



House of Commons  
Treasury Committee

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# The 2007 Budget

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**Fifth Report of Session 2006–07**

***Volume I***

*Report, together with formal minutes*

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## The Treasury Committee

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

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### Publications

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

### Committee staff

The current staff of the Committee are Colin Lee (Clerk), Fiona McLean (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young, Aruni Muthumala and Dominic Webb (Committee Specialists), Lis McCracken (Committee Assistant), Michelle Edney (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

### Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is [treascom@parliament.uk](mailto:treascom@parliament.uk). Media inquiries should be addressed to Laura Humble on 020 7219 2003.

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## Summary

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### *The economy*

The overall economic outlook remains broadly unchanged from that in last year's Pre-Budget Report, although there are signs of upward pressure on inflation and some evidence of re-balancing of the economy. We observe that migration of uncertain magnitude and the greater stability of the economy may reduce the value of the concept of the output gap as a tool of economic analysis and we recommend that the Government examine the impact of these factors on the role which the concept of the output gap should play in Treasury forecasting and analysis.

### *The public finances*

We note the very significant downward revision of forecast North Sea oil revenues in 2006–07 and 2007–08 compared with the 2006 Pre-Budget Report. We are concerned that the Treasury's estimate at Budget 2007 is so much lower than its forecast in the 2006 Pre-Budget Report, only three months earlier. We believe that the volatility of North Sea oil revenues constitutes a risk to taxation revenues in the future.

We examine the operation and interpretation of the two fiscal rules—the golden rule and the sustainable investment rule. We expect the Treasury to continue its practice of counting the last year of the present economic cycle as the first year of the next economic cycle for the purposes of assessing whether or not the Government meets the golden rule. We reiterate our recommendation that the Government review the golden rule and consider how to make it more forward-looking and its application less dependent on the dating of the economic cycle. We call for the Government to give an account of the circumstances in which it would change its current interpretation of the sustainable investment rule for the next economic cycle.

### *Tax measures*

We examine the overall impact of the personal tax measures in the Budget, as well as that of trends in take-up of Tax credits. We note that, given that the personal taxation changes announced in this year's Budget will have an impact on the post-tax earnings of those who are childless and earning an income entitling them to claim Working Tax Credit, the need to increase the low take-up rate of Working Tax Credit among that group should be a priority. We therefore welcome the evidence of a recent increase in the take-up of Working Tax Credit provided by the Chancellor of the Exchequer, although we would welcome further details as to the increase in the take-up of Working Tax Credit in percentage terms. We also note the Government's efforts to increase take-up still further. However, we expect the Treasury to carefully monitor the impact of any increase in the take-up rate on the fiscal planning assumptions within Annually Managed Expenditure.

We are concerned by the recently reported rise in child poverty in 2005–06 of 100,000 children, according to the Government's preferred measure. We welcome the extra resources allocated in the Budget, which it is estimated will help around 200,000 children

out of relative poverty. We reiterate the recommendation made in our Report on the 2006 Pre-Budget Report that the Government, in reporting on the outcome of the Comprehensive Spending Review, state how it intends to meet the 2010–11 target to halve the number of children in poverty and where the resources will come from to meet that target. We welcome the Government's increased emphasis on improving incentives to work and recommend that, in reporting on the outcome of the Comprehensive Spending Review, the Government publish its analysis of the impact of improving incentives to work on meeting its child poverty targets.

We conclude that it is not clear whether measures such as the increase in the R&D tax credit and the introduction of the Annual Investment Allowance will have the desired beneficial impact on investment levels by small companies. We recommend that, prior to the 2009 Budget, the Treasury review the impact of these measures on business investment in order to ensure that the measures are having a positive impact on investment and business growth, including the impact on small businesses that do not qualify for R&D tax credit or the Annual Investment Allowance.

# 1 Introduction

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1. The Chancellor of the Exchequer, the Rt. Hon. Gordon Brown MP, delivered his eleventh Budget on Wednesday 21 March 2007.<sup>1</sup> In accordance with past practice, we held an inquiry into the Budget with a view to reporting to the House of Commons prior to the Second Reading of the Finance Bill. We held three evidence sessions in the week following the Budget—from outside experts<sup>2</sup> on Monday 26 March, from Treasury officials on Wednesday 28 March and from the Chancellor of the Exchequer on Thursday 29 March. In addition, we received a range of written evidence which is being published in Volume II of this Report. We are most grateful to all those who gave evidence to the Committee, and to Professor David Heald of Sheffield University and to Professor Colin Talbot of Manchester Business School for their specialist advice.

2. Our inquiry into the Budget is closely linked to other aspects of our programme of work.

- This Report is informed by oral evidence which we took from the Governor of the Bank of England, Mr Mervyn King, and other members of the Monetary Policy Committee (MPC) of the Bank of England on Tuesday 27 March as part of our scrutiny of the February 2007 Inflation Report.<sup>3</sup>
- This year's Budget included an announcement about overall spending levels for the years 2008–09 to 2010–11. We consider this announcement in relation to the fiscal framework and also examine some aspects of spending plans for coming years in this Report, but we will be reporting separately in due course on the prospects and processes for the 2007 Comprehensive Spending Review.
- Both the 2006 Pre-Budget Report and the 2007 Budget included environmental measures which we propose to examine in a wider context in our forthcoming Report on Climate change and the Stern review: implications for HM Treasury policy.

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1 HC Deb, 21 March 2007, cols 815–828. The accompanying Economic and Fiscal Strategy Report and Financial Statement and Budget Report was published as *Budget 2007: Building Britain's long-term future: Prosperity and fairness for families*, HC (2006–07) 342 (hereafter *Budget 2007*)

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

3 Treasury Committee, *Bank of England February 2007 Inflation Report: Oral and Written Evidence*, HC (2006–07) 414–i

## 2 The economy

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### Economic outlook

3. The 2007 Budget forecast real GDP growth of 2¾% to 3¼% in 2007 and 2½% to 3% in both 2008 and 2009.<sup>4</sup> These forecasts are unchanged from the 2006 Pre-Budget Report.<sup>5</sup> They are slightly higher than the most recent average of independent forecasts, which is for growth of 2.6% in 2007 and of 2.3% in 2008.<sup>6</sup> There has been a modest change to the Treasury's forecast of the components of GDP in 2007. Compared with the 2006 Pre-Budget Report, the 2007 Budget forecast a slightly higher contribution to growth from business investment, but a slightly lower contribution from net trade.<sup>7</sup> Dr Martin Weale of the National Institute of Economic and Social Research thought that, while his forecast for growth in 2008 was slightly lower than the Treasury's, "the overall position that the Treasury is taking is perfectly reasonable".<sup>8</sup> Professor David Miles of Morgan Stanley considered the Treasury forecast to be "slightly on the optimistic side", but went on to observe that "it clearly is not far away from the consensus at the moment and it is in no sense a ridiculously optimistic forecast".<sup>9</sup>

### The output gap

4. The output gap measures the economy's point in the economic cycle by comparing the economy's current position with an "on-trend" point. The output gap cannot be measured directly, but information can be gained from a number of indicators. A paper published by the Treasury at the time of the 2005 Pre-Budget Report listed these indicators, which included business surveys, the number of vacancies in the labour market and wage and price inflation.<sup>10</sup> In our Report on last year's Budget, we observed the measurement and definitional problems associated with the output gap,<sup>11</sup> and in our Report on last year's Pre-Budget Report, we noted the Treasury's upward revision to its trend output growth assumption and the importance of this assumption in the measurement of the output gap.<sup>12</sup> In the 2007 Budget, the Treasury stated:

the trend growth arithmetic, based on the latest National Accounts data and the Treasury's trend output assumptions, implies only a small negative output gap in late 2006, of around -¼%. This is close to estimates from a number of external forecasters, and well within their range.<sup>13</sup>

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4 *Budget 2007*, Table 2.2, p 26

5 *Pre-Budget Report 2006*, Table 2.2, p 22

6 *Budget 2007*, Table B.9, p 264

7 *Ibid*, Table B.5, p 254; *Pre-Budget Report 2006*, Table A.5, p 201

8 Q 14

9 Q 6

10 HM Treasury, *Technical note on cyclical indicators*, December 2005, Table 1, p 3

11 Treasury Committee, Fourth Report of Session 2005–06, *The 2006 Budget*, HC 994–I, para 10

12 Treasury Committee, Second Report of Session 2006–07, *The 2006 Pre-Budget Report*, HC 115, para 20

13 *Budget 2007*, para B.49, p 250

The 2007 Budget also noted the differing evidence provided by surveys of capacity utilisation on the one hand and labour market data on the other and concluded that, on balance, “capacity utilisation indicators tend to signal that output is currently close to trend, while labour market indicators point to some ongoing slack suggesting that overall the output gap may be slightly negative”.<sup>14</sup>

5. Ms Bridget Rosewell, of Volterra Consulting, told us that “the whole concept of an output gap ... is really quite a hard one”.<sup>15</sup> In evidence on the February 2007 Inflation Report, the Governor of the Bank of England told us that the availability of labour from outside the United Kingdom made defining the output gap more difficult than in the past:

I myself have doubts as to whether, in a situation where it is possible to acquire labour from abroad when demand for labour expands here, the output gap is as precise and useful a concept as it was. The ability to recruit migrant labour does actually undermine, to some extent, the ability to construct, and the usefulness of, a concept such as the output gap. In broad terms, the Treasury say in the Red Book that they believe that whatever they think the output gap is will close in the first quarter of this year, and then will remain roughly where it is. That is consistent with our forecast that their growth rate in the central view is very similar to ours, but I go back to the point I make each time I come, which is: for heaven’s sake, please do not put too much weight on the central projection; it is very unlikely to materialise. A forecast has to focus on the risks as well, otherwise it is of little value.<sup>16</sup>

In written evidence, Dr Weale noted:

In the longer term, the Government assumption that the trend rate of growth of output is now 2¾% p.a. is a result of their assumption about the rate of growth of the population of working age. Estimates of this change in the short term because of changes to estimates of the rate of net immigration; the data difficulties with measuring net immigration have been widely discussed and it is important that the Office for National Statistics has the resources to improve the migration statistics.<sup>17</sup>

In oral evidence, he also observed that, since the early 1990s, the amplitude of economic cycles has decreased and that the weaker cycles since then have been more difficult to date.<sup>18</sup>

6. The output gap plays an important role in Treasury economic forecasting, particularly in its estimates of and decisions on the timings of economic cycles which in turn affect the interpretation of the Treasury’s fiscal rules. We put to the Chancellor of the Exchequer the implication of the earlier evidence from the Governor of the Bank of England that the concept of the output gap was of diminishing value in view of the availability of migrant labour. The Chancellor of the Exchequer replied that the output gap

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14 *Budget 2007*, para B.53, p 252

15 Q 36

16 HC (2006–07) 414-i, Q 49

17 Ev 54

18 Q 35

is the basis on which we present both the record of the economy and our fiscal rules. [The Governor of the Bank of England] is obviously right that, because of the influence of international factors, whether it is migration or other factors where we have very little control, like oil prices internationally, there are other factors which have to be taken into account, but it is still a significant indicator for the Treasury about how we plan both for the economy as a whole and for our fiscal rules.<sup>19</sup>

**Migration of uncertain magnitude and the greater stability of the economy may reduce the value of the concept of the output gap as a tool of economic analysis. We recommend that the Government examine the impact of these factors on the role which the concept of the output gap should play in Treasury forecasting and analysis, and report on the outcome of such examination in its response to this Report.**

## Migration

7. In our Report on the 2006 Pre-Budget Report, we noted the absence of robust statistics on migration and the problems this posed for assessing the state of the labour market.<sup>20</sup> The 2007 Budget referred to “uncertainties surrounding official labour market data relating to the measurement of migration flows and growth of the working-age population, and the number of temporary foreign workers in the UK”.<sup>21</sup> Treasury officials told us that the Office for National Statistics was pursuing a “twin-track” approach in improving these problematic statistics, both by improving existing surveys and by “broadening the flows of information on migration”.<sup>22</sup> Treasury officials also indicated that, while some improvements were expected this year, “this is really a longer-term agenda leading up to the Census in 2011”.<sup>23</sup>

8. The Bank of England has commented on the beneficial “tailwind” provided to the economy in recent years by inward migration, which has contributed to the increase in the effective labour force.<sup>24</sup> The Bank of England did, however, express concern about the reliability of migration statistics:

The data in this area are poor, so it is difficult to know by exactly how much the labour force has been boosted. But it seems likely that migration from the A8 countries has added between 215,000 and half a million people to the UK labour force since May 2004.<sup>25</sup>

Dr Weale also commented on the problems with migration statistics and emphasised the importance of the Office for National Statistics having sufficient resources to make improvements in this area.<sup>26</sup> **Given the importance of migration for both the labour**

19 Q 253

20 HC (2006–07) 115, para 19

21 *Budget 2007*, para B.42, p 248

22 Q 114

23 Q 115

24 Treasury Committee, *The Monetary Policy Committee of the Bank of England: ten years on: Written evidence*, HC (2006–07) 299–II, Ev 9

25 *Ibid*

26 Ev 54

market and the measurement of the output gap, we welcome the work undertaken by the Office for National Statistics aimed at improving the quality of migration statistics. We recommend that the Treasury report regularly in Budget and Pre-Budget Reports on the progress of this work.

## Inflation and monetary policy

9. Inflation has risen in recent months after a number of years when it has been at historically very low levels. In the year to December 2006, inflation measured by the Consumer Prices Index (CPI) rose to 3.0%, up from 1.9% in December 2005.<sup>27</sup> This was then the highest recorded level on this measure and a full percentage point above the Bank of England's inflation target of 2%.<sup>28</sup> Inflation measured by the CPI fell back to 2.7% in January 2007 before increasing slightly to 2.8% in February.<sup>29</sup> On the Retail Prices Index (RPI) measure, inflation reached 4.6% in February 2007. This was then its highest level since August 1991 and over two percentage points higher than the level in February 2006 (2.4%).<sup>30</sup> The 2007 Budget attributed the increase in headline inflation to "energy and food prices, rather than domestic cyclical pressures".<sup>31</sup> On 17 April, after we concluded taking evidence, it was announced that CPI inflation had risen to 3.1%, thus for the first time triggering the requirement for the Governor of the Bank of England to write to the Chancellor of the Exchequer explaining why inflation had moved more than 1 percentage point away from its target and setting out the steps to be taken to move inflation back towards its target. On the same day, it was announced that RPI inflation had risen to 4.8%.<sup>32</sup>

10. The Monetary Policy Committee of the Bank of England raised short-term interest rates by 0.25 percentage points on three occasions between August 2006 and January 2007. The Governor of the Bank of England told us that the central projection in the February 2007 Inflation Report was for "inflation to fall back quite sharply later this year as lower retail gas and electricity prices entered household bills".<sup>33</sup> Similarly, the 2007 Budget forecast that CPI inflation would return to around target in the second half of 2007 as energy and food prices stabilised or fell.<sup>34</sup> Dr Weale thought the Treasury was "taking an excessively optimistic view".<sup>35</sup> Professor Miles, however, suggested that inflation might even go below the Bank of England target, following falling gas and electricity prices.<sup>36</sup>

11. One perceived risk to the economy from relatively high levels of inflation is that increased inflation might push up inflation expectations and lead to upward pressure on

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27 Office for National Statistics, First Release Consumer price indices for March 2007, 17 April 2007, Table 1

28 CPI inflation is estimated prior to 1997. CPI inflation has been above 3.0% before 1997.

29 Office for National Statistics, First Release Consumer price indices for March 2007, Table 1

30 Office for National Statistics, [www.statistics.gov.uk/downloads/theme\\_economy/RP04.pdf](http://www.statistics.gov.uk/downloads/theme_economy/RP04.pdf)

31 *Budget 2007*, para B.56, p 253

32 Office for National Statistics, First Release Consumer price indices for March 2007, Table 1

33 HC (2006-07) 414-i, Q 3

34 *Budget 2007*, paras B.56-B.57, p 253

35 Q 3

36 Q 4

wages. The 2007 Budget acknowledged this risk, but noted that inflation expectations had so far remained “anchored to the inflation target”.<sup>37</sup> The Governor of the Bank of England noted that movements in household surveys of inflation expectations were not unconnected with changes in prices of large items of expenditure such as gas and electricity and might not be an accurate measure of underlying expectations of inflation.<sup>38</sup> He also told us that one of the reasons for the increase in interest rates in January 2007 was to send a clear signal that the Bank of England would take action to bring inflation back to its target level.<sup>39</sup>

12. According to the 2007 Budget, earnings growth has remained “subdued” despite the increase in inflation.<sup>40</sup> In the three months to January 2007, earnings including bonuses were 4¼% higher than a year earlier. Excluding bonuses, earnings were 3½% higher.<sup>41</sup> Professor Miles concurred that “there has been very little acceleration in wage settlements”, despite the increase in inflation and fall in unemployment.<sup>42</sup> Kate Barker, a member of the MPC, thought that, while there was a risk that the increase in RPI inflation might influence pay settlements, there was little evidence that this had happened so far, although the full picture had not yet emerged.<sup>43</sup> The Governor of the Bank of England saw no sign of excessive wage settlements, although he also thought it was too early to reach a firm conclusion.<sup>44</sup> The Government has stressed the need for wage settlements to be consistent with the 2% inflation target.<sup>45</sup> When asked about the possibility of upward pressure on wage settlements arising from the increase in inflation measured by the RPI, the Chancellor of the Exchequer replied:

the official index is now CPI and I caution people, when they are examining the potential for the wage settlements, to look at CPI. That is the target that the Bank of England is trying to meet and that is the target which I have always tried to focus the public sector pay settlements upon, and it is 2%.<sup>46</sup>

**The recent rise in inflation has been caused in part by a number of short-term factors, such as higher energy bills. There is little evidence at the moment that higher inflation is having second-round effects. We will, however, continue to keep the situation under review through our regular hearings on the Bank of England’s Inflation Reports and our scrutiny of Budgets and Pre-Budget Reports.**

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37 *Budget 2007*, para B.105, p 266

38 HC (2006–07) 414–i, Q 56

39 *Ibid*, Q 57

40 *Budget 2007*, para B.46, p 249

41 *Ibid*, para B.52, p 252

42 Q 10

43 HC (2006–07) 414–i, Q 70

44 *Ibid*, Q 66

45 *Budget 2007*, para B.46, p 249

46 Q 251

## Business investment

13. In our Report on the 2006 Pre-Budget Report, we welcomed the recent increase in business investment. We also noted that earlier weakness in business investment remained unexplained, and that uncertainty about the causes of past weakness could constitute a downside risk to the Treasury's forecast on business investment.<sup>47</sup> In the 2007 Budget, the Treasury observed that business investment had been strong in the second half of 2006 and that "some of that momentum is expected to carry through into 2007".<sup>48</sup> Business investment grew by 7% in 2006, exceeding the forecast of 5¾% in last year's Pre-Budget Report.<sup>49</sup> In this year's Budget, the Treasury revised upwards its forecast for business investment growth in 2007 compared with that in last year's Pre-Budget Report. The 2007 Budget forecast growth in the range 7¼ to 7¾% in 2007,<sup>50</sup> compared with a forecast of 4¾ to 5½% last December.<sup>51</sup> The Treasury commented that "there is again scope for investment growth to exceed expectations" if financing conditions remained supportive and firms' margins recovered.<sup>52</sup>

14. The Governor of the Bank of England told us that business investment "has been growing strongly and I think we would expect that to continue".<sup>53</sup> Dr Weale commented on recent trends in business investment:

The Chancellor focused on what was happening to business investment measured in constant prices and what he said was correct but that does rather flatter the figures. If you look at the share of business investment in national income in current prices, in 1998 it was 12.5%, it has been as low as 9% and it has now got back up to 9.5%. It is true that the prices of things that people are buying have made that look more favourable in constant price terms but you might think if the investment goods are cheap that they are not actually going to get very much benefit from them.<sup>54</sup>

Ms Rosewell took a different view:

We should put the other case too, which is that the kinds of investment goods which are, in fact, most productive—computerisation, CAD/CAM systems, whatever it may be—have been getting cheaper in real terms and they are easier to acquire. It does not make them necessarily less productive, which I think is the implication of what [Dr Weale] was saying. You could argue that it is the constant price number which is really important and, therefore, there is this rebalancing and recovery and investment going on. Probably the truth is somewhere in the middle, I do not think

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47 HC (2006–07) 115, para 9

48 *Budget 2007*, para B.55, p 252

49 *Ibid*, para B.73, p 258

50 *Ibid*, Table B.7, p 258

51 *Pre-Budget Report 2006*, Table A.7, p 206

52 *Budget 2007*, para B.104, p 265

53 HC (2006–07) 414–i, Q 63

54 Q 47

one need be quite as negative as to say that the cheap goods are necessarily bad goods.<sup>55</sup>

Treasury officials told us that, while business investment could be erratic, it had “really picked up through last year”.<sup>56</sup> They thought that economic conditions such as growth, profitability and interest rates were currently supportive of investment.<sup>57</sup> The Treasury’s view was that the ratio of business investment to GDP in real terms “makes sense in terms of thinking about real activity”.<sup>58</sup>

## The international economy and net trade

15. The US economy grew by 3¼% in 2006. The 2007 Budget noted that US “growth eased through the year” and that the US economy was expected to grow more slowly in 2007.<sup>59</sup> Dr Weale thought that that “the Treasury view of the world economy is a perfectly reasonable one” and that the difficulties in the sub-prime mortgage market were not likely to cause a recession in the USA.<sup>60</sup> In the 2007 Budget, the Treasury observed that growth in the euro area had strengthened in 2006,<sup>61</sup> and commented that “macroeconomic fundamentals ... have improved”, which could lead to higher than expected output growth from the euro area.<sup>62</sup> Treasury officials told us that growth in the euro area “seems to be now reasonably well-established”.<sup>63</sup> Mr Dave Ramsden, Director, Macroeconomics and Fiscal Policy, HM Treasury, thought that

because nearly 50% of our trade is with the euro area, ... the fact that there has been evidence of a little bit more momentum in the euro area is what is supporting the improvement that we are forecasting in terms of the drag from trade between 2006 and 2007, so we think the contribution from net trade will actually be less in 2007 than in 2006, the negative contribution, because of this greater confidence that we now have in the euro area economy, and we are still expecting a slowdown, but we actually see solid growth, certainly by euro area standards, in 2007.<sup>64</sup>

In the 2007 Budget, the Treasury forecast a slight negative contribution to GDP growth from net trade in 2007.<sup>65</sup> This compared with a forecast zero contribution for that year in last year’s Pre-Budget Report.<sup>66</sup> However, the Treasury expects the scale of the negative contribution to be smaller than that in 2006.<sup>67</sup> The Budget revised upwards the forecast for

55 Q 48

56 Q 112

57 Q 112

58 Q 113

59 *Budget 2007*, para B.10, p 240

60 Q 21

61 *Budget 2007*, para B.11, p 240

62 *Ibid*, para B.99, p 265

63 Q 119

64 *Ibid*

65 *Budget 2007*, Table B.5, p 254

66 *Pre-Budget Report 2006*, Table A.5, p 201

67 *Budget 2007*, Table B.5, p 254

export growth in 2007 and 2008 “as the balance of world growth has tilted towards Europe”.<sup>68</sup> The Budget also revised upwards the forecast for import growth in 2007, reflecting stronger than expected import growth in 2006 and higher forecast business investment growth in 2007.<sup>69</sup>

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68 *Budget 2007*, para B.80, p 259

69 *Ibid*, para B.81, p 259

## 3 The public finances

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### The current budget balance

16. The Treasury's forecast in the 2007 Budget of the current budget deficit for 2006–07 was £9.5 billion, compared to a forecast deficit of £7.9 billion for that year in the 2006 Pre-Budget Report and a forecast deficit of £7 billion for that year in the 2006 Budget.<sup>70</sup> In the 2007 Budget, the Treasury also revised its forecast of the current budget deficit for the next financial year, 2007–08, from a forecast deficit of £1 billion at the time of last year's Pre-Budget Report to a forecast deficit of £4 billion.<sup>71</sup> Dr Weale observed that this year's Budget,

continues the process which has gone on for some years now of acknowledging the budgetary position is worse than the Treasury had previously hoped. The ... [current budget balance] for 2007–08 has moved from a deficit of £1 billion to a deficit of £4 billion with smaller changes in subsequent years. This is worth mentioning not because the change is itself large but because it happens repeatedly.<sup>72</sup>

The increase in the current budget deficit for 2007–08 from the 2006 Pre-Budget Report is caused in part by a downward revision of the forecast current receipts from 40.2% of GDP to 40.1% of GDP and in part by an upward revision of the forecast current expenditure from 38.9% of GDP to 39.1% of GDP.<sup>73</sup> The forecast for net borrowing for 2007–08 has also increased, from £31 billion at the time of last year's Pre-Budget Report to £34 billion.<sup>74</sup>

### Revenue receipts

#### North Sea revenue

17. Although the forecast for overall economic growth remains the same as that in the Pre-Budget Report, there has been a further downward revision in the forecasts of corporation tax receipts.<sup>75</sup> Treasury officials explained that this was principally due to a downward revision in the forecast of North Sea revenues (which consist of North Sea corporation tax, petroleum revenue tax and royalties) since last year's Pre-Budget Report.<sup>76</sup> That Pre-Budget Report had already seen a reduction of the forecasts for North Sea oil revenues in 2007–08 from that in the 2006 Budget by £2.8 billion.<sup>77</sup> In our Report on the 2006 Pre-Budget Report, we noted “the significant downward revision of forecast North Sea oil revenues in 2007–08” and looked forward “to seeing whether the more cautious forecast

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70 *Budget 2006*, Table C4, p 259; *Pre-Budget Report 2006*, Table B8, p 229; *Budget 2007*, Table C4, p 278

71 *Pre-Budget Report 2006*, Table B8, p 229; *Budget 2007*, Table C4, p 278

72 Ev 54

73 *Pre-Budget Report 2006*, Table B9, p 229; *Budget 2007*, Table C5, p 278

74 *Pre-Budget Report 2006*, Table B8, p 229; *Budget 2007*, Table C4, p 278

75 *Budget 2007*, Table C7, p 280

76 Q 138

77 *Pre-Budget Report 2006*, Table B12, p 232

proves to be accurate”.<sup>78</sup> In the 2007 Budget, the forecasts for North Sea oil revenues were revised downwards once again. They were reduced by £1.3 billion for 2006–07 and £2.7 billion for 2007–08 from the respective forecasts in the 2006 Pre-Budget Report.<sup>79</sup>

18. Treasury officials told us that, since last year’s Pre-Budget Report had been published, they had received the most recent survey on oil production from the United Kingdom Offshore Operators’ Association and the latest financial results of a number of oil companies.<sup>80</sup> The Chancellor of the Exchequer explained that the recent revision of North Sea oil forecasts was caused by higher than expected production costs and lower than expected overall production, and not changes in the exchange rate or the price of oil:

the production costs in the North Sea have been higher and, therefore, companies can offset their production costs at very high levels against their tax revenues, but also, and more significantly perhaps, production has been lower than anticipated.<sup>81</sup>

Treasury officials also pointed out that higher investment levels had meant that companies were eligible for higher capital allowances.<sup>82</sup> Treasury officials described the recent events affecting the North Sea oil industry as an “almost a perfect combination [of factors], all of which are reducing revenue”.<sup>83</sup>

19. Treasury officials denied that the recent downward revision of forecasts of North Sea revenue indicated a sustained pattern of over-optimism in forecasting. They pointed out that “in 2005, we actually had a windfall gain on North Sea revenues, so it is not as if we have persistently over-forecast North Sea revenues”.<sup>84</sup> Table 1 demonstrates that there has been significant volatility in the forecasts of North Sea oil revenues for the years 2005–06 onwards.

**Table 1: Forecasts of North Sea revenues, 2003–04 to 2007–08**

	Budget 2005 £ billion	Pre-Budget Report 2005 £ billion	Budget 2006 £ billion	Pre-Budget Report 2006 £ billion	Budget 2007 £ billion
2003–04	4.3				
2004–05	5.2	5.2	5.2		
2005–06	7.1	9.1	9.7	9.6	9.7
2006–07		11.7	10.2	10.4	9.1
2007–08			13.5*	10.7	8.1

Source: *Budgets and Pre-Budget Reports*

\* Deduced from *Pre-Budget Report 2006*, Box B2 and Table B12, pp 232, 233

78 HC (2006–07) 115, para 24

79 *Budget 2007*, Table C7, p 280

80 Q 148

81 Q 266

82 Q 122

83 *Ibid*

84 *Ibid*

We note the very significant downward revision of forecast North Sea oil revenues in 2006–07 and 2007–08 compared with the 2006 Pre-Budget Report. We are concerned that the Treasury’s estimate at Budget 2007 is so much lower than its forecast in the 2006 Pre-Budget Report, only three months earlier. We believe that the volatility of North Sea oil revenues constitutes a risk to taxation revenues in the future.

### *Non-North Sea corporation tax*

20. Forecasts of non-North Sea corporation tax receipts for 2005–06 have also been revised downwards since the 2006 Pre-Budget Report. The forecast for non-North Sea corporation tax receipts for 2006–07 in the 2007 Budget was £2.6 billion below that in the 2006 Budget and £1.9 billion below that in the 2006 Pre-Budget Report. The forecast for non-North Sea corporation tax receipts for 2007–08 in the 2007 Budget was £2.2 billion below the forecast in the 2006 Budget and £1.4 billion below the forecast in the 2006 Pre-Budget Report.<sup>85</sup> Treasury officials explained that the corporation tax instalments that companies had made in July and October 2006 had been “slightly deceptive”; in January 2007 the Treasury found out that a large number of companies had been overpaying on account in previous months in 2006, which those companies then proceeded to claim back in January 2007.<sup>86</sup> **The deterioration of the current budget balance predicted for 2006–07 and 2007–08 compared with the forecasts in last year’s Budget and Pre-Budget Report has been caused by a reduction in the Treasury’s forecasts of non-North Sea corporation tax revenues as well as a fall in its forecasts of North Sea oil revenues.**

### *Forecasting record*

21. Table 2 demonstrates that, if estimated revenues for 2006–07 are as predicted in the 2007 Budget, 2006–07 will be the first financial year since 2000–01 in which the Treasury has not over-estimated its total tax revenues in the preceding Budget.

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85 *Budget 2007*, Table C7, p 280

86 Q 123

Table 2: Difference between forecast and actual tax receipts, 1998–99 to 2006–07

	Forecast at Budget £ billion	Forecast at Pre-Budget £ billion	Outturn £ billion	Difference between Budget and actual £ billion
1998–99	333	335.9	335.9	2.9
1999–2000	345	352.1	358.7	13.7
2000–01	375.6	380.3	382.9	7.3
2001–02	398.4	391.2	390	-8.4
2002–03	407.2	399.7	393.2	-14
2003–04	428.3	422.8	419.2	-9.1
2004–05	454.7	451	451.9	-2.8
2005–06	486.6	483	485.3	-1.3
2006–07	516.4	517.9	<i>517.2</i>	<i>0.8</i>

Source: Budgets and end of year fiscal reports. 2006-07 figures taken from Budget 2006, Pre-Budget Report 2006 and Budget 2007

Note: Figures in italics are estimated outturn figures

Treasury officials pointed out that “value added tax ... has come in higher than we forecast in the Budget 2006, stamp duties have come in higher than we forecast in the Budget 2006 and also income tax and [National Insurance Contributions] taken together”.<sup>87</sup>

22. Despite the overall upward tendency of recent revisions to forecasts of most components of Government revenue, Table 3 indicates that the Treasury has over-estimated its corporation tax revenues for the past six years.

Table 3: Difference between forecast and actual corporation tax receipts

	Forecast at Budget £ billion	Outturn £ billion	Difference between Budget and actual £ billion
2000–01	33.8	32.4	-1.4
2001–02	37.6	32.0	-5.6
2002–03	32.9	29.3	-3.5
2003–04	30.3	28.1	-2.2
2004–05	34.3	33.6	-0.6
2005–06	43.1	41.9	-1.3
2006–07	48.4	<i>44.4</i>	<i>-4</i>

Source: End of year fiscal reports. 2006-07 figures taken from Budget 2006, Table C8 and Budget 2007, Table C8 (corporation tax credits deducted)

Note: Figures in italics are estimated outturn figures

Treasury officials emphasised that the reduction in North Sea oil corporation tax had a particularly large impact this year.<sup>88</sup> Even so, Nick Macpherson, Permanent Secretary at the Treasury, conceded that “it is fair to say that in recent years ... [the Treasury has] tended to over-forecast corporate revenues, just as ... [it] tended to under-forecast them in the late 1990s.” He thought that “there may a bit of a cyclical effect”.<sup>89</sup> This was similar to Jon Cunliffe’s statement to us in December 2005 that

there is a tendency for forecast errors to be 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.<sup>90</sup>

Treasury officials explained that the “timing of receipts payments through the financial year”,<sup>91</sup> particularly the fact that a large proportion of receipts were received in January, made forecasting of receipts more difficult and told us that they had spent “a lot of time trying ... to improve these forecasts”.<sup>92</sup> Dr Weale thought that “looking three or four years ahead”, the Treasury “still have optimistic estimates of tax revenues”, and that consequently he expected the current account balance to move into surplus perhaps a year later than the Treasury did. However, he stressed that this “does not mean that the budgetary position is unsustainable because fiscal drag is quite a powerful tool”.<sup>93</sup> **We recognise that the Government’s forecasting record for overall revenues appears to have improved this year and that its forecasts of corporation tax receipts have been**

88 Q 138

89 Q 123

90 HC (2005–06) 739, Q 145

91 Q 146

92 Q 139

93 Q 25

affected by the unanticipated reduction in North Sea oil revenues in 2006-07. However, the Treasury has over-estimated corporation tax receipts for the past six years. If the direction of forecasting errors is correlated with the economic cycle, as Treasury officials have suggested, the Treasury's recent forecasting record of over-estimation should be more cautious in the near future if output moves above trend. We will continue to monitor the Treasury's performance in forecasting corporation tax receipts with this in mind.

## Public spending

### *Overall spending limits up to 2010–11*

23. Following the practice of the 2002 and 2004 Budgets, this year's Budget announced the overall spending envelope for the ensuing Spending Review.<sup>94</sup> For the purposes of fiscal projections, the Treasury has previously made assumptions about levels of spending beyond the period covered by the preceding Spending Review. Thus, an assumption about levels of current spending in 2008–09 was included in the 2003 Pre-Budget Report, an assumption about current spending in 2009–10 was included in the 2004 Pre-Budget Report and an assumption about current spending in 2010–11 was first provided in the 2005 Pre-Budget Report. In each case, it was assumed that current public expenditure would grow by 1.9% a year in real terms.<sup>95</sup> During our inquiry into the 2005 Pre-Budget Report, after the Government had announced that spending up to 2010–11 would be set in a 2007 Comprehensive Spending Review and when assumptions for the entire period covered by that Review were first available, we asked the Chancellor of the Exchequer whether those projections represented the overall spending envelope for the Review. He replied:

These have been our working assumptions for a number of years, but these are not necessarily the final figures.<sup>96</sup>

At the time of the 2006 Budget, the assumption about the level of current spending in 2008–09 was changed from earlier assumptions, with the new assumption being that current spending in that year would grow by 2.0% in real terms.<sup>97</sup>

24. In this year's Budget, the Chancellor of the Exchequer confirmed for the first time that the overall spending envelope up to 2010–11 would be "consistent with the figures set out in the 2005 and 2006 Budgets and the most recent Pre-Budget Report".<sup>98</sup> It was thus confirmed that public sector current expenditure would rise by 2.0% in real terms in 2008–09 and by 1.9% in real terms in both 2009–10 and 2010–11, with the overall growth rate of current public spending at an average of 1.9% a year in real terms over the period as a whole.<sup>99</sup> On the basis of these figures and the totals for capital spending up to 2010–11,

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94 *Budget 2002*, para 6.33, pp 118–119; *Budget 2004*, para 6.27, p 138

95 *Pre-Budget Report 2004*, para B.26, p 197; *Pre-Budget Report 2005*, para B.28, p 213

96 HC (2005–06) 739, Q 389

97 *Budget 2006*, para C.27, p 255

98 HC Deb, 21 March 2007, col 818

99 *Budget 2007*, paras C.26 and 6.47, pp 275, 152

which were confirmed at the time of last year's Pre-Budget Report,<sup>100</sup> the Government stated that total public spending would rise by an average of 2% a year in real terms in the period from 2008–09 to 2010–11.<sup>101</sup> Final plans for the split between Departmental Expenditure Limit spending and Annually Managed Expenditure spending will be announced at the time of the final publication of the outcome of the Comprehensive Spending Review.<sup>102</sup>

25. Although what were previously “working assumptions” for the purposes of fiscal projections have now become firm limits for the purposes of spending allocations, the Chancellor of the Exchequer was keen to downplay the novelty of the latest announcement, claiming that, by March 2005,

we had set out our figures for public spending and set out the path on which public spending would grow for the next few years ... We have always said that public expenditure would grow by something in the order of 2% ... It was always made clear to people right across the board before the 2005 election that the rate of growth of public expenditure would be lower than in the previous Parliament and, if you and the Committee did not know that when you had the chance to interrogate me before, then that is your responsibility, but it was always made clear that that was the position and we published tables and figures showing that.<sup>103</sup>

**This year's Budget includes confirmed levels of overall current public spending for the period from 2008–09 to 2010–11 which are in line with the figures used for the purposes of fiscal planning in the 2006 Pre-Budget Report, although previously-cited figures relating to spending in this period were characterised by the Chancellor of the Exchequer at the time as “working assumptions” rather than final figures.**

### **Public sector net investment**

26. Public sector net investment is planned to rise from 2.0% in 2006–07 to 2.1% in 2007–08 and 2.2% in 2008–09 and 2009–10.<sup>104</sup> During the last Parliament, our predecessors expressed concern that capital spending consistently failed to match the levels forecast by the Treasury.<sup>105</sup> Treasury officials told us in December 2005 that “departments are getting better at actually spending and realising their investment plans”.<sup>106</sup> However, for 2006–07, public sector net investment is estimated to be £3.4 billion below that allocated, with the capital budget specifically showing a £3.8 billion under-spend.<sup>107</sup> This is part of a continued pattern of downward revision, as Table 4 demonstrates.

100 HC Deb, 6 December 2006, col 313

101 *Budget 2007*, para 6.47, p 152

102 *Ibid*, para 6.48, p 152

103 Qq 269, 271

104 *Budget 2007*, Table C5, p 278

105 Treasury Committee, First Report of Session 2004–05, *The 2004 Pre-Budget Report*, HC 138, paras 56–58

106 HC (2005–06) 739, Q 153

107 *Budget 2007*, Table C12, p 290

Table 4: Delivery of public sector net investment, 2005–06 to 2007–08

	Forecast at time of PBR 2005	Forecast at time of Budget 2006	Forecast at time of PBR 2006	Forecast at time of Budget 2007
	£bn	£bn	£bn	£bn
2005–06	26.3	25.7	22.4	22.7
2006–07	29.3	28.8	28.9	25.5
2007–08	31.1	30.9	29.8	29.4

Sources: PBR 2005, Table B17, p 232; Budget 2006, Table C11, p 269; PBR 2006, Table B16, p 240; Budget 2007, Table C11, p 289

27. Treasury officials pointed out that public sector net investment had increased significantly in recent years.<sup>108</sup> The Treasury estimated in this year’s Budget that public sector net investment would rise from £22.7 billion in 2005–06 to £25.5 billion in 2006–07.<sup>109</sup> However, Treasury officials also accepted that there were “some issues in terms of capacity of the departments”; they pointed out that this was partly because some departments such as the Department of Health “have seen a very large and ambitious programme of expansion in their capital building”.<sup>110</sup> Treasury officials informed us that, within central Government, they were “initiating a round of procurement capability reviews modelled on the departmental capability reviews, which will be looking at procurement capability and skill in central government bodies” and that, within the wider public sector, “the gateway review process is used to assist local authorities, the Health Service and other parts of the wider public sector to improve their ability to deliver on the major programmes and projects they have to manage”.<sup>111</sup> **We welcome the procurement capability reviews that the Government is initiating in central government departments. We will continue to monitor outturns of public sector net investment expenditure against allocated budgets to develop an understanding of whether and how soon these capability reviews affect performance.**

### The golden rule

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 will be operated. There are currently two fiscal rules—the sustainable investment rule, which is discussed further below,<sup>112</sup> 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. Compliance with the golden rule is evaluated by calculating the average of the Government’s annual current budget balances as a percentage of GDP over the economic cycle. The current budget balance represents the

108 Q 133

109 Budget 2007, Table C4, p 278

110 Q 133

111 Q 136

112 See paragraphs 32–33

difference between current receipts and current expenditure, including depreciation.<sup>113</sup> The 2007 Budget stated:

The projections show that the Government is meeting the golden rule, on the basis of cautious assumptions, with an average annual surplus on the current budget over this economic cycle of 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 £11 billion in this cycle. Based on cautious assumptions, the Government will continue to meet the golden rule after the end of this economic cycle with the current budget returning to surplus by 2008-09.<sup>114</sup>

29. The 2007 Budget contains no changes to the Treasury's previous forecasts on the timing of the economic cycle. In the 2006 Pre-Budget Report, the Treasury changed its forecast of the end-date of the economic cycle from 2008-09, which was its forecast at the time of the 2006 Budget, to early 2007. In our Report on the 2006 Pre-Budget Report, we discussed the impact of changes to the timing of the economic cycle on the application of the golden rule.<sup>115</sup> In the same Report we recommended that the Treasury clarify "whether the last year of the economic cycle will count as the first year of the next economic cycle, for the purposes of judging whether the golden rule has been met".<sup>116</sup> The Government, in its response to that Report, stated that "the Government will set out in the normal way the details of the fiscal position under the framework over the next cycle when it provides its view on the end of the current cycle".<sup>117</sup> When we pursued the matter further with the Chancellor of the Exchequer, he acknowledged that it had been the "tradition" for the last year of the economic cycle to be counted as the first year of the new economic cycle and noted that it was likely that he would be accused of "breaking the rules" if this was not going to be done in the future.<sup>118</sup> **We welcome the Chancellor of the Exchequer's acknowledgment that counting the last year of the present economic cycle as the first year of the next economic cycle for the purposes of assessing whether or not the Government meets the golden rule would represent adherence to the Treasury's past practice. We expect to see this practice continue into the future.**

30. In our Report on last year's Pre-Budget Report, we recommended that the Treasury review the golden rule and consider whether that rule could be made more forward-looking and its application less dependent on estimates of the dating of the economic cycle.<sup>119</sup> During this inquiry, Mr Robert Chote of the Institute for Fiscal Studies argued that there was now a "window of opportunity" for the fiscal rules to be reviewed.<sup>120</sup> Dr Weale considered that the golden rule as a concept "made a lot more sense" in the period when there were cycles with very high amplitude, such as during the recession of the early 1990s

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113 *Pre-Budget Report 2006*, para 2.54, p 30

114 *Budget 2007*, paras C.5-C.6, p 270

115 HC (2006-07) 115, paras 28-32

116 *Ibid*, para 35

117 Treasury Committee, Third Special Report of Session 2006-07, *The 2006 Pre-Budget Report: Government Response to the Committee's Second Report of Session 2006-07*, HC 423, p 5

118 Qq 288-289

119 HC (2006-07) 115, para 35

120 Q 35

relative to the boom of the late 1980s, and noted that, “since the recovery from that recession we have seen very weak cycles and because they are weak, they are difficult to date”.<sup>121</sup> Treasury officials confirmed that the reduction in amplitude of economic cycles had had the effect of making the dating of those cycles more difficult:

One of the challenges around forecasting the economy and indeed understanding where we are going on the public finances is the fact that the amplitude of this cycle has clearly been substantially less than historical cycles.<sup>122</sup>

31. The Chancellor of the Exchequer told us that the “discipline ... achieved by having two fiscal rules which have been met is something that we do not want to lose”, but he informed us that he would “continue to review all ... issues because the main aim of having a golden rule, a sustainable investment rule and any fiscal rule is to have a degree of stability in ... [the] economy which allows you to plan ahead without the fear of either stop-go in ... [the] economy or stop-go in public spending”.<sup>123</sup> **The reduction in amplitude of the economic cycles in the past decade or so and the difficulties of measuring the output gap have made the dating of the economic cycle and application of the golden rule a particularly difficult process. We reiterate our recommendation that the Government review the golden rule and consider how to make it more forward-looking and its application less dependent on the dating of the economic cycle.**

### The sustainable investment rule

32. The objective of the sustainable investment rule is to ensure that the Government maintains sound public finances in the medium term. In order to meet the sustainable investment rule in the current economic cycle, the Government aims to maintain net debt below 40% of GDP in each and every year of the economic cycle.<sup>124</sup> In the 2007 Budget the Treasury forecast that the sustainable investment rule would be met over the current and new economic cycle, with net debt stabilising at 38.8% in 2009–10 before falling in 2011–12.<sup>125</sup> At the time of last year’s Pre-Budget Report, the Treasury forecast that net debt would stabilise at 38.7% in 2009–10, before falling in 2011–12.<sup>126</sup> Dr Weale considered that the sustainable investment rule would be more likely to act as a constraint on fiscal policy over the next economic cycle than the golden rule:

in the new cycle the fiscal rules are likely to be met; the 40% debt rule is probably the more vulnerable of the two since the figure for net debt is projected to rise to almost 39% of GDP, and it is easy to imagine the sort of fiscal surprise which could take it above 40%. It is also the case that the sort of techniques used to ensure that the Golden Rule is met (adjustment of the length of the cycle and arithmetical errors in the calculation) are not so readily available to help with the debt rule.<sup>127</sup>

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121 Q 35

122 Q 131

123 Q 291

124 *Pre-Budget Report 2006*, para 2.58, p 31

125 *Budget 2007*, Table C5, p 278

126 *Pre-Budget Report 2006*, Table B1, p 218

127 Ev 54

33. We have previously recommended that the Treasury clarify whether, during the subsequent economic cycle, it proposed to interpret the sustainable investment rule as requiring that net debt be maintained below 40% of GDP in each and every year of that cycle.<sup>128</sup> During our current inquiry, Treasury officials were unable to tell us more about the interpretation of the sustainable investment rule in the next cycle, although they pointed out that their projections indicated that the Government would meet the sustainable investment rule as it was currently interpreted over the projection period.<sup>129</sup> **We note that the interpretation of the sustainable investment rule in the current economic cycle requires that net debt is maintained below 40% in each and every year of the economic cycle. We recommend that the Government, in its response to this Report, give an account of the circumstances in which it would change its current interpretation of the sustainable investment rule for the next economic cycle.**

### International Financial Reporting Standards and PFI liabilities

34. In the 2007 Budget it was announced that, from the first year of the Comprehensive Spending Review period, 2008–09, Government “accounts will be prepared using International Financial Reporting Standards (IFRS) adapted as necessary for the public sector.” The Treasury explained that the switch to IFRS would be carried out “in order to bring benefits in consistency and comparability between financial reports in the global economy and to follow private sector best practice”.<sup>130</sup> The switch to IFRS has caused the Treasury to change its timetable for the publication of Whole of Government Accounts (WGA). The 2005 Pre-Budget Report indicated that the Government’s intention was for the first set of WGA to be produced according to the United Kingdom’s Generally Accepted Accounting Practice (GAAP) for the financial year 2006–07.<sup>131</sup> The 2007 Budget announced that the WGA would now be published according to IFRS for the first time for 2008–09.<sup>132</sup> When asked why they could not produce WGA according to UK GAAP for 2006–07 as was previously intended, Treasury officials responded that it would not be a good use of accountants’ time to prepare the accounts according to UK GAAP and then according to IFRS.<sup>133</sup> They informed us that another reason for the delay to the WGA was certain “methodological issues” that needed more work, in particular around the local authority sector.<sup>134</sup>

35. Treasury officials could not confirm whether the switch to IFRS was likely to increase or decrease the amount of PFI liabilities on the public sector’s balance sheet, informing us that the effect would be dependent on the relevant auditors’ interpretation of the standards from 2008–09 onwards.<sup>135</sup> Table 5, which reflects figures we requested and received from the Treasury, indicates that around 46% of PFI liabilities for departments and devolved

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128 HC (2005–06) 739, para 56

129 Qq 152–155

130 *Budget 2007*, para 6.59, p 154

131 *Pre-Budget Report 2005*, para B.5, p 208

132 *Budget 2007*, para 6.59, p 154

133 Q 236

134 *Ibid*

135 Q 233

administrations are currently on-balance sheet, although there is considerable variation between departments in the proportion of PFI liabilities which are on-balance sheet.

**Table 5 : Proportion of PFI capital values, on and off the public sector's balance sheet**

	On-balance sheet £ million	Off-balance sheet £ million	Total £ million	% on-balance sheet
Cabinet Office	330	18	348	95
Chancellor of the Exchequer's departments	323	706	1,029	31
Communities and Local Government	0	1,154	1,154	0
DCMS	0	149	149	0
DEFRA	0	1,506	1,506	0
DfES	9	4,389	4,389	0
DTI	22	57	79	28
DWP	66	1,073	1,139	6
FCO	17	74	91	19
Health	243	8,048	8,291	3
Home Office	516	860	1,375	38
Constitutional Affairs	290	98	387	75
MoD	2245	3,400	5,644	40
Office of First Minister and Deputy First Minister, Northern Ireland	306	347	653	47
Scottish Executive	230	3,946	4,176	6
Transport	19,742	2,755	22,497	88
Wales	7	490	497	1
<b>Overall</b>	<b>24,335</b>	<b>29,069</b>	<b>53,404</b>	<b>46</b>

Source: Ev 69

**We welcome the Government's decision to adopt International Financial Reporting Standards. We recommend that the Government, in its response to this Report, provide a fuller technical explanation of the differences between International Financial Reporting Standards and UK GAAP that could affect the future accounting treatment of PFI liabilities. We further recommend that the Government, in its response to this Report, explain more fully the reasons for the existing variations in on- and off-balance sheet classifications between departments.**

## 4 Tax measures

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### Personal taxation, tax credits and child poverty

#### *Simplifying the personal taxation system*

36. The 2007 Budget contained several reforms of the personal taxation system. The 10% starting tax band was removed, and the basic tax rate lowered from 22% to 20%.<sup>136</sup> However, the 10% tax band will be retained on savings income.<sup>137</sup> The National Insurance system is also being reformed, and from April 2009 the upper earnings limit will be aligned with the higher tax rate threshold.<sup>138</sup> The stated aim of the Government's personal taxation reforms was to "simplify the tax system".<sup>139</sup>

37. In 1999, when introducing the 10% starting rate of tax, the Chancellor of the Exchequer said the tax cuts were "to encourage work and make work pay".<sup>140</sup> Commenting on the removal of the 10% starting tax rate, Mr Chote told us that "it was never very clear that the 10p rate was a particularly effective tool in terms of the distributional implications that were claimed for it at the time, so removing that and the rather curious drop in the combined marginal rate of income tax and [National Insurance] above the top of the upper earnings limit look like sensible changes".<sup>141</sup>

38. On the decision to maintain the 10% starting rate for savings, Mr John Whiting of PricewaterhouseCoopers told us that he thought that this was "entirely to make sure that the pensioner community in particular are protected from the withdrawal of the 10% main band".<sup>142</sup> He felt that the Government could have gone further, questioning "whether it would not have been easier just to give the pensioner community that bit extra by way of personal allowance, combine the 65-plus and 75-plus amounts into one figure and have done, although actually there will be others on low income, apart from pensioners, who will benefit from the retention of that savings band".<sup>143</sup> Dr Weale felt that the maintenance of the 10% starting rate on savings income could be seen in the light of the fact that the capital saved was probably derived from the income of labour.<sup>144</sup> Mr Chote suggested that "in terms of labour income the Chancellor could say that people were compensated from raising the 10p rate to 20p by the cut in the basic rate from 22p to 20p, but for savings the basic rate was already 20p so there was no equivalent cut there. There may have been a

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<sup>136</sup> *Budget 2007*, para 5.5, p 106

<sup>137</sup> *Ibid*, para 5.5, p 106

<sup>138</sup> *Ibid*, para 5.6, p 106

<sup>139</sup> *Ibid*, para 5.5, p 106

<sup>140</sup> HC Deb, 9 March 1999, col 189

<sup>141</sup> Q 54

<sup>142</sup> Q 55

<sup>143</sup> *Ibid*

<sup>144</sup> Q 56

presentational concern that you could not tell the same story of taking with one hand and giving back with the other.”<sup>145</sup>

39. The other main area of simplification in this year’s Budget lay in the changes to the National Insurance system. Despite the modifications to be adopted after the Budget, Mr Whiting was still convinced that there was a meaningful distinction between the National Insurance and taxation systems,<sup>146</sup> although when asked whether he still thought there was a case for National Insurance, he replied “I would say that there is probably a lot to be said for combining the two”.<sup>147</sup> Dr Weale concurred with this notion on the grounds of transparency, stating that “It seems to me the main reason for keeping National Insurance separate from income tax is that the Chancellor can say to people, ‘There is a standard 20p rate of tax’ and forget about the employers’ and employees’ National Insurance contributions which are in effect also deductions from wages”.<sup>148</sup>

### ***Winners and losers and the importance of tax credits***

40. The changes to the personal taxation regime mean that some households will gain, while others lose. When asked about this, Mr Chote outlined how the IFS thought the proportions would work out:

The estimate of the winners and losers if you look just at income tax and national insurance is that you have a group of losers on earnings between around £5,000 and around £18,000 and another around £40,000. If you look at the overall number of households affected by the income tax, national insurance and tax credit changes altogether, you probably have on our estimate about 5.3 million families losing in total. Of those, 2.2 million would be single working people with no children who are not getting the working tax credit. They may not be getting the working tax credit, most of them, because they earn more than £12,500 but less than £18,000. It depends a bit on what you define as low income, but there is clearly a chunk of people in that category. They may also not get the working tax credit because they work fewer than 30 hours or because they are too young. The losers within that group lose about £125 per year on average per family. You then have about 1.2 million losers who will be two earner couples with no children. They may not qualify for the working tax credit or they may fail to take it up. They may also be in the position where the two earners both lose from the income tax and national insurance changes but there is only one gain from the tax credit which is assessed on the household. You can imagine that the biggest loss would be £446, I think, if you had a couple, both of whom were on £7,445, that is where you get the maximum loss from the increase in the lower rate from 10 to 20 and not getting the working tax credit. You have another 0.4 million losing households who are one earner couples without children, most of them because they will be in a range of about £17,000 to £18,500 where they are not compensated. You get 0.7 million two earner couples with children who lose again twice from the income tax and national insurance changes but maybe only gain once

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145 Q 56

146 Q 57

147 Q 59

148 Ibid

from child tax credit/working tax credit. You have 0.3 million losers who would be tax paying women between the ages of 60 and 64 who do not get tax credits and are too young to be compensated by the rise in the pensioner tax allowance and a final 0.5 million non-workers who pay more tax on their taxable benefit or pensions than they gain. Those might be early retirees or incapacity benefit claimants. That is roughly how you get to the 5.3 million total household losers, although most of them do not lose very much. It has to be said that this is an estimate based on much crunching over the last few days and, like shares, it may go up or down. That is our best guess at the moment.<sup>149</sup>

41. When asked about the 5.3 million ‘losers’, Mr Mark Neale, Managing Director, Budget, Tax and Welfare Directorate in HM Treasury, told us that “the figures that Robert Chote gave you are in the right ball-park”, and that they were consistent with the Chancellor of the Exchequer’s statement that four out of five households would either gain or remain the same.<sup>150</sup> In response to these figures, the Chancellor of the Exchequer referred to the actions undertaken to help those identified by Mr Chote as “losers”. The Chancellor of the Exchequer outlined the support given to low-paid workers through the minimum wage. He argued that the take-up rate of working tax credit would rise in response to a campaign encouraging people to apply, and that some people, who for income tax purposes were dealt with individually, would benefit from being part of a couple for the purposes of children’s tax credit and working tax credit.<sup>151</sup> The Chancellor of the Exchequer then went on to reiterate the Government’s commitment to encourage the take-up of working tax credit, and stated that an increase in the take-up rate had not been taken into account when the Institute for Fiscal Studies had calculated its figures, which had assumed a static take-up rate across the periods under discussion.<sup>152</sup> **An important part of any change to the personal taxation regime must be that both winners and losers can identify, with ease, how they are affected by the changes stated within a Budget package. We recommend that, in future, this information be provided within the Red Book.**

### **Tax credit take-up**

42. The Government has implied that it is important to assess the winners and losers from this year’s Budget measures taking into account the whole system of personal taxation and tax credits. The take-up rate of tax credits is therefore important for two reasons. On a personal level, those who are entitled to, but do not claim, tax credits, and are then penalised by the changes in the personal taxation scheme, require assistance. From a fiscal perspective, an increase in the take-up rate of tax credits will require additional spending, which will be part of Annually Managed Expenditure (AME), that part of public expenditure not subject to firm three-year plans.

43. On the personal level, Mr Chote pointed out that “The working tax credit is notably not taken up very highly by people who do not have children. Take-up is about 19% by

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149 Q 61

150 Qq 189–190

151 Q 306

152 Q 308

caseload, 25% by value.”<sup>153</sup> Figures produced by HM Revenue & Customs in March 2007 indicate that, for 2004–05, there were, in the central case for those without families, £1,290 million unclaimed amongst 980,000 entitled non-recipients of working tax credits.<sup>154</sup> Treasury officials confirmed that these figures represented the take-up rate for working tax credits in 2004–05, but pointed out that take-up was “showing a steady increase” and that HM Revenue & Customs was “very much looking to boost the take-up of the working tax credit”.<sup>155</sup> The Chancellor of the Exchequer was able to provide us with new information on working tax credit take-up rates, informing us that, while the 19% figure was correct for 2004–05, the latest figures showed an increase of almost 100,000 taking up working tax credits since April 2005.<sup>156</sup> The Chancellor of the Exchequer reiterated that the Government was looking to boost the number of working tax credit claimants, telling us “We are both obliged to pay it and want to pay it to those people who are entitled to it”.<sup>157</sup>

44. On the fiscal level, Mr Neale told us that when the Treasury forecast public expenditure, it assumed take-up rates in line with the current take-up rate: “the latest figure for 2004–05, as I said, is 25% of entitlement”.<sup>158</sup> We questioned the Chancellor of the Exchequer as to what would happen to the fiscal position if take-up rates improved. He pointed out that the take-up rate had improved,<sup>159</sup> and said that the Government provided “a margin in our AME projections to pay for any increase” in the take-up rate.<sup>160</sup> He went on to note that the AME margin was £1 billion for 2007–08.<sup>161</sup>

**45. Given that the personal taxation changes announced in this year’s Budget will have an impact on the post-tax earnings of those who are childless and earning an income entitling them to claim Working Tax Credit, the need to increase the low take-up rate of Working Tax Credit among that group should be a priority. We therefore welcome the evidence of a recent increase in the take-up of Working Tax Credit provided by the Chancellor of the Exchequer, although we would welcome further details as to the increase in the take-up of Working Tax Credit in percentage terms. We also note the Government’s efforts to increase take-up still further. However, we expect the Treasury to carefully monitor the impact of any increase in the take-up rate on the fiscal planning assumptions within Annually Managed Expenditure.**

### ***Meeting the child poverty targets***

46. The Government has set itself two demanding targets relating to child poverty—to halve the rate of child poverty by 2010–11, and to eliminate child poverty by 2020. The Government defines a child as in poverty if that child lives in a household earning less than

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153 Q 62

154 ‘Child Tax Credit and Working Tax Credit: Take-up rates: 2004-05’, HMRC Analysis Team, March 2007, Table 10

155 Q 191

156 Q 312

157 Ibid

158 Q 196

159 Q 324

160 Q 321

161 Q 328

60% of median income, before housing costs. In our Report on the 2006 Pre-Budget Report, we expressed concern that the 2006 Pre-Budget Report had not clearly set out how the Government expected to meet the 2010–11 target.<sup>162</sup> In its response to our Report, the Government pointed to its strategy on child poverty reduction, outlined in *Child Poverty Review*, a document now nearly three years old.<sup>163</sup>

47. The 2007 Budget contained several measures aimed at helping children. The Government committed itself to increasing the child element of Child Tax Credit by £150 a year above earnings indexation in April 2008.<sup>164</sup> As well as this, the Government announced that the weekly rate of Child Benefit for the eldest child would rise to £20 in April 2010.<sup>165</sup> We asked our expert witnesses how far they thought the measures announced in the 2007 Budget would help the Government reach its 2010–11 target. Mr Chote agreed with the Government’s estimate that the 2007 Budget package would lift 200,000 children out of relative poverty.<sup>166</sup> In subsequent written evidence, the IFS provided figures stating that, following the 2007 Budget package, it would cost the Government £3.8 billion a year of extra spending to reach its 2011 target, down from a prior estimate of £4.3 billion a year (in 2006–07 prices).<sup>167</sup> When asked how he would achieve the child poverty targets, Mr Chote considered that “the most targeted way of achieving it is to increase the child element of the child tax credit”.<sup>168</sup> In subsequent written evidence, the IFS told us that, for the Government to reach its 2010–11 target on child poverty, “by far the most important policy decision will be that taken by whoever is Chancellor of the Exchequer in 2009 on the generosity of tax credits, income support and child benefit in April 2010” and “the current toolkit of welfare-to-work policies can make only a marginal contribution to hitting the Government’s ambitious target for child poverty in 2010–11”.<sup>169</sup> However, Mr Chote also acknowledged that increasing benefits meant that work incentives might be harmed.<sup>170</sup> Mr Chote believed that, in order to meet the 2020 target, the Government would have to ensure that lifetime chances, rather than cash transfers, were also aided.<sup>171</sup> Dr Weale agreed that work incentives could be damaged by over-generous benefits, and pointed out that, in order to afford the increases in tax credits, the Government had increased the taper and withdrawal rates on tax credits, to the detriment of work incentives.<sup>172</sup> Regarding the Chancellor of the Exchequer’s decision to raise the rate of child benefit for the first child, Mr Chote pointed out that “larger families tend to be poorer ones” and contended that providing support directed to larger families might therefore have a role to play in child poverty reduction.<sup>173</sup>

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162 HC (2006–07) 115, para 71

163 HC (2006–07) 423, p 10

164 *Budget 2007*, para 5.13, p 107

165 *Ibid*, para 5.20, p 111

166 Q 63

167 Ev 70

168 Q 66

169 Ev 72

170 Q 66

171 *Ibid*

172 Q 67

173 Q 67

48. Before we heard oral evidence from Treasury officials, the most recent *Households below average income statistics* were released. These showed that, on the Government's preferred measure—children living in a household earning less than 60% of median income, before housing costs—child poverty had increased by 100,000 children in 2005–06.<sup>174</sup> In discussing this increase, Treasury officials thought that it would be premature to assume that the Government would now miss its 2010 target, pointing out that the increase of 100,000 children was well within the margin of error on such statistics.<sup>175</sup> Treasury officials refused to give a costing of the expenditure that would be needed to achieve the 2010 target,<sup>176</sup> but did say that the required measures would be re-visited and looked at “in the context of each Pre-Budget Report and Budget”.<sup>177</sup> They did accept that efforts would be needed both to provide additional income to poor families, and to ensure that such families were helped into work.<sup>178</sup> The Chancellor of the Exchequer also highlighted the need for a multi-stranded approach to tackling child poverty, including both work and benefits.<sup>179</sup> However, he too refused to be drawn on how much achieving the 2010–11 target of halving of child poverty would cost, reiterating the need for a more comprehensive approach, using incentives to work, child benefit, child tax credits, and the minimum wage.<sup>180</sup> **We are concerned by the recently reported rise in child poverty in 2005–06 of 100,000 children, according to the Government's preferred measure. We welcome the extra resources allocated in the Budget, which it is estimated will help around 200,000 children out of relative poverty. We reiterate the recommendation made in our Report on the 2006 Pre-Budget Report that the Government, in reporting on the outcome of the Comprehensive Spending Review, state how it intends to meet the 2010–11 target to halve the number of children in poverty and where the resources will come from to meet that target. We welcome the Government's increased emphasis on improving incentives to work and recommend that, in reporting on the outcome of the Comprehensive Spending Review, the Government publish its analysis of the impact of improving incentives to work on meeting its child poverty targets.**

### **An additional child poverty target?**

49. During our inquiry, we heard evidence advocating the value of an additional child poverty target, designed to ensure that the needs of those children who are in families with the lowest incomes are properly addressed. Mr Chote outlined the problem with the current targets focused on the measure of whether or not a child lives in a household earning less than 60% of median income, before housing costs:

It is certainly true that the Government has a headcount measure so it is clearly attractive to them to be able to get people jumping just over the line. The poverty line is at a very highly populated bit of the income distribution, so it can make a lot of

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174 Office for National Statistics, 'Households below average income statistics', first release, 27 March 2007, Table 3.2

175 Q 181

176 Q 182

177 Q 211

178 Qq 181–182

179 Q 316

180 Qq 316–320, 300

difference where exactly you draw the poverty line because a small shift will get a large number of people in or out.<sup>181</sup>

He went on to say that there had not been an improvement in relation to the numbers of children living in severe poverty comparable to that seen in relation to those previously living in households earning less than 60% of median income level before housing costs,<sup>182</sup> although he acknowledged that information at the very lowest levels of income was unreliable.<sup>183</sup> Dr Weale supported the proposition that there ought to be an additional target relating to extreme poverty because he thought that it was important to consider who was in the greatest need of help, and how to target them.<sup>184</sup> Dr Weale, however, shared Mr Chote's acknowledgement of the limitation of statistics relating to extreme poverty, so that a target relating to extreme poverty might be more technical and less satisfactory than existing targets.<sup>185</sup>

50. In explaining why the Government had not hitherto adopted a target specifically relating to children in the most extreme poverty, Mr Neale also warned about the problems with interpreting the data around those on very low incomes, stating that "I think we need to do a bit more work to understand what is going on at the very lowest levels of income".<sup>186</sup> However, he did state that "the Government, looking forward to the 2020 target, has indicated that it will introduce a measure of deprivation which will pick up perhaps what you are seeking to get at here, namely those families who are suffering particular difficulty".<sup>187</sup> He also defended the 60% of median income target as "an internationally recognised threshold and I would not under-estimate the importance of moving families across that line".<sup>188</sup> The Chancellor of the Exchequer confirmed that he was aware of the particular challenge relating to children in households with the lowest incomes, and told us that the Government "do try to look at the different groups and there are some people who are very, very poor and we have got to do more, as we have said, to help them".<sup>189</sup> **Targeting those children in families at the very lowest income levels must be a priority for the Government, but is important to ensure that adopting a target to help such children does not detract from meeting the overall 2020 target. We recommend that, in publishing the outcome of the Comprehensive Spending Review, the Government set out its latest understanding of the dynamics of the very poor, perhaps in the context of the Government's work on its new deprivation index. We further recommend that, at the same time, the Government set out its views on the possible value of an additional target specifically focussed on child poverty in the very poorest households (defined as earning less than 40% of median income) within the context of its target of eliminating child poverty by 2020.**

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181 Q 68

182 Ibid

183 Ibid

184 Qq 70–71

185 Q 71

186 Q 186

187 Q 187

188 Q 186

189 Q 356

### *The need for comprehensive analysis*

51. We have noted the Government's reference to many different strands of the personal tax, benefits and tax credits system when describing its efforts to combat child poverty. On top of this, there is also a need to consider the efforts of other departments, such as the Department for Work and Pensions. It is appropriate that the Government use every means at its disposal when tackling such a difficult but important issue. But, this also raises issues of transparency and accountability. **We recommend that whenever the Government reports on complicated, multi-faceted responses to policy issues, such as child poverty, it should attempt to draw together all the analysis on all relevant policy instruments in the appropriate Budget or related document, so that it is transparent what the different policies are intended to achieve, at what cost, and how the whole package of policies will interact and achieve their purpose.**

## Corporate taxation

### *Changes to the main rate and capital allowances*

52. The Chancellor of the Exchequer announced the following changes to corporate taxation in the 2007 Budget:

- a reduction in the main rate of corporation tax from 30% to 28%, effective from April 2008;
- a reduction in the rate of capital allowances on the general pool of plant and machinery from 25% to 20%, effective from April 2008, bringing it closer into line with economic depreciation;
- an increase in the rate of capital allowances on the pool of long-life assets, which applies to assets with expected lives of more than 25 years, from 6% to 10%, effective from April 2008;
- fixtures that are integral to a building will be separately classified and will be included in the 10% capital allowances pool, effective from April 2008;
- the phased removal of the Industrial Buildings Allowances (IBA) and Agricultural Building Allowance (ABA) with the effective rate of allowance falling to 3% from April 2008, 2% from April 2009, 1% from April 2010 and full abolition taking effect from April 2011.<sup>190</sup>

53. The 2007 Budget stated that the "Government will continue to assess the case for further reductions in the corporation tax rate".<sup>191</sup> Treasury officials told us that the two main factors that would be considered when assessing the case for a further cut in the corporation tax rate were the "the competitiveness of ... corporation tax rates" and also the impact of "tax-motivated incorporation".<sup>192</sup> The Chancellor of the Exchequer emphasised

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<sup>190</sup> *Budget 2007*, Box 3.3, p 51

<sup>191</sup> *Ibid*, para 3.26, p 50

<sup>192</sup> Q 162

that the cut in the corporation tax rate meant that the United Kingdom had the lowest corporation tax rate out of all G7 countries:

Our tax rate was lower than America, it was lower than Germany, lower than France, lower than the other countries, like Italy, in the G7, and lower than Japan. Germany then made a decision that it would move to a 29.8% rate, which is just below our 30% rate. We looked at all of these issues and thought the right thing to do is for us to have a 28 pence rate, so we have now again, and will have when they introduce the German rate, without change, the lowest corporate tax rate in the G7, lower than America, lower than the other European countries and lower than Japan.<sup>193</sup>

However, the IFS Budget analysis pointed out that, even after the recent cut in the corporation tax rate, the United Kingdom had the ninth highest corporation tax rate out of the twenty seven European Union countries.<sup>194</sup> The Chancellor of the Exchequer argued that the corporation tax rate was only one factor amongst many affecting businesses' relocation decisions. He considered the "attractiveness of the location, the skills base of the economy, the openness of the economy, the competitive and entrepreneurial nature of the economy" to be more important factors.<sup>195</sup>

54. The Chancellor of the Exchequer described the corporate tax reform in the 2007 Budget as the "biggest since 1984" because of the reduction in the corporation tax rate and the distinction made between short-term and long-term assets in the capital allowance system.<sup>196</sup> He told us that the change in allowances would reduce anomalies such as warehouses being given more beneficial capital allowances than investment in intellectual property or research and development.<sup>197</sup> Dr Weale thought that the changes to the corporation tax regime were "not very big" and were unlikely to stimulate business growth very much. He told us that on the one hand the change in allowances might place a slight downward pressure on business investment, but on the other hand, the slight reduction in corporation tax could stimulate business activity.<sup>198</sup> Mr Whiting thought that the changes to corporation tax for larger firms would result in manufacturing companies being "hit" and the service sector being "helped".<sup>199</sup> He pointed out that long-term property infrastructure companies would be particularly affected, especially those that had already made commitments on the basis that they would get allowances over some 20 to 25 years.<sup>200</sup> Treasury officials explained that the rationale behind the corporation tax rates was not to produce a different impact on sectors, but to improve incentives for investment.<sup>201</sup>

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193 Q 299

194 IFS Budget Analysis, *Corporation Tax*, 22 March 2007

195 Q 299

196 Q 296

197 Ibid

198 Q 7

199 Q 97

200 Q 106

201 Qq 167–168

### **Small businesses**

55. The Chancellor of the Exchequer announced the following changes to corporation taxation for small companies in the 2007 Budget:

- a phased increase in the small companies' rate from 19% to 20% from April 2007, 21% from April 2008 and 22% from April 2009 to reduce the differential between incorporated and unincorporated businesses;
- the continuation of the 50% first year allowance for small enterprises to April 2008;
- an increase in the enhanced deduction element of the SME and mid-sized R&D tax credit from 150% to 175%, effective from April 2008, subject to State aid clearance;
- the introduction of an Annual Investment Allowance (AIA) available to all businesses regardless of size and regardless of their legal form.

The new AIA will mean that 100% of expenditure up to £50,000 on general plant and machinery (other than cars) can be offset against taxable profits. The AIA will be effective from April 2008 and will target support on all businesses that are investing for growth. The Government considers that the AIA will be particularly beneficial to small and medium sized businesses.<sup>202</sup>

56. The Chancellor of the Exchequer explained that the corporation tax rate had been increased for small businesses, whilst being lowered for other businesses, in order to prevent tax avoidance:

We have had individuals artificially incorporating as companies for purely taxation purposes, and one of the problems that we have found, faced and had to act upon is that people who are coming to work in this country are being encouraged to form, and work through, managed services companies even before they come into this country. We faced the prospect of schemes that are being marketed right across Eastern Europe, encouraging people to set up companies purely for the purposes of avoiding taxation.<sup>203</sup>

Treasury officials told us that “the Annual Investment Allowance will cover the investments made by 95% of small businesses and in fact will give them a big cash-flow advantage”.<sup>204</sup> The Chancellor of the Exchequer argued that “most companies which are investing in the future will not only be as well off, but better off under the proposals we made”.<sup>205</sup>

57. Mr Whiting pointed out that “even if a smaller business does invest for a couple of years, at some stage ... proprietors need to take some money out to live on”.<sup>206</sup> Furthermore, he told us that a PricewaterhouseCoopers survey carried out in 2006 had

202 *Budget 2007*, Box 3.3, p 51

203 Q 248

204 Q 174

205 Q 248

206 Q 97

shown that the R&D tax credit was often given to companies who were already undertaking the R&D, and in many cases the R&D tax credit was not always claimed because it was too difficult to establish that the company qualified.<sup>207</sup> He argued that the changes to the taxation system in the 2007 Budget were unlikely to be behaviour-changing and that businesses tended to prefer a lower tax rate and simpler taxation system to incentives to invest.<sup>208</sup> Dr Weale also stated that he was “in favour of tax simplicity rather than having lots of tax allowances” because “a major disadvantage of a complicated system is that people devote resources trying to exploit the boundaries and to put themselves on the favourable side of the boundary”.<sup>209</sup> **It is not clear whether measures such as the increase in the R&D tax credit and the introduction of the Annual Investment Allowance will have the desired beneficial impact on investment levels by small companies. We recommend that, prior to the 2009 Budget, the Treasury review the impact of these measures on business investment in order to ensure that the measures are having a positive impact on investment and business growth, including the impact on small businesses that do not qualify for R&D tax credit or the Annual Investment Allowance.**

## Climate change and environmental measures

### Background

58. The Stern Review on *The Economics of Climate Change* was published on 30 October 2006.<sup>210</sup> That Review identified three key elements in an appropriate policy response to mitigate the effects of climate change:

- pricing carbon through trading, tax or regulation;
- encouraging research, development, demonstration and deployment to bring forward a range of low-carbon technologies; and
- measures to encourage long-term behavioural change and overcome barriers, particularly on energy efficiency.<sup>211</sup>

This year’s Budget included measures relating to each of these elements.

### Carbon pricing

59. The Government is committed to the use of market mechanisms and incentives to work towards global carbon trading.<sup>212</sup> The EU Emissions Trading Scheme remains “the central component in the Government’s domestic policy framework to tackle climate

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207 Q 98

208 Qq 98–99

209 Q 9

210 HM Treasury, Stern Review on *The Economics of Climate Change*, October 2006

211 *Budget 2007*, Box 7.1, p 171

212 HC (2006–07) 115, para 81

change”.<sup>213</sup> In his Budget statement, the Chancellor of the Exchequer said that the Government had “secured support for a strengthened European carbon trading scheme on the road to a global scheme”.<sup>214</sup> He also referred to the longer term strategy for the EU set by the 8–9 March 2007 European Council meetings, characterising this as “a new agreement for 2020 on cutting European emissions by at least 20% and potentially 30%”.<sup>215</sup>

60. The EU Emissions Trading Scheme covers approximately half of United Kingdom emissions. In sectors not currently covered by that Scheme, the Government considers that national measures can play a part in pricing carbon.<sup>216</sup> In his Budget statement, the Chancellor of the Exchequer announced that the main fuel duty rates for 2007–08 would increase by 2 pence per litre, with the increase deferred until 1 October 2007.<sup>217</sup> The period of deferral is somewhat shorter than that for 2006–07, when the increase did not come into effect until 6 December 2006 following the Pre-Budget Report.<sup>218</sup> The increase in the main fuel duty from 1 October 2007 will provide an Exchequer yield of £480 million in 2007–08 in non-indexed terms.<sup>219</sup> The Chancellor of the Exchequer also announced the level of proposed increases in the main fuel duty rates for 2008–09 and 2009–10 and increases in rebated oil duty rates.<sup>220</sup>

61. These increases in the price of carbon for surface transport follow the doubling of the rates of Air Passenger Duty which was announced in last year’s Pre-Budget Report and came into force on 1 February 2007. The Government claimed at the time that these increases would have environmental benefits through reduced emissions.<sup>221</sup> During the present inquiry, Treasury officials went further, telling us that the new rates of Air Passenger Duty had come into force when they did because “there were pressing environmental reasons for bringing that change in quickly”.<sup>222</sup>

### **Promoting low carbon technologies**

62. The second element in the Government’s approach to mitigating the effects of climate change is the promotion of low carbon technologies. The Budget announced several measures to support research and deployment in this area, including:

- the launch of a competition to develop the United Kingdom’s first full-scale carbon capture and storage demonstration, the results of which are to be announced in 2008;<sup>223</sup>

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213 *Budget 2007*, para 7.34, p 175

214 HC Deb, 21 March 2007, col 820. See also *Budget 2007*, paras 7.25–7.31, pp 173–174.

215 *Budget 2007*, para 7.28, p 174; HC Deb, 21 March 2007, col 820

216 *Budget 2007*, para 7.34, p 175

217 HC Deb, 21 March 2007, cols 822–823; *Budget 2007*, para 7.36, p 175

218 HC (2006–07) 115, para 83

219 *Budget 2007*, Table A1, p 209

220 *Budget 2007*, para 7.36, p 175

221 HC (2006–07) 115, para 82

222 Q 164

223 HC Deb, 21 March 2007, col 821; *Budget 2007*, para 7.40, p 176

- increases in the funding of the Low Carbon Buildings Programme to support the development of microgeneration for households;<sup>224</sup>
- the establishment of a review to examine the vehicle and fuel technologies which over the next 25 years could help to “de-carbonise” road transport, particularly cars;<sup>225</sup> and
- a range of measures to promote biofuels.<sup>226</sup>

### **Encouraging behavioural change**

63. The third aspect of the Government’s approach in this area is to encourage behavioural change. The Government seeks to encourage business energy efficiency through the Climate Change Levy which was introduced in 2001. From 1 April 2007, the Climate Change Levy was uprated in line with current inflation for the first time,<sup>227</sup> and the Budget confirmed that the Levy would also be uprated in the same way from 1 April 2008.<sup>228</sup>

64. The Budget also announced changes to the Vehicle Excise Duty regime to encourage the use of more fuel-efficient vehicles. New rates were announced with effect from 22 March 2007, and further announcements were made about rates in 2008–09 and 2009–10. The highest rate for what the Government characterised as “the most polluting cars” would rise to £300 immediately and to £400 in 2008–09. Further changes were made to encourage more fuel-efficient vehicles.<sup>229</sup> The indexed additional Exchequer yield of these changes is expected to be £125 million in 2007–08, £220 million in 2008–09 and £280 million in 2009–10.<sup>230</sup> The Chancellor of the Exchequer said that, “taken together, those measures will cut vehicle emissions since 1997 by 2 million tonnes”.<sup>231</sup> Dr Weale questioned whether the overall environmental effect of increasing Vehicle Excise Duty was as beneficial as that arising from increases in fuel duty.<sup>232</sup> Mr Whiting argued that increasing the cost associated with a less fuel-efficient vehicle might encourage the user to increase the mileage used to recoup the additional cost.<sup>233</sup> The Chancellor of the Exchequer argued that the effect of increases in fuel duty had to be considered together with the impact of incentives, such as a graduated Vehicle Excise Duty regime and those for bio-friendly fuels, as well as scientific advances towards lower carbon vehicles.<sup>234</sup>

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224 HC Deb, 21 March 2007, col 821; *Budget 2007*, para 7.42, p 177

225 HC Deb, 21 March 2007, col 822; *Budget 2007*, paras 7.44–7.45, pp 177–178

226 *Budget 2007*, paras 7.48–7.55, pp 178–180

227 HC (2005–06) 994–I, para 94

228 HC Deb, 21 March 2007, col 822; *Budget 2007*, para 7.61, pp 180–181

229 HC Deb, 21 March 2007, col 822; *Budget 2007*, para 7.78, p 185

230 *Budget 2007*, Table A1, p 209

231 HC Deb, 21 March 2007, col 822

232 Q 80

233 *Ibid*

234 Q 362

### **The Government's overall approach**

65. Mr Whiting considered that, while the Government was “going down the route of answering the Stern review”, there were not yet signs of a clear strategic approach to environmental taxation.<sup>235</sup> He contended that the Government had not clarified the extent to which environmental measures were designed to raise revenue or to change behaviour, leaving businesses in need of a clear statement about the overall purpose and direction of environmental tax measures.<sup>236</sup> The Government's overall approach to environmental taxation, as well as the impact of particular tax measures and the role of HM Treasury in environmental policy more generally, are matters we will consider when we report on our inquiry into Climate change and the Stern review: implications for HM Treasury policy.

### **Missing Trader Intra-Community fraud**

66. The total amounts of the Government's VAT receipts in recent years have been adversely affected by Missing Trader Intra-Community fraud, characterised by the Government as “an organised criminal attack on the EU VAT system”.<sup>237</sup> Such fraud seeks to exploit the fact that exports are zero-rated for VAT, while VAT on imports is subject to deferred payment. The fraud involves company A which sells goods for export reclaiming VAT on those goods because exports are zero-rated while company B importing the goods sells the goods to company C and requires company C to pay to company B the cost of VAT on those goods subject to import. Company B (the “missing trader”) then disappears before the VAT which it received from company C is remitted to the revenue authority in the relevant country. The fraudsters involved have regularly changed their methods, but a frequent feature of the fraud is that certain high value goods continue to circulate within the European Union (“carousel fraud”), attracting the rebate when they are exported but with the matching import charge never actually paid by the “missing trader”.<sup>238</sup> At the time of last year's Pre-Budget Report, HM Revenue & Customs provided new estimates of the Exchequer losses from Missing Trader Intra-Community fraud, indicating that the United Kingdom's VAT receipts could have been reduced by between £2 billion and £3 billion in 2005–06 alone due to such fraud.<sup>239</sup>

67. The EU VAT system is vulnerable to such fraud in part because the value of VAT on imports is paid by the purchaser to the seller, on whom the VAT liability falls; this opens up the opportunity for the seller who is a “missing trader”. One way to combat such fraud is to establish an arrangement whereby the liability to pay VAT does not fall on the seller, but is incurred at the end of the supply chain; this arrangement is referred to as the “reverse charge”.<sup>240</sup> The introduction of the “reverse charge” requires a derogation from EU VAT law. In evidence to us on 13 December 2006, the Chancellor of the Exchequer announced:

235 Qq 77, 52

236 Qq 77, 78

237 *Budget 2007*, para 5.146, p 133

238 Institute for Fiscal Studies, *The IFS Green Budget*, January 2007, pp 167–171

239 HC (2006–07) 115, para 85

240 *The IFS Green Budget*, January 2007, p 175

Securing a derogation from European Union VAT law to enable what is called a ‘reverse charge’ has been a vital part of the Government’s strategy against carousel fraud. The reverse charge would enable VAT to be charged for those particular items where fraud has been more prevalent, mobile phones and computer chips, at the point of sale to the consumer rather than at different points in the supply chain. This now would remove the mechanism by which the fraudster steals VAT in the supply chain. I am, therefore, pleased to tell the Committee that last night an agreement was reached on the derogation we have sought with France and, with the support now of other Member States, I am confident that the derogation will be adopted ... The impact of the reverse charge has been cautiously estimated with a yield of an additional £500 million in 2007–08, although the true impact will obviously depend on the levels of fraud in future years. However, the reverse charge will move the mechanism for stealing VAT from around 90% of goods currently traded in carousel fraud.<sup>241</sup>

68. In the event, however, the Chancellor of the Exchequer’s announcement was not followed immediately by agreement within the EU on the derogation to permit the introduction of a “reverse charge” on certain types of goods, perhaps in part because certain Member States favoured an approach whereby the “reverse charge” would apply to all goods above a certain value, rather than to particular categories of goods.<sup>242</sup> However, on 19 March 2007, the Government was able to announce that agreement had been reached enabling the “reverse charge” to be introduced on 1 June 2007 for mobile phones and computer chips, the goods most commonly used in Missing Trader Intra-Community fraud.<sup>243</sup> This was followed by a further announcement in the Budget of changes that would enable the Treasury to extend the joint and several liability provisions, which already cover certain goods used by the traders, to a wider range of specified goods.<sup>244</sup> Under the current provisions, HM Revenue & Customs can direct that a business receiving certain goods from another business is jointly and severally liable for VAT if HM Revenue & Customs have reasonable grounds to suspect that VAT would go unpaid elsewhere in the supply chain.<sup>245</sup>

69. The Budget estimated the additional Exchequer yield from the latest measures to counter Missing Trader Intra-Community fraud at £50 million in 2007–08.<sup>246</sup> When asked to explain why the estimated yield in that year was significantly lower than the figure of £500 million cited by the Chancellor of the Exchequer in December 2006 for the gains from the introduction of the “reverse charge”, Treasury officials gave two reasons. First, they said that the operational strategy of HM Revenue & Customs to bear down on such fraud had been “very successful, so there is less revenue to save as a result of the derogation”.<sup>247</sup> Second, they told us that “the derogation is coming in slightly later than we

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241 HC (2006–07) 115, Q 316

242 *The IFS Green Budget*, January 2007, p 175

243 “New measure to tackle international VAT fraud”, HM Treasury press notice, 19 March 2007; *Budget 2007*, para 5.146, p 133

244 *Budget 2007*, para 5.147, p 133

245 HM Treasury, *Budget Notes*, 21 March 2007, Note 60, “VAT: Joint and Several Liability”, para 5

246 *Budget 2007*, Table A1, p 208

247 Q 198

expected and is only covering the key goods”.<sup>248</sup> Overall, the Treasury observed that the deterioration of VAT receipts resulting from the “shock” of Missing Trader fraud “now looks as if it has been contained to a short period”.<sup>249</sup> Mr Whiting supported the view that progress was being made in tackling such fraud, both through the “reverse charge” and operational measures taken by HM Revenue & Customs, while noting that there would be a challenge in the future in responding to the possibility that the introduction of a “reverse charge” on certain categories of goods might encourage fraudsters to switch their attention to other types of goods not previously the subject of such fraud.<sup>250</sup> After we concluded taking oral evidence, further information about the derogation became available, indicating that the derogation will initially only be for the period up to 30 April 2009 “because it cannot be ascertained with certainty that the objectives of the measure will be achieved, nor can the impact of the measure on the functioning of the VAT system in the United Kingdom and in other Member States be gauged in advance”.<sup>251</sup> **We welcome signs of progress by HM Revenue & Customs in combating Missing Trader Intra-Community fraud. We also welcome the agreement secured by the United Kingdom Government to a derogation from EU VAT law to enable the application from 1 June 2007 of a “reverse charge” to certain categories of goods that have proved attractive to fraudsters. We note that estimates of the additional Exchequer receipts from this measure appear to have been revised downwards substantially since the Chancellor of the Exchequer’s initial announcement in evidence to us on 13 December 2006 and we recommend that the Government, in its response to this Report, provide a fuller explanation for this downward revision, including an assessment of the likely impact of the time-limited nature of the initial derogation. We expect the Government to remain vigilant for signs that fraudsters are switching their attention to categories of goods that are not covered by the new derogation from EU VAT law. We further recommend that, in its response to this Report, the Government set out the state of discussions within the EU about the possibility of subsequent, further extensions of the VAT derogation to combat Missing Trader Intra-Community fraud, both in terms of the range of goods covered by the derogation and the duration of the derogation.**

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248 Ibid

249 Q 124

250 Qq 100–101. See also *The IFS Green Budget*, January 2007, p 175.

251 Council of the European Union, Council Decision authorising the United Kingdom to introduce a special measure derogating from Article 193 of Council Directive 2006/112/EC on the common system of value added tax, 7583/07, 30 March 2007, Article 4 and Preamble, para 8

## 5 Other issues

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### The Gershon programme of efficiency savings

#### *Background and overall progress*

70. At the time of the 2004 Spending Review, the Government published the results of a study by Sir Peter Gershon on the potential for efficiency savings across central and local government. The study established targets for annual savings worth £21.48 billion to be achieved by the end of March 2008, and these targets were incorporated in the spending settlements up to 2007–08.<sup>252</sup> Last year's Pre-Budget Report announced that the total value of annual efficiency gains reported to the end of September 2006 across central and local government was £13.3 billion.<sup>253</sup> This year's Budget announced that, by the end of 2006, reported annual efficiency savings across central and local government had reached £15.58 billion,<sup>254</sup> representing reported progress of around £2.3 billion in the last three months of 2006.

#### *Transparency and verification*

71. In our Reports on the 2006 Budget and Pre-Budget Report we expressed concern that the way in which progress on the efficiency programme was reported did not maximise opportunities to strengthen public and parliamentary confidence in the progress of the efficiency programme.<sup>255</sup> We made three specific recommendations for improvement by the Treasury and the Office of Government Commerce: the introduction of a table in Budgets and Pre-Budget Reports providing a departmental breakdown of the overall total; the provision of further information on progress by theme or "work stream"; and an indication of the progress of verification of savings.<sup>256</sup> In response, the Government stated that it would "consider further the need for greater centrally-driven transparency across the programme".<sup>257</sup> Mr John Oughton, the then Chief Executive of the Office of Government Commerce, told us that "it is important to have good visibility and transparency",<sup>258</sup> and this year's Budget provides evidence of significant progress on the three points we identified for action by that Office and the Treasury.

72. The Government has responded positively to our recommendation for a table in the Red Book providing a breakdown of reported delivery against efficiency targets by individual department.<sup>259</sup> Table 6.1 of that document provides such a breakdown, effectively updating and broadening the information provided in departmental autumn

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252 *Releasing resources to the front line: Independent Review of Public Sector Efficiency*, Sir Peter Gershon CBE, July 2004; HC (2006–07) 115, para 40

253 HC (2006–07) 115, para 40

254 *Budget 2007*, para 6.17 and Table 6.1, p 145

255 HC (2005–06) 994-I, para 76; HC (2006–07) 115, para 46

256 HC (2006–07) 115, paras 46–47

257 HC (2006–07) 423, p 7

258 Q 228

259 See HC (2006–07) 115, para 46.

performance reports—and summarised by us in Table 2 of our Report on last year’s Pre-Budget Report—in advance of the publication of departmental annual reports.<sup>260</sup> Comparison of the Treasury’s latest figures with the figures available up to September 2006 shows that some departments have reported significant progress in the closing months of 2006. Both the Home Office and the Department for Work and Pensions are reported to have already exceeded the efficiency targets originally set to the end of March 2008 by the end of 2006. The Department for Education and Skills, which had been the slowest to report savings up to the end of September 2006 as a proportion of its overall target, in part due to reporting systems operating by academic year and in part as a result of the time taken to gather data from frontline institutions, indicated that a further efficiency gain of over £400 million had been reported in the last quarter of 2006.<sup>261</sup>

73. The Gershon review identified the potential for progress in efficiency in relation to six themes or “work streams” which applied across individual departments—back office functions, transactional services, procurement, productive time, “policy, funding and regulation” and other savings which did not fall into any of the preceding five categories. In our Reports on both last year’s Budget and last year’s Pre-Budget Report we recommended that the Government provide further information on progress in relation to each “work stream”.<sup>262</sup> On the day after this year’s Budget, the website of the Office of Government Commerce was updated with information along the lines we had requested, which is summarised in Table 6:

**Table 6: Efficiency progress reported to December 2006 by “work stream”**

Work stream	Total savings to December 2006 £ billion	Savings to December 2006 as percentage of total
Procurement	6.2	40
Productive time	3.0	19
Policy, funding and regulation	1.8	12
Corporate services	0.9	6
Transactions	0.6	4
Other	3.0	19

Source: OGC website, [www.ogc.gov.uk](http://www.ogc.gov.uk)

Mr Oughton considered that this information

suggests that the programme ... is delivering broadly as we expected, namely that procurement would be the earliest area of gains, the easiest to measure, straight to cash off the bottom line as contracts were negotiated, and that some of the more substantial tasks that had to be undertaken, developing an approach to productive time, dealing with corporate services, the other Gershon workstreams, would take longer to plan. I would not say they are harder, they just take longer to plan and

260 *Budget 2007*, Table 6.1, p 145; HC (2006–07) 115, p 29

261 HC (2006–07) 115, para 49 and Table 2; *Budget 2007*, Table 6.1, p 145

262 HC (2005–06) 994–I, para 76; HC (2006–07) 115, para 47

longer to invest in in order to deliver, but the benefits will still be contained within the three years of the programme.<sup>263</sup>

74. In our Report on last year's Pre-Budget Report we welcomed the progress made by the Office of Government Commerce, in consultation with the National Audit Office (NAO), in establishing a new framework for verifying reported efficiency gains, under which gains would be classified as "preliminary", "interim" or "final". We recommended that the Government report progress against efficiency using these classifications.<sup>264</sup> Following this year's Budget, the Office of Government Commerce placed on its website an assessment that, of £15.58 billion of annual savings reported to the end of 2006, 68% were final, 22% were interim and 10% were preliminary.<sup>265</sup> These figures differ somewhat from the assessment provided by the NAO, in its latest assessment of the efficiency programme published in February 2007, which concluded that, of the £13.3 billion of efficiency savings reported to the end of September 2006, "£3.5 billion (26%) fairly represent efficiencies made; £6.7 billion (51%) represent efficiency but carry some measurement issues and uncertainties; and £3.1 billion (23%) may represent efficiency, but the measures used either do not yet demonstrate it or the reported gains may be substantially incorrect".<sup>266</sup> Mr Oughton considered the NAO report to be "very fair", and did not see any significant differences between the NAO's findings and the figures presented by the Office of Government Commerce: "I do not think there is very much between us, frankly, because the NAO is saying a very large proportion of this programme does fairly represent efficiencies; but there are measurement issues that still need to be resolved, and I agree with that".<sup>267</sup> The Budget confirmed that the Office of Government Commerce "will do further work to tackle the remaining measurement challenges during the final year of the programme, including by encouraging greater use of departmental internal auditors and through further engagement with the NAO and the Audit Commission".<sup>268</sup>

75. When we have previously considered the efficiency programme, we have particularly highlighted the difficulties associated with verifying that reported efficiency gains have been secured without detrimental effects on service quality.<sup>269</sup> The NAO Report published in February 2007 noted that:

The new reporting process introduced by the Office of Government Commerce embeds the need for reporting quality indicators alongside the efficiency gains. There are many examples across the Programme where service quality has been maintained or has actually improved, although in a number of instances projects are finding it hard to demonstrate fully that quality has been maintained ... The OGC has ... initiated a new reporting system which requires senior management in departments

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263 Q 224

264 HC (2006–07) 115, paras 45, 47

265 [www.ogc.gov.uk](http://www.ogc.gov.uk), "Efficiency programme progress to December 2006"

266 National Audit Office, *The Efficiency Programme: A Second Review of Progress*, February 2007, HC (2006–07) 156–I, Executive Summary, para 5, p 6

267 Q 225

268 *Budget 2007*, para 6.19, p 146

269 HC (2005–06) 994–I, paras 73–74; HC (2006–07) 115, paras 50–51

to sign off on the accuracy of reporting efficiencies [and] provide assurance that service quality has been maintained.<sup>270</sup>

Professor Talbot, in oral evidence, considered that the overall problem of measuring service outputs in the public sector remained unresolved.<sup>271</sup> Mr Oughton argued that departments were best-placed to measure the effect of efficiency measures on service quality, although he emphasised that figures provided by departments were challenged and validated by the Office of Government Commerce and were also open to inspection by the NAO or the Audit Commission as appropriate.<sup>272</sup>

### **Civil Service workforce reductions**

76. In addition to the overall targets for efficiency savings measured in monetary terms, departments were set targets for reductions in the Civil Service workforce—and for military posts in administrative and support functions in the case of the Ministry of Defence—arising out of the efficiency programme. The overall target was for a gross reduction of 84,150 posts by April 2008, with a net target of 70,600 and the remaining reduction accounted for by reallocation of staff to “front-line” tasks.<sup>273</sup> The targets related to reductions attributable to the Gershon efficiency programme; the possibility of increases arising from other developments was not ruled out.<sup>274</sup> At the time of last year’s Pre-Budget Report, the Government reported gross reductions of nearly 55,000 posts.<sup>275</sup> In February 2007, the NAO concluded that the figures reported up to September 2006 were “broadly robust” and was able to provide “substantial reassurance” on the reported reductions, while noting that a small minority of reductions arose from departments using early baselines, “partly diminishing confidence in what has been achieved”.<sup>276</sup> This year’s Budget provides new figures for overall reductions in Civil Service numbers as a result of the efficiency programme up to the end of December 2006. Gross reductions reported to that date total 60,591 posts, with 9,703 of that figure attributable to reallocations to front-line roles and 50,888 resulting from reductions.<sup>277</sup> The Ministry of Defence reported around 2,500 posts reduced in the last quarter of 2006, while HM Revenue & Customs reported a further reduction or re-allocation of over 1,000 posts in the same period.<sup>278</sup> Mr Oughton considered the overall progress achieved to be “good”, while acknowledging that “there are some remaining challenges”, particularly those associated with those departments which had a significant amount of their headcount reduction target up to April 2008 still to achieve.<sup>279</sup>

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270 National Audit Office, *The Efficiency Programme: A Second Review of Progress*, February 2007, HC (2006–07) 156–I, Executive Summary, paras 8, 11, p 6

271 Q 96

272 Qq 226–228

273 HC (2005–06) 994–I, para 78

274 HC (2005–06) 739, para 75

275 HC (2006–07) 115, para 52

276 National Audit Office, *The Efficiency Programme: A Second Review of Progress*, February 2007, HC (2006–07) 156–I, Executive Summary, para 9, p 6

277 *Budget 2007*, Table 6.2, p 146

278 HC (2006–07) 115, Table 3, p 35; *Budget 2007*, Table 6.2, p 146

279 Q 232

## Conclusions

77. In our Reports on Budgets and Pre-Budget Reports in the current Parliament we have set out an agenda for improvements in the reporting framework for the efficiency programme in three areas, relating to the central reporting of progress by the Treasury and the Office of Government Commerce, reporting by individual departments and verification issues surrounding service quality. We welcome the significant improvement in the first area since we last reported: the Government has responded positively to our recommendations for a departmental breakdown of efficiency savings in the Red Book and for further information on savings by work stream and by verification status. The response to our recommendations about the quality and consistency of departmental reporting on the efficiency programme should be apparent when 2007 departmental annual reports are published shortly. Regarding service quality, we welcome the further steps taken through collaboration between the Office of Government Commerce, the National Audit Office and the Audit Commission to establish agreed measures of service quality, and expect further information about this work to be provided in departmental annual reports.

## Aspects of the Comprehensive Spending Review

### Introduction

78. This year's Budget contained several significant announcements relating to the 2007 Comprehensive Spending Review. We referred earlier to the decision on the overall public spending envelope for the period from 2008–09 to 2010–11.<sup>280</sup> In this section of the current Report, we briefly examine some of the main issues relating to that Review which have emerged from this year's Budget. We will be reporting separately in due course on the prospects and processes for this Review.

### Timing of the outcome of the Review

79. In the course of his Budget statement, the Chancellor of the Exchequer announced that the final public expenditure allocations arising from the 2007 Comprehensive Spending Review would be published in the autumn.<sup>281</sup> The outcome of each previous Spending Review since 1998 has been announced to the House of Commons in July.<sup>282</sup> Treasury officials declined to confirm when in the autumn the announcement would be made,<sup>283</sup> but in January this year the Rt. Hon. Stephen Timms MP, Chief Secretary to the Treasury, told us that the announcement of the outcome of the Review “needs really to be [made] by October in order that departments have the details they need for putting in place their

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280 See paragraphs 23–25

281 HC Deb, 21 March 2007, col 817

282 HM Treasury, *Comprehensive Spending Review: Modern Public Services for Britain*, Cm 4011, July 1998; HM Treasury, *Spending Review 2000*, Cm 4087, July 2000; HM Treasury, *2002 Spending Review*, Cm 5570, July 2002; HM Treasury, *2004 Spending Review*, Cm 6237, July 2004

283 Q 199

arrangements for the new financial year”.<sup>284</sup> A similar point was made by Treasury officials during this inquiry.<sup>285</sup>

### *The timing of departmental settlements*

80. The current Comprehensive Spending Review differs from previous Spending Reviews in the extent to which individual departmental spending limits have been settled in advance of the final allocation of the overall spending totals. In the 2006 Budget, the following announcements were made:

- that Departmental Expenditure Limits for the Department for Work and Pensions, HM Revenue & Customs, HM Treasury and the Cabinet Office would fall by 5% in real terms per year in 2008–09, 2009–10 and 2010–11;<sup>286</sup> and
- that the Home Office budget would remain flat in real terms over the same three-year period.<sup>287</sup>

In the 2006 Pre-Budget Report it was announced that:

- the Departmental for Constitutional Affairs had agreed a settlement which would reduce its budget by an annual average of 3.5% in real terms over the period from 2008–09 to 2010–11; and
- early settlements had been agreed with the Privy Council Office, National Savings & Investments, the Central Office of Information, the Food Standards Agency and the Government Actuary’s Department which would see their budgets reduced by 5% a year in real terms over the same period.<sup>288</sup>

Further decisions were announced in this year’s Budget:

- that an early settlement had been reached with the Department for Education and Skills which would see the Departmental Expenditure Limits set at £67,298 million in 2008–09, £70,622 million in 2009–10 and £75,188 million in 2010–11, thus rising on average at 2.7% a year in real terms;<sup>289</sup>
- that the Attorney General’s Departments had agreed budgets that would fall by 3.5% per year in real terms over the period covered by the Comprehensive Spending Review;<sup>290</sup> and
- that there had been an early settlement for the Office of Fair Trading which would reduce its budget by 5% a year in real terms over the years from 2008–09 to 2010–11.<sup>291</sup>

284 Corrected transcript of oral evidence to the Treasury Committee, 31 January 2007, Q 10

285 Q 200

286 *Budget 2006*, Box 6.3, p 136

287 HC (2005–06) 994–I, para 66

288 *Pre-Budget Report 2006*, Box 6.3, p 143

289 *Budget 2007*, Table 6.3, p 157; Q 84

290 *Budget 2007*, para 6.25, p 147

Treasury officials told us that, taken together, the effect of these early settlements announced since March 2006 was to commit about 30% of total spending within Departmental Expenditure Limits.<sup>292</sup> Ms Rosewell drew attention to the fact that the impact of the Comprehensive Spending Review was becoming apparent through “a staged series of conclusions”,<sup>293</sup> suggesting the possibility that there could be further announcements in advance of the final outcome being published in the autumn of this year.

### **Education spending**

81. As we have just noted, this year’s Budget saw the announcement of total spending allocations to the Department for Education and Skills for the period from 2008–09 to 2010–11. Within these overall totals, education spending in England will rise to £66.9 billion in 2008–09, £70.0 billion in 2009–10 and £74.4 billion in 2010–11.<sup>294</sup> Education spending in England will thus rise in real terms by 2.5% a year on average between 2007–08 and 2010–11.<sup>295</sup> The Government’s ambitions for increasing education expenditure have sometimes been expressed in terms of a proportion of GDP. Total education spending in the United Kingdom as a proportion of GDP is subject to a number of variables, including the spending decisions of the devolved administrations and the rate of growth of GDP.<sup>296</sup> Mr Chote indicated that, over the period subject to allocations as part of the Comprehensive Spending Review, assuming 2.5% GDP growth per year, United Kingdom education spending would be “fractionally below ... or around the growth rate of the economy”, although he noted that the Government was using cautious assumptions about GDP growth in its own calculations.<sup>297</sup> The Chancellor of the Exchequer pointed out that the education settlement meant that “we will achieve our ambition during the course of this Parliament ... to raise the percentage of national income spent on education”.<sup>298</sup> Taking the period from 1997 to 2010–11 as a whole, spending on education is projected to rise from 4.5% of GDP to 5.6% of GDP.<sup>299</sup>

82. The Chancellor of the Exchequer stressed that the new spending settlement announced for education facilitated greater emphasis on the needs of individual pupils.<sup>300</sup> The Budget announced funding to provide an average of 10 hours of one-to-one teacher-led tuition for over 300,000 under-attaining pupils a year in English by 2010–11, and 300,000 under-attaining pupils a year in Maths.<sup>301</sup> The spending settlement up to 2010–11 also forms part of the context of the Government’s proposal, foreshadowed in the Budget and set out in more detail the following day, to require all young people to participate in education or

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291 *Budget 2007*, para 6.25, p 147

292 Q 201

293 Q 28

294 *Budget 2007*, Table 6.3, p 157

295 *Ibid*, para 6.73, p 157

296 Qq 90, 84

297 Q 84

298 Q 358

299 HC Deb, 21 March 2007, col 827; *Budget 2007*, Table 6.4, p 158; Q 358

300 Q 358

301 *Budget 2007*, para 6.80, p 160

training until their eighteenth birthday with effect from 2015—a proposal the implementation of which the Rt. Hon. Alan Johnson MP, Secretary of State for Education and Skills, indicated on 22 March 2007 would entail around £200 million in capital spending in the run-up to 2015 and around £700 million in revenue expenditure.<sup>302</sup>

83. In last year's Budget, the Chancellor of the Exchequer set out a “long-term aim” for State spending per pupil to match the average level of spending per pupil in private sector days schools in 2005–06 of £8,000. Treasury officials told us at the time that there was “no timetable attached” to this “pledge”.<sup>303</sup> On the basis of the new spending settlement, spending per pupil in the State sector is expected to rise from £4,800 per pupil in 2005–06 to £6,600 per pupil in 2010–11 (the equivalent of £5,800 per pupil in 2005–06 prices). The Institute for Fiscal Studies has forecast that, if education spending were to continue to rise in line with the rates of spending increase now set for the period from 2008–09 to 2010–11, the level of private sector spending in 2005–06 would be matched by the level of State sector spending in 2020–21.<sup>304</sup> Treasury officials indicated that spending announcements since the 2006 Budget provided for around one-fifth of the expenditure required to match private sector spending levels in 2005–06 in real terms.<sup>305</sup> In the longer term, the level of education spending per pupil may be affected not only by spending plans, but also by demographic change and by the implications of the proposal to extend compulsory schooling or training to all children up to their eighteenth birthday.

84. The overall levels of capital spending on education were announced in last year's Pre-Budget Report.<sup>306</sup> In our Report on that document, we noted the difficulties in ascertaining the path of expenditure in annual terms on major capital programmes, including the Building for Schools Programme.<sup>307</sup> In its response, the Government indicated that it would not be possible to provide such information before the outcome of the Comprehensive Spending Review was finalised “because of the interaction between capital and revenue allocations in respect of the local government settlement”.<sup>308</sup> This year's Budget does provide further information about the expected overall contribution of the Private Finance Initiative towards the previously-announced capital budgets for education. Table 6.3 in the Red Book shows the contribution of the Private Finance Initiative as static in nominal terms at £1,320 million between 2007–08 and 2010–11.<sup>309</sup> Treasury officials confirmed that this represented a fall of the Private Finance Initiative contribution from about 20% of total capital expenditure on education to about 16% over the period,<sup>310</sup> but

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302 HC Deb, 21 March 2007, col 827; Department for Education and Skills, *Raising Expectations: staying in education and training post-16*, Cm 7065, 22 March 2007; HC Deb, 22 March 2007, col 978

303 HC (2005–06) 994–I, para 56

304 Q 86

305 Q 213

306 HC Deb, 6 December 2006, col 314

307 HC (2006–07) 115, para 61

308 HC (2006–07) 423, pp 9–10

309 *Budget 2007*, Table 6.3, p 157

310 Q 217

neither they nor the Chancellor of the Exchequer appeared to see this forecast reduction as significant.<sup>311</sup>

### **The Financial Assistance Scheme**

85. We have previously considered the possible costs of assistance concerning occupational pension schemes in the context of the Comprehensive Spending Review.<sup>312</sup> The main form of such assistance provided by the Government is through the Financial Assistance Scheme, which came into operation on 1 September 2005. The Scheme is designed to help some of the members of defined benefit pension schemes which are under-funded where the employer has become insolvent or no longer exists.<sup>313</sup> In his Budget speech, the Chancellor of the Exchequer stated that:

There are 125,000 employees who, through no fault of their own, lost their work pension when their employer became insolvent. My right hon. Friend the Secretary of State for Work and Pensions is announcing that he will extend the Financial Assistance Scheme from its present budget of £2 billion to a total of £8 billion. Every one of those 125,000 workers will now receive help. Reporting later this year, my right hon. Friend will also investigate in full the assets within the affected schemes, and how those funds can also now help those who have lost their pensions.<sup>314</sup>

Treasury officials told us that “the additional support the Chancellor announced would bring the net present value of the support offered through the scheme up to £1.9 billion over its lifetime”.<sup>315</sup> When asked where in the Red Book this increase was accounted for, they responded that the additional support would be provided from within the budget of the Department of Work and Pensions over the period covered by the Red Book.<sup>316</sup>

### **Efficiency**

86. As part of departmental spending settlements for the period covered by the Comprehensive Spending Review, the Government is seeking to embed some of the practices and processes employed as part of the Gershon efficiency programme. At the time of last year’s Pre-Budget Report, it was announced that agreement had been reached that all departments would be required to achieve net efficiency savings of 3% a year in their overall budgets and to reduce their administration budgets by 5% a year in the period from 2008–09 to 2010–11.<sup>317</sup> In this year’s Budget, the Treasury has made it explicit that “all of the savings delivered under the 2007 Comprehensive Spending Review value for money programme will be net of implementation costs and cash-releasing”.<sup>318</sup> Professor Talbot characterised the new targets as involving “a massive step change in the amount of

<sup>311</sup> Qq 218, 359

<sup>312</sup> HC (2005–06) 994–I, paras 59–60

<sup>313</sup> Department of Work and Pensions website, [www.dwp.gov.uk/lifeevent/penret/penreform/fas/](http://www.dwp.gov.uk/lifeevent/penret/penreform/fas/)

<sup>314</sup> HC Deb, 21 March 2007, col 824

<sup>315</sup> Q 219

<sup>316</sup> Qq 221–223

<sup>317</sup> HC (2006–07) 115, para 58

<sup>318</sup> *Budget 2007*, para 6.24, p 147

money which is supposed to be saved in efficiency savings” in view of the fact that only around 1.5% of the efficiency savings in the period of the Gershon programme were intended to be cash-releasing.<sup>319</sup> The Chancellor of the Exchequer appeared to accept that the new targets could be seen as more stretching than the variable efficiency targets set out in the Gershon review, many of which were not set net of implementation costs.<sup>320</sup>

87. The Office of Government Commerce has played an important role in monitoring achievements against the Gershon efficiency targets and promoting a relatively consistent approach to reporting progress. Mr Oughton indicated that the Office of Government Commerce would not play a comparable role in relation to the programme for the period from 2008–09 onwards:

The challenge now is to assess whether efficiency is now in the mainstream of how departments conduct their business planning and undertake their tasks. To be frank two and a half years ago when the programme started this was new territory for most departments and it was clear when they developed their plans that they were struggling to identify how to address the task. I am much more confident now that this is part of the routine, it is part of the mainstream of what departments do, and that gives us the confidence that we can mainstream the approach to efficiency for the next spending review into the normal financial control mechanisms of the Treasury ... The Government’s direction of the Efficiency Programme will be extremely strong. It will be handled by the Public Spending Directorate in the Treasury so I think the mechanisms and levers will be as strong in the future as they are now.<sup>321</sup>

**We expect to consider the implications of changes in the central management of the efficiency programme when we report on prospects for the Comprehensive Spending Review.**

### **Front-line services**

88. In his Budget statement, the Chancellor of the Exchequer talked about the additional expenditure available for allocation in the Comprehensive Spending Review as a result of the combined effect of the reductions in administration budgets, of the early spending settlements for certain departments incorporating a real terms reduction in expenditure and of the new targets for 3% efficiency savings:

I have agreed with Departments savings in administrative costs worth £1 billion a year by 2011, which will also release money for front-line services. The same front-line services will benefit from below-inflation spending review settlements for the Department for Work and Pensions, Her Majesty’s Revenue and Customs, the Cabinet Office, the Treasury, the Department for Constitutional Affairs and the Attorney-General’s Department. That will release for front-line services £2 billion,

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319 Q 93

320 Qq 368–369

321 Qq 229, 231

and with efficiency savings of 3% a year, we release, in total, £26 billion a year by 2010 for front-line services.<sup>322</sup>

He went on to say:

Just over a decade ago, when unemployment and debt were high and as much as three quarters of all new public spending went to pay for debt and social security costs, it left only one quarter of new spending for health, education, transport, defence and policing. But because of our success in cutting debt by a quarter and claimant count unemployment by a half, those front-line services will, in the coming spending round, receive not 25% of all new spending as in the past, but 75% of all new spending. In this new spending round, our aim has also been—in line with the Gershon report and with continuing reform—to ensure that resources for improving the front-line services, our service priorities, will continue to grow at the 4 to 4.5% yearly rate of this spending round.<sup>323</sup>

89. Professor Talbot observed that “it is unclear how front-line services are defined in relation to both redistribution of money and redistribution of personnel, and it would be interesting to see what those definitions are”.<sup>324</sup> In the context of staff reallocations to front-line roles, the NAO observed in February 2007 that “there is also no overall agreed definition of what constitutes a ‘front-line’ role”.<sup>325</sup> Treasury officials suggested that the term “front-line services” was used to refer to all departmental expenditure, as opposed to expenditure on social security and debt interest.<sup>326</sup> In his oral evidence, the Chancellor of the Exchequer made a similar point to that he had made in his Budget statement, namely that, in 1994–95, 75% of all new expenditure has been committed to debt interest and unemployment, whereas “75% or so of most new public expenditure is actually going to health, education, transport, infrastructure and investment in our future”.<sup>327</sup> It is likely that, in our future work on the Comprehensive Spending Review, we will seek to explore further the Treasury’s definition or definitions of “front-line” services.

## Conclusions

**90. In this Report, we have examined several aspects of the Comprehensive Spending Review, including the timing of departmental settlements, education spending, the efficiency targets for the period from 2008–09 to 2010–11 and the Treasury’s definition or definitions of “front-line” services. We intend to explore these matters further in our Report on the prospects and processes for the Comprehensive Spending Review.**

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322 HC Deb, 21 March 2007, cols 817–818

323 Ibid, col 818

324 Q 103

325 National Audit Office, *The Efficiency Programme: A Second Review of Progress*, February 2007, HC (2006–07) 156–I, Executive Summary, para 10, p 6

326 Q 208

327 Q 295

## Conclusions and recommendations

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### *The economy*

#### *The output gap*

1. Migration of uncertain magnitude and the greater stability of the economy may reduce the value of the concept of the output gap as a tool of economic analysis. We recommend that the Government examine the impact of these factors on the role which the concept of the output gap should play in Treasury forecasting and analysis, and report on the outcome of such examination in its response to this Report. (Paragraph 6)

#### *Migration*

2. Given the importance of migration for both the labour market and the measurement of the output gap, we welcome the work undertaken by the Office for National Statistics aimed at improving the quality of migration statistics. We recommend that the Treasury report regularly in Budget and Pre-Budget Reports on the progress of this work. (Paragraph 8)

#### *Inflation and monetary policy*

3. The recent rise in inflation has been caused in part by a number of short-term factors, such as higher energy bills. There is little evidence at the moment that higher inflation is having second-round effects. We will, however, continue to keep the situation under review through our regular hearings on the Bank of England's Inflation Reports and our scrutiny of Budgets and Pre-Budget Reports. (Paragraph 12)

### *The public finances*

#### *Revenue receipts*

4. We note the very significant downward revision of forecast North Sea oil revenues in 2006–07 and 2007–08 compared with the 2006 Pre-Budget Report. We are concerned that the Treasury's estimate at Budget 2007 is so much lower than its forecast in the 2006 Pre-Budget Report, only three months earlier. We believe that the volatility of North Sea oil revenues constitutes a risk to taxation revenues in the future. (Paragraph 19)
5. The deterioration of the current budget balance predicted for 2006–07 and 2007–08 compared with the forecasts in last year's Budget and Pre-Budget Report has been caused by a reduction in the Treasury's forecasts of non-North Sea corporation tax revenues as well as a fall in its forecasts of North Sea oil revenues. (Paragraph 20)
6. We recognise that the Government's forecasting record for overall revenues appears to have improved this year and that its forecasts of corporation tax receipts have been affected by the unanticipated reduction in North Sea oil revenues in 2006-07.

However, the Treasury has over-estimated corporation tax receipts for the past six years. If the direction of forecasting errors is correlated with the economic cycle, as Treasury officials have suggested, the Treasury's recent forecasting record of over-estimation should be more cautious in the near future if output moves above trend. We will continue to monitor the Treasury's performance in forecasting corporation tax receipts with this in mind. (Paragraph 22)

### *Public spending*

7. This year's Budget includes confirmed levels of overall current public spending for the period from 2008–09 to 2010–11 which are in line with the figures used for the purposes of fiscal planning in the 2006 Pre-Budget Report, although previously-cited figures relating to spending in this period were characterised by the Chancellor of the Exchequer at the time as “working assumptions” rather than final figures. (Paragraph 25)
8. We welcome the procurement capability reviews that the Government is initiating in central government departments. We will continue to monitor outturns of public sector net investment expenditure against allocated budgets to develop an understanding of whether and how soon these capability reviews affect performance. (Paragraph 27)

### *The golden rule*

9. We welcome the Chancellor of the Exchequer's acknowledgment that counting the last year of the present economic cycle as the first year of the next economic cycle for the purposes of assessing whether or not the Government meets the golden rule would represent adherence to the Treasury's past practice. We expect to see this practice continue into the future. (Paragraph 29)
10. The reduction in amplitude of the economic cycles in the past decade or so and the difficulties of measuring the output gap have made the dating of the economic cycle and application of the golden rule a particularly difficult process. We reiterate our recommendation that the Government review the golden rule and consider how to make it more forward-looking and its application less dependent on the dating of the economic cycle. (Paragraph 31)

### *The sustainable investment rule*

11. We note that the interpretation of the sustainable investment rule in the current economic cycle requires that net debt is maintained below 40% in each and every year of the economic cycle. We recommend that the Government, in its response to this Report, give an account of the circumstances in which it would change its current interpretation of the sustainable investment rule for the next economic cycle. (Paragraph 33)

### *International Financial Reporting Standards and PFI liabilities*

12. We welcome the Government's decision to adopt International Financial Reporting Standards. We recommend that the Government, in its response to this Report, provide a fuller technical explanation of the differences between International

Financial Reporting Standards and UK GAAP that could affect the future accounting treatment of PFI liabilities. We further recommend that the Government, in its response to this Report, explain more fully the reasons for the existing variations in on- and off-balance sheet classifications between departments. (Paragraph 35)

## **Tax measures**

### ***Personal taxation, tax credits and child poverty***

13. An important part of any change to the personal taxation regime must be that both winners and losers can identify, with ease, how they are affected by the changes stated within a Budget package. We recommend that, in future, this information be provided within the Red Book. (Paragraph 41)
14. Given that the personal taxation changes announced in this year's Budget will have an impact on the post-tax earnings of those who are childless and earning an income entitling them to claim Working Tax Credit, the need to increase the low take-up rate of Working Tax Credit among that group should be a priority. We therefore welcome the evidence of a recent increase in the take-up of Working Tax Credit provided by the Chancellor of the Exchequer, although we would welcome further details as to the increase in the take-up of Working Tax Credit in percentage terms. We also note the Government's efforts to increase take-up still further. However, we expect the Treasury to carefully monitor the impact of any increase in the take-up rate on the fiscal planning assumptions within Annually Managed Expenditure. (Paragraph 45)
15. We are concerned by the recently reported rise in child poverty in 2005–06 of 100,000 children, according to the Government's preferred measure. We welcome the extra resources allocated in the Budget, which it is estimated will help around 200,000 children out of relative poverty. We reiterate the recommendation made in our Report on the 2006 Pre-Budget Report that the Government, in reporting on the outcome of the Comprehensive Spending Review, state how it intends to meet the 2010–11 target to halve the number of children in poverty and where the resources will come from to meet that target. We welcome the Government's increased emphasis on improving incentives to work and recommend that, in reporting on the outcome of the Comprehensive Spending Review, the Government publish its analysis of the impact of improving incentives to work on meeting its child poverty targets. (Paragraph 48)
16. Targeting those children in families at the very lowest income levels must be a priority for the Government, but is important to ensure that adopting a target to help such children does not detract from meeting the overall 2020 target. We recommend that, in publishing the outcome of the Comprehensive Spending Review, the Government set out its latest understanding of the dynamics of the very poor, perhaps in the context of the Government's work on its new deprivation index. We further recommend that, at the same time, the Government set out its views on the possible value of an additional target specifically focussed on child poverty in the very poorest households (defined as earning less than 40% of median income) within the context of its target of eliminating child poverty by 2020. (Paragraph 50)

17. We recommend that whenever the Government reports on complicated, multi-faceted responses to policy issues, such as child poverty, it should attempt to draw together all the analysis on all relevant policy instruments in the appropriate Budget or related document, so that it is transparent what the different policies are intended to achieve, at what cost, and how the whole package of policies will interact and achieve their purpose. (Paragraph 51)

### *Corporate taxation*

18. It is not clear whether measures such as the increase in the R&D tax credit and the introduction of the Annual Investment Allowance will have the desired beneficial impact on investment levels by small companies. We recommend that, prior to the 2009 Budget, the Treasury review the impact of these measures on business investment in order to ensure that the measures are having a positive impact on investment and business growth, including the impact on small businesses that do not qualify for R&D tax credit or the Annual Investment Allowance. (Paragraph 57)

### *Missing Trader Intra-Community fraud*

19. We welcome signs of progress by HM Revenue & Customs in combating Missing Trader Intra-Community fraud. We also welcome the agreement secured by the United Kingdom Government to a derogation from EU VAT law to enable the application from 1 June 2007 of a “reverse charge” to certain categories of goods that have proved attractive to fraudsters. We note that estimates of the additional Exchequer receipts from this measure appear to have been revised downwards substantially since the Chancellor of the Exchequer’s initial announcement in evidence to us on 13 December 2006 and we recommend that the Government, in its response to this Report, provide a fuller explanation for this downward revision, including an assessment of the likely impact of the time-limited nature of the initial derogation. We expect the Government to remain vigilant for signs that fraudsters are switching their attention to categories of goods that are not covered by the new derogation from EU VAT law. We further recommend that, in its response to this Report, the Government set out the state of discussions within the EU about the possibility of subsequent, further extensions of the VAT derogation to combat Missing Trader Intra-Community fraud, both in terms of the range of goods covered by the derogation and the duration of the derogation. (Paragraph 69)

### *Other issues*

#### *The Gershon programme of efficiency savings*

20. In our Reports on Budgets and Pre-Budget Reports in the current Parliament we have set out an agenda for improvements in the reporting framework for the efficiency programme in three areas, relating to the central reporting of progress by the Treasury and the Office of Government Commerce, reporting by individual departments and verification issues surrounding service quality. We welcome the significant improvement in the first area since we last reported: the Government has responded positively to our recommendations for a departmental breakdown of efficiency savings in the Red Book and for further information on savings by work

stream and by verification status. The response to our recommendations about the quality and consistency of departmental reporting on the efficiency programme should be apparent when 2007 departmental annual reports are published shortly. Regarding service quality, we welcome the further steps taken through collaboration between the Office of Government Commerce, the National Audit Office and the Audit Commission to establish agreed measures of service quality, and expect further information about this work to be provided in departmental annual reports. (Paragraph 77)

### *Aspects of the Comprehensive Spending Review*

21. We expect to consider the implications of changes in the central management of the efficiency programme when we report on prospects for the Comprehensive Spending Review. (Paragraph 87)
22. In this Report, we have examined several aspects of the Comprehensive Spending Review, including the timing of departmental settlements, education spending, the efficiency targets for the period from 2008–09 to 2010–11 and the Treasury’s definition or definitions of “front-line” services. We intend to explore these matters further in our Report on the prospects and processes for the Comprehensive Spending Review. (Paragraph 90)

# Formal minutes

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**Wednesday 18 April 2007**

Members present:

Mr John McFall, in the Chair

Angela Eagle

Mr Michael Fallon

Mr David Gauke

Ms Sally Keeble

Mr Andrew Love

Kerry McCarthy

Mr George Mudie

Mr Brooks Newmark

Mr Mark Todd

John Thurso

## ***The 2007 Budget***

The Committee considered this matter.

Draft Report (The 2007 Budget), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 5 read and agreed to.

Paragraph 6 read, amended and agreed to.

Paragraphs 7 and 8 read and agreed to.

Paragraphs 9 and 10 read, amended and agreed to.

Paragraph 11 read and agreed to.

Paragraph 12 read, amended and agreed to.

Paragraphs 13 and 14 read and agreed to.

Paragraph 15 read, amended and agreed to.

Paragraph 16 read and agreed to.

Paragraph 17 read, amended and agreed to.

Paragraph 18 read and agreed to.

Paragraph 19 read, amended and agreed to.

Paragraph 20 read and agreed to.

Paragraphs 21 and 22 read, amended and agreed to.

Paragraph 23 read and agreed to.

Paragraph 24 read, amended and agreed to.

Paragraphs 25 to 31 read and agreed to.

Paragraphs 32 to 35 read, amended and agreed to.

Paragraphs 36 to 40 read and agreed to.

Paragraphs 41 and 42 read, amended and agreed to.

Paragraphs 43 and 44 read and agreed to.

Paragraph 45 read, amended and agreed to.

Paragraph 46 read and agreed to.

Paragraphs 47 and 48 read, amended and agreed to.

Paragraph 49 read and agreed to.

Paragraph 50 read, amended and agreed to.

Paragraph 51 read and agreed to.

Paragraph 52 read, amended and agreed to.

Paragraph 53 read and agreed to.

Paragraphs 54 and 55 read, amended and agreed to.

Paragraph 56 read and agreed to.

Paragraph 57 read, amended and agreed to.

Paragraphs 58 and 59 read and agreed to.

Paragraph 60 read, amended and agreed to.

Paragraphs 61 to 68 read and agreed to.

Paragraph 69 read, amended and agreed to.

Paragraphs 70 to 76 read and agreed to.

Paragraph 77 read, amended and agreed to.

Paragraphs 78 to 89 read and agreed to.

A paragraph—(*The Chairman*)—brought up, read the first and second time, and added (now paragraph 90).

Summary read, amended and agreed to.

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

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

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

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

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[Adjourned till Tuesday 24 April at 9.30 am.]

## List of witnesses

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### Monday 26 March 2007

**Mr Robert Chote**, Institute for Fiscal Studies, **Professor David Miles**, Morgan Stanley, **Ms Bridget Rosewell**, Volterra Consulting, and **Dr Martin Weale**, National Institute of Economic and Social Research Ev 1

**Mr John Whiting**, PricewaterhouseCoopers, **Professor Colin Talbot**, Manchester Business School, **Mr Robert Chote**, Institute for Fiscal Studies, and **Dr Martin Weale**, National Institute of Economic and Social Research Ev 9

### Wednesday 28 March 2007

**Mr Nick Macpherson**, Permanent Secretary, **Mr Mark Neale**, Managing Director, Budget, Tax and Welfare, **Mr John Kingman**, Managing Director, Public Services and Growth, **Mr Dave Ramsden**, Director, Macroeconomics and Fiscal Policy, **Ms Sarah Mullen**, Director, Public Spending, and **Mr John Oughton**, Chief Executive, Office of Government Commerce, HM Treasury Ev 19

### Thursday 29 March 2007

**Rt Hon Gordon Brown MP**, Chancellor of the Exchequer, **Mr Nick Macpherson**, Permanent Secretary, **Mr Dave Ramsden**, Director, Macroeconomics and Fiscal Policy, and **Mr Michael Ellam**, Director, Policy and Planning, HM Treasury Ev 34

## List of written evidence

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1	Dr Martin Weale, National Institute of Economic and Social Research	Ev 54
2	John Whiting, PricewaterhouseCoopers	Ev 56
3	Bridget Rosewell, Volterra Consulting	Ev 58
4	British Chambers of Commerce	Ev 60
5	Institute of Chartered Accountants in England and Wales	Ev 61
6	CBI	Ev 63
7	HM Treasury	Ev 69
8	Institute for Fiscal Studies	Ev 70
9	HM Treasury	Ev 72

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<b>Session 2006–07</b>		Report
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Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50
<b>Session 2005–06</b>		Report
First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	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
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111
Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	“Banking the unbanked”: banking services, the Post Office Card Account, and financial inclusion	HC 1717