Report of the Parliamentary Ombudsman on final salary occupational pensions is essential to a proper public and parliamentary debate on that report in the context of the Comprehensive Spending Review. We recommend that the Government publish**

estimates of the cost of various options for compensating affected pensioners in net present value terms as part of the Department for Work and Pensions' further reply to the Report of the Parliamentary Ombudsman, including options for expanding the Financial Assistance Scheme."

Question put, That the paragraph stand part of the Report.

The Committee divided.

Ayes, 7

Noes, 4

Mr Michael Fallon
Mr David Gauke
Ms Sally Keeble
Mr George Mudie
Mr Brooks Newmark
Mr Mark Todd
Peter Viggers

Jim Cousins
Angela Eagle
Mr Andrew Love
Kerry McCarthy

Paragraphs 61 to 75 read and agreed to.

Paragraph 76 read, amended and agreed to.

Paragraphs 77 to 108 read and agreed to.

Paragraph 109 read, amended and agreed to.

Paragraphs 110 and 111 read and agreed to.

Paragraph 112 read, amended and agreed to.

Paragraph 113 read and agreed to.

Paragraph 114 read, amended and agreed to.

Paragraphs 115 to 119 read and agreed to.

Summary read and agreed to.

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

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

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

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

Several Memoranda were ordered to be reported to the House.

[Adjourned till Tuesday 25 April at quarter to ten o'clock

List of witnesses

Monday 27 March 2006

page

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

Ev 1

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

Ev 12

Wednesday 29 March 2006

Mr Jon Cunliffe, Second Permanent Secretary and Managing Director of Macroeconomics and International Finance, **Mr Mark Neale**, Managing Director, Budget, Tax and Welfare, **Ms Sarah Mullen**, Director, Public Spending, and **Mr Chris Martin**, Head of Productivity Team, HM Treasury

Ev 23

Thursday 30 March 2006

Rt Hon Gordon Brown, MP, Chancellor of the Exchequer, **Mr Jon Cunliffe**, Second Permanent Secretary and Managing Director of Macroeconomics and International Finance, **Mr Michael Ellam**, Director of Policy and Planning, **Mr Mark Neale**, Managing Director, Budget, Tax and Welfare, **Ms Sarah Mullen**, Director, Public Spending, and **Mr Chris Martin**, Head of Productivity Team, HM Treasury

Ev 42

List of written evidence

1	The National Audit Office	Ev 66
2	Letter to the Chairman from The Pensions Regulator	Ev 71
3	Anne Redston	Ev 71
4	The Institute of Chartered Accountants in England and Wales	Ev 74
5	John Whiting	Ev 76
6	Professor David Heald	Ev 79
7	HCI Alliance	Ev 82
8	John Butler, HSBC	Ev 84
9	Bridget Rosewell	Ev 87
10	Professor Sheila Dow	Ev 89
11	Confederation of British Industry	Ev 90
12	Law Society	Ev 98
13	Microsoft	Ev 101

List of unprinted written evidence

Additional papers include the following, which have been reported to the House. To save printing costs they have not been printed and copies have been placed in the House of Commons Library where they may be inspected by Members. Other copies are in the Record Office, House of Lords and are available to the public for inspection. Requests for inspection should be addressed to the Record Office, House of Lords, London SW1 (Tel 020 7219 3074); hours of inspection are from 9:30am to 5:00pm on Mondays to Fridays.

Charles Eales	Alex Wilson	Jacqueline White	Richard Galliers
Mick Pilsworth	Michael Arkell	George Howells	Martyn Ryan
Bernard Spring	Graham Seeley	Fidelma Carolan	Frank Bebbington
Steven Briggs	Phillip Mathe	Geoff Garside	John Hollow
Dr James T Wise	Chris Howell	Marisa Connolly-Alvarez	Viv Duggan
Mike Clayton	Andy Jerram	John Power	Nick Winch
John Mills	Steve Kendall-Smith	Stuart Jones	Tim Watson
Jane Rockel	Paul Dolman-Darrell	Jane Vivier	Adrian Metson
Dave Quinlan	Nick Kerin	Janine Ramsey	Diane Shilton
Peter Godwin	John Griffin	Alessandra Verrini	David Clinker
Richard Kendall-Smith	Phil Wood	Mark Faulkner	Richard Allen
Darren Spence	Lawrence Howes	Trevor Barnes	Anne Wilson
Jo Guy	Richard Dale	Allan Collins	Tim Reed
Granville Smithies	Harold Shand	Ron Nelson	Michael Bishop
Phillip Westerman	David Hards	Robin Seaman	Roxy Grimshaw
Michael Baker	Ian Snadden	Stuart Macdonald	Karen Hoyle
Steve Harman	Ben Debnath	Colin Stevens	Philip Butterworth
Steve Hill	Alan Hunt	Seb Fitzjohn	Judy Stirling
Nigel Yates	Bill Joss	Patricia O'Connor	Tim Walker-Sharp
Marilyn Patrick-Smith	Fiona Chamberlain	Melvyn Baber	Michelle Beck
Mike Rowley	Anne Sadler	Martin Prescott	K E Wilson
Neil Pease	Brian Curel	Dave Pickersgill	Carol Long
Roger Jones	Austin Platt	Anthony Donaldson	Ian Clark
Trevor Finlay	Susan Hayward	Nicola Green	Danny Clifford
Lindsay Barnes-Batty	Richard Hook	Pauline Lyon	S T Hannam
John Cornall	Ruth Schofield	Paul Crowther	Stanley Wynd
Stephen Slater	Tristan Wilkinson	Caroline Lewis	John Reid
David Green	Mandy Peay	Alastair Pride	James McBrearty
Ian Brooks	Billy Harley	Lucinda Kirkham	John Savage
Bridget Kerle	Ian Irving	Steve Floyd	Stephen Collier
Gordon Lindsay	Clive Farrow		
	John Power		

List of Reports from the Treasury Committee during the current Parliament

Session 2005–06		Report
First Report	The Monetary Policy Committee of the Bank of England: appointment hearing	HC 525
Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861