



House of Commons
Treasury Committee

**The 2006 Pre-Budget
Report: Government
Response to the
Committee's Second
Report of Session
2006–07**

**Third Special Report of Session
2006–07**

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The Treasury Committee

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

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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. 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 and Aruni Muthumala (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. Media inquiries should be addressed to Laura Humble on 020 7219 2003.

Third Special Report

The Treasury Committee published its Second Report of Session 2006–07, *The 2006 Pre-Budget Report*, on 25 January 2007, as House of Commons Paper No. 115. The Government response to this Report was received on 21 March 2007, and is appended below.

Government response

The economy

Business investment

1. We welcome the recent rise in the growth rate of business investment, although we note that, given the supportive conditions at the time, the previous weakness in business investment remains unexplained. In these circumstances, although there may be an upside risk to the Treasury's forecast for business investment, it needs to be borne in mind that there is also a downside risk in that the previous weakness remains unexplained, and it is possible that this period of weaker than expected performance may be resumed. (Paragraph 9)

As set out in paragraph A.72 of the 2006 Pre-Budget Report, strong profitability, low cost of capital and recent private sector business surveys all suggest that the outlook for business investment is positive and the balance of risk is on the upside.

Consumption

2. We note there are several risks around the consumption growth forecast. These include the potential for house prices to fall, for an increase in the influence of insolvencies on consumer spending, and for an increase in the overall saving rate of households, which then dampens consumption. We note the rise in the numbers of households using official forms of insolvency, especially Individual Voluntary Arrangements. We may return to examine matters relating to the regulation of the marketing of Individual Voluntary Arrangements, as well as further considering the economic implications of the rise in personal insolvencies. (Paragraph 14)

The Treasury's view on the outlook for consumer spending was set out in paragraph A.59 on the 2006 Pre-Budget Report. The Treasury's views on the risks to the outlook were set in paragraph A.105. These included a higher than forecast increase in the saving ratio, and a higher than expected dampening effect from increases in interest rates given household debt levels.

The 2006 Pre-Budget Report forecast was for consumption to grow below overall GDP growth, and the latest independent forecasts for consumption in 2007 are within the Pre-Budget Report forecast range.

While the number of individual insolvencies has risen, it is important to remember that it only affects a very small minority of the population. The Bank of England recently noted in ‘The state of British household finances: results from the 2006 NMG Research Survey 2006’ that “[debt] problems are unlikely to have large implications for monetary policy because any effect they might have had on aggregate consumer spending is likely to have been relatively small”.

The system of regulation of insolvency practitioners is one of Government-monitored self-regulation. All IVA providers and companies offering non-statutory debt management plans must hold a consumer credit licence and are subject to the Office of Fair Trading’s guidance on debt management, including guidance relating to advertising.

The labour market

3. The rise in the employment rate is welcome. However, the lack of robust statistics on migration means that it is difficult to assess the overall functioning of the labour market. We note that the Office for National Statistics is undertaking work on these statistics, and we recommend that the Government summarise the results of that work in the 2007 Budget. (Paragraph 19)

The Office for National Statistics formed the Inter-Department Task Force on Migration Statistics in May 2006 with the objective of recommending timely improvements that could be made to estimates of migration and migrant populations in the United Kingdom. As the Chancellor of the Exchequer and Treasury officials indicated in oral evidence, the Task Force was to publish a report of its work and recommendations before Christmas. The report¹ was published on 15 December 2006, setting the following vision:

“The aspiration is to move to a situation where we have timely, accurate estimates of the number of people coming into, going out of and present in the country for different durations and reasons (short and long term residence, seeking refuge, study, etc). Sufficient detail (e.g. geographic breakdowns) would be available to meet key requirements for population and migration statistics. This would be accompanied by the capacity to interpret trends and anticipate how changes and new uses will impact on the requirement for statistics.”

The report has also set a timetable of actions to move toward this aspiration. Full details of the report and other ONS work on improving its migration and population statistics can be found on the ONS’ website.

The ONS has also produced a further paper in January 2007, *Short-term Migration Feasibility Report*,² to provide an initial assessment of the feasibility of producing short-term migration estimates for England and Wales.

1 Report of the Inter-Departmental Task Force on Migration Statistics, ONS, December 2006
<http://www.statistics.gov.uk/statbase/Product.asp?vlnk=14731>

2 Short-term Migration Feasibility Report, ONS, January 2007
<http://www.statistics.gov.uk/about/data/methodology/specific/population/future/imps/updates/downloads/Short-termMigrationFeasibilityReport.pdf>

The trend growth assumption

4. The change to the trend growth rate assumption, post-2006, though audited by the National Audit Office, is mainly based on migration statistics of questionable quality. We note that any significant error in this assumption will have implications for the Government's assessment of its compliance with its fiscal rules. (Paragraph 20)

As set out in *Trend growth: New evidence and economic prospects*,³ published alongside the 2006 Pre-Budget Report, projections of net migration are subject to uncertainty, and this is why migration projections produced by GAD included not only a principal projection, but also a high and low variant.

The GAD principal projection released in October 2005 was based on the assumption that the present high net inflows of migrants were temporary, and flows would quickly decline to levels seen in the late 1990s. However, data released since Budget 2006 relating to inward migration provides grounds to support an upward revision of the assumed working age population growth rate post-2006.

As set out in *Trend growth: New evidence and economic prospects*, the Treasury has taken the view that net migration will be maintained well below the 2004 peak and broadly in line with the level for 2005, at a level between the GAD principal and high variant projections. This is similar to the approach taken at Budget 2002, when the Treasury also adopted a net migration projection that was between the GAD's latest principal and high migration scenarios: a decision that has been justified by high migration outturns since. As with the other components of Trend Growth, the Treasury will keep developments in migration under review.

It should also be noted that public finance projections are made using a cautious case projection of trend growth—¼ percentage points lower than the central case.

As the committee notes, the NAO has audited the revision to the trend growth projection. The NAO concluded that “the Treasury's revised underlying growth rate assumption adopted for the fiscal projections, ¼ percentage points below the Treasury's neutral estimate, is below the range of external forecasts of the long term growth rate. On this basis the revised assumption is reasonable and cautious”⁴.

The public finances

The overall fiscal position

5. Despite the improved forecast for economic growth in 2006, the Treasury has not forecast an improvement in the fiscal position compared with its forecasts in the 2006 Budget, partly as a result of downward revision of forecasts for tax receipts in future years as a percentage of GDP. The Treasury's current fiscal forecasts may well be

3 *Trend growth: new evidence and prospects*, HMT, December 2006 http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adtrendgrowth.cfm

4 *Audit of Assumptions for the 2006 Pre-Budget Report*, NAO, December 2006 http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebus_pbr06_adnao.cfm

realistic, but they indicate the medium-term constraints that will form part of the context for the conduct of the 2007 Comprehensive Spending Review. (Paragraph 22)

As is normal, the spending envelope for the 2007 Comprehensive Spending Review will be set in Budget 2007. The Government is meeting its strict fiscal rules, and will continue to meet these rules over the 2007 Comprehensive Spending Review period.

6. We welcome the fact that the past concerns of the Treasury Committee about the apparent over-optimism of Treasury forecasts of tax receipts, and of corporation tax receipts in particular, appear at the moment to have been addressed. We note the significant downward revision of forecast North Sea oil revenues in 2007-08, and look forward to seeing whether the more cautious forecast proves to be accurate. (Paragraph 24)

As set out in the Pre-Budget Report, the rise in the non-North Sea corporation tax to GDP ratio in recent years reflects the recovery in profitability, particularly in the financial sector. The ratio is expected to flatten off during 2008-09, with both the overall economy and financial company profitability expected to grow in line with trend.

The Treasury's forecasting performance over the previous two years is appraised annually in the *End of Year Fiscal Report*, published alongside the Pre-Budget Report.

The golden rule

7. On the basis of its current forecasts of the length of the current economic cycle, the Government appears to be on track to meet the golden rule in the current economic cycle. However, the Treasury's forecasts also indicate that the Government will start the next economic cycle with its current budget in deficit, compared to the projections outlined in the 2006 Budget, which foresaw the Government starting the next economic cycle with its current budget in surplus. (Paragraph 28)

Projections in the 2006 Pre-Budget Report show that the Government is set to meet the golden rule over the current cycle, which is expected to end during 2007. The golden rule has worked to ensure sound public finances: the surplus on the current budget over the current economic cycle is projected to average 0.1% of GDP. This compares with an average deficit of 2% of GDP over the last economic cycle from 1986-87 to 1997-98.

The projections in the 2006 Pre-Budget Report also show that, at this early stage and based on cautious assumptions, the Government is on course to meet the golden rule beyond the end of the current cycle. From 2006-07 onwards the current balance is set to improve in each year of the forecast period, with the current surplus rising to 0.8% of GDP by 2011-12.

8. We understand that forecasting the start and end of the economic cycle is a complex matter and that there are no clear cut answers. We recommend that, in future Budgets and Pre-Budget Reports, the Treasury provide a fuller explanation of its current forecast of the start and end dates of the current economic cycle. Such an explanation should include, if applicable, the reasons why any movements in economic growth above or below trend have not been interpreted as marking the beginning or the end of an economic cycle. (Paragraph 32)

The approach to dating the start and end points of economic cycles is set out in the Treasury's July 2005 paper *Evidence on the UK economic cycle*.⁵ As explained in this paper, to be sure that the economic cycle has come to an end, output must have passed decisively through trend, with this assessment being corroborated by the evidence from a wide range of cyclical indicators.

The Treasury sets out its latest assessment of the economic cycle at each Pre-Budget Report and Budget. In line with this, the Treasury will review its assessment of the economic cycle and provide an update at Budget 2007.

9. There is a tension between fiscal planning, which is a forward-looking process, and the assessment of whether or not the golden rule stands to be met in the present cycle, which is primarily a backwards-looking exercise. We recommend that the Treasury review the golden rule and consider the merits of whether that rule could be made more forward-looking and its application less dependent on estimates of the dating of the economic cycle. We further recommend that the Treasury clarify in its response to this Report 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. (Paragraph 35)

Setting the golden rule over the cycle allows fiscal policy to support monetary policy in maintaining macroeconomic stability. As the Government has made clear, this allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand. According to the OECD, the UK's fiscal and monetary policy frameworks have, "...played a key role in improving macroeconomic stability relative both to the past and to other OECD countries".⁶ The UK is in the middle of the longest period of sustained growth in our history, and the longest post-war period of continuous growth of all the major world economies. As the IMF noted in March 2006, "*Macroeconomic performance in the United Kingdom remains remarkable*".⁷

The fiscal rules provide a clear measure of success that plays a vital role in ensuring the credibility and accountability of the fiscal framework. The Government will continue to publish its assessment of progress against the Golden Rule in each Budget and Pre-Budget Report. 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.

Fiscal policy is made in a forward looking way, as is made clear by the extensive use of projections in the 2006 Pre-Budget Report, covering the five years to 2011–12. The Government reports in each Budget and Pre-Budget Report on whether the golden rule, using cautious assumptions, is set to be met after the current cycle ends on the assumption that the economy is on trend. It also reports on projected performance against the golden

5 Evidence on the UK economic cycle, HMT, July 2005
http://www.hm-treasury.gov.uk/media/2E6/A5/economic_cycles190705.pdf

6 OECD Economic Survey of the United Kingdom 2005, Organisation for Economic Cooperation and Development, October 2005

7 United Kingdom: 2005 Article IV Consultation - Staff Report; Public Information Notice on the Executive Board Decision, and Statement by the Executive Director for the United Kingdom, International Monetary Fund, March 2006

rule in a cautious case of trend output being lower by 1 percentage point to stress test the projections.

The sustainable investment rule

10. We continue to believe that the sustainable investment rule has considerable value in helping to assess the sustainability of public sector investment and the potential burden on future generations. However, with the Treasury now forecasting that a new economic cycle will begin in 2007 and the Comprehensive Spending Review underway, we believe that the time is ripe for the Government to clarify how the sustainable investment rule will operate in the next economic cycle. We therefore recommend that, either in the 2007 Budget or in reporting the outcome of the Comprehensive Spending Review, the Government—

- a) **state whether it proposes to interpret the sustainable investment rule over the next economic cycle as requiring that net debt be maintained below 40% of GDP in each and every year of that economic cycle;**
- b) **set out an analysis of steps it has taken to ensure that the sustainable investment rule does not operate so as to prevent the implementation of appropriate public sector investment projects with positive rates of return; and**
- c) **clarify its position as to whether possible changes to the measurement of net debt would necessitate changes to the sustainable investment rule. (Paragraph 39)**

The Government agrees that the sustainable investment rule helps ensure that public investment decisions are sustainable and that an unfair burden of debt is not left on future generations. Additionally, by separating capital and current spending the fiscal rules operate together to *promote* capital spending, helping the Government to tackle the UK's historical bias against capital spending and chronically low investment in public infrastructure. Public sector investment has risen from less than ¾% of GDP in 1997–98 to over 2% this year. At the same time the public finances remain sustainable, as the Government continues to meet the sustainable investment rule. According to Pre-Budget Report 2006 projections net debt is 37.5% of GDP in 2006–07 and remains below 40% until the end of the projection period.

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.

Public sector net debt is measured by means of National Accounts aggregates compiled by the independent Office for National Statistics using internationally accepted methodology. The Government uses this agreed methodology.

Other issues

Efficiency savings and the Civil Service workforce

11. We agree with the Chief Secretary to the Treasury that a high level of transparency in the Gershon efficiency programme would improve its chances of success. There is likely to be a correlation between the quality and effectiveness of reporting on the

efficiency programme by the Treasury, the Office of Government Commerce and individual departments and the extent of parliamentary and public confidence in the true extent of the progress achieved. We are not persuaded by the Treasury's contention that departmental totals for reported efficiency gains can be issued only by departments themselves because they are responsible for delivery: departments are accountable for their expenditure, but the Treasury is still expected by Parliament to report on departmental expenditure performance. We recommend that future Budgets and Pre-Budget Reports provide a breakdown of reported efficiency gains by department. (Paragraph 46)

The Government agrees that public and parliamentary confidence in the programme, and in the effectiveness of the central coordination function of the OGC, is important. To this end, there already exists a substantial amount of publicly available information related to the efficiency programme, for example in Efficiency Technical Notes, Budget and Pre-Budget Report updates, regular departmental reporting and published Annual Efficiency Statements from local authorities.

The Government will consider further the need for greater centrally driven transparency across the programme.

12. We welcome the steps taken by the Office of Government Commerce, in consultation with the National Audit Office, to establish a new framework for assessing and reporting efficiency gains, but we continue to believe that the quality and consistency of reporting could be improved. To enhance transparency and enable effective scrutiny, we recommend that the Treasury require departments, in their departmental annual reports and Autumn Performance Reports in 2007 and subsequent years, to provide consistent and comprehensive information on progress against efficiency targets, including by "work stream" in each case, and to classify all reported gains as preliminary, interim or final. We further recommend that Budget and Pre-Budget Report documents provide a comprehensive breakdown of all reported gains by "work stream" and according to their classification as preliminary, interim or final. (Paragraph 47)

Departments are primarily responsible for explaining and accounting for their programmes, including validating their gains according to the published OGC measurement criteria. Departments are already reminded in this guidance that they must be able to defend the merits of their programmes in order to ensure public credibility. Departments will continue to discuss their efficiency programmes in departmental reports and Autumn Performance Reports. More information on the classification of gains made to date will be published in Spring 2007.

13. We are concerned that the Treasury and the Office of Government Commerce, in their oversight of and reporting on the Gershon efficiency programme, may not have made sufficient allowance for the risk that claimed efficiency savings might not be delivered without a reduction in the quality of service. Departments have every incentive to assert that reductions in service have been avoided in order that efficiency savings can be recorded and targets can be met. If the Government simply asserts that service quality has been maintained if efficiency savings are reported and then accepted by the Office of Government Commerce, there is a risk that the credibility of the overall

efficiency programme might be undermined. We recommend that the Treasury and the Office of Government Commerce undertake research into the quality of measures in place within departments to provide assurance that efficiency savings do not lead to a reduction in the quality of services delivered or products provided, and publish the outcome of such research no later than the 2007 Pre-Budget Report. (Paragraph 51)

Measures of service quality are in place across the programme and are regularly monitored by departments and OGC. The recent NAO report⁸ looked at a sample of gains and found many instances where service levels have been at least maintained or actually improved and indeed many of the efficiency initiatives within the programme are aimed at directly improving service delivery. Regarding the one instance where NAO noted an issue relating to service quality, the NAO noted that ‘there is not conclusive evidence the deterioration has been caused by the efficiency initiative’. The way forward, in the Government’s view, is continued monitoring of the service quality measures already in place, rather than the further research proposed in this recommendation.

14. We note that there are significant divergences between reported progress against overall efficiency targets by some departments and their progress on workforce reduction targets agreed as part of the same programme; for example, the Home Office claims to have very nearly met its overall efficiency target, but needs to secure a further workforce reduction of 1,466 in order to meet its headcount target. We support the recommendation of the Committee of Public Accounts that the Treasury provide a reconciliation of claimed headcount reductions arising from the Gershon efficiency programme with data from the Office for National Statistics on changes in the overall size of the Civil Service, and we recommend that such a reconciliation be included in future Budget and Pre-Budget Reports. We further recommend that the Office of Government Commerce undertake a formal review of future departmental returns on headcount reductions to satisfy itself, Parliament and the public that such returns are being reported on a consistent and comparable basis. (Paragraph 54)

The recent NAO report into the efficiency noted that headcount reduction figures were broadly robust, that within the departments considered in their study substantial assurance could be given to headcount reductions, that they are based on sound information systems and use consistent definitions of headcount over the reporting period.

Guidance for 2007 departmental reports requires departments to publish a full reconciliation between their reported Gershon workforce reduction numbers and the numbers supplied to the Office of National Statistics regarding civil service employment. A Technical Note on the Cabinet Office website⁹ provides information on the reasons why data derived from the ONS series on civil service employment do not match exactly with the reported Gershon reduction numbers.

OGC already scrutinise departmental returns on headcount reduction each quarter and work closely with departments to continually monitor and challenge progress.

8 The Efficiency Programme: A Second Review of Progress, NAO, February 2007
http://www.nao.org.uk/publications/nao_reports/06-07/0607156i.pdf

9 http://www.civilservice.gov.uk/management/statistics/publications/doc/workforce_reductions_tech_note.doc

15. We recommend that, in reporting the outcome of the Comprehensive Spending Review, the Treasury report on the economic benefits of relocation to the receiving locations and on the extension of locally flexible pay in the public sector, and estimates the contribution of both factors to achieving Treasury targets on reducing the differences of Gross Value Added per head across regions and countries. (Paragraph 56)

The Lyons Review,¹⁰ published in March 2004, set out the economic case for relocating public sector employment away from London and the South East and the Government broadly accepted the report and its analysis, and continues to implement its conclusions. At the Pre-Budget Report it was announced that 10,500 relocations had taken place towards the 20,000 target by 2010.

The Public Sector Pay Committee (PSPC) is continuing to review progress on local pay and will consider options to encourage increased regional flexibility. Currently the terms of reference in remit letters to the Pay Review Bodies (PRBs) require them to have regard to regional/local labour markets and their effects on recruitment and retention. Departments responsible for workforces covered by PRBs are required to provide robust evidence on local and regional recruitment and retention issues and make clear to PRBs how they expect pay to reflect these different markets. Civil service pay guidance instructs Departments to fully consider local pay and ensure that their pay and reward systems reflects their individual relevant labour market.

Expenditure on education

16. We are seriously dissatisfied at the lateness and vagueness of the information supplied to the Committee subsequent to our oral evidence, which fails to meet the detailed questions put to both officials and the Chancellor of the Exchequer at the meeting. It would be premature to reach an assessment of the overall trend of public expenditure on education in advance of the announcement of the outcome of the Comprehensive Spending Review. However, the early announcement of capital spending plans for education up to 2010–11 provides a welcome opportunity for the path of expenditure on an annual basis up to 2010–11 on major capital programmes, including the Building Schools for the Future Programme, to be set out at an early stage. We recommend that such information be provided at the time of the announcement of the outcome of the Comprehensive Spending Review. (Paragraph 61)

The Government regrets the Committee's dissatisfaction with the information supplied subsequent to oral evidence. The Treasury strives to respond fully to requests by the Committee for information in a timely manner.

The Government agrees with the Committee's conclusion that the 2006 Pre-Budget Report announcement of capital spending plans for education up to 2010–11 provides the department with early certainty to take forward major long-term capital programmes. DfES has already announced the authorities that will benefit from Wave 4 of the Building Schools for the Future programme. DfES will confirm further details at the earliest appropriate stage although this will not be possible before the Comprehensive Spending

¹⁰ Well Placed to Deliver? – Shaping the Pattern of Government Service, March 2004 www.hm-treasury.gov.uk/consultations_and_legislation/lyons/consult_lyons_index.cfm#final_pdf

Review because of the interaction between capital and revenue allocations in respect of the local government settlement.

Child poverty

17. The Chancellor of the Exchequer told us that the Government had “actually met” the first of its targets to reduce child poverty—namely, to reduce the number of children in low-income households by at least a quarter between 1998-99 and 2004-05. This conflicts with earlier statements by the Secretary of State for Work and Pensions, the Rt Hon John Hutton MP, acknowledging that the Government had not achieved this target. Given that the Government has previously accepted that, although significant steps were taken towards achieving the target, the target was not met, we expect the Chancellor of the Exchequer to explain the basis of his statement in the Government’s response to this Report. (Paragraph 70)

The Chancellor referred specifically, as he stated, to the ‘first five years’ of the Government. After 1997, the very first target was to reduce child poverty following its trebling in the previous two decades. In Budget 1998 he announced measures to address child poverty. The result has been that child poverty has been reduced instead of it rising, falling from 3.2 million in 1996-97 to 2.6 million in 2000-02. It was in March 1999 that the Government set a new ambition—to eliminate child poverty over 20 years. Only later in Spending Review 2000, prefigured by an announcement in November 1999, did we set a Public Service Agreement to reduce child poverty by a quarter. This was explained in detail in Spending Review 2002. The Government has reported clearly on the 2004-05 PSA, including in the Treasury Departmental (Cm 6830) and autumn (Cm 6990) reports. The latest data shows that before housing costs the number of children in poverty has fallen by 23 per cent.

18. The Government’s initiative to end child poverty is now focused on its second target—to reduce child poverty by 50% between 1998-99 and 2010-11. We are concerned that the 2006 Pre-Budget Report fails to set out clearly how the Government proposes to meet its target to halve child poverty by 2010-11. We recommend that, either in the 2007 Budget or in reporting the outcome of the Comprehensive Spending Review, the Government outline its strategic position with respect to the 2010-11 target. The Government should both set out its progress to date towards achieving the target, including the measures it has implemented to date, and specify how it intends to achieve the target, including the extent to which it expects various measures to contribute towards achieving the target. (Paragraph 71)

The Government has most recently set out its strategy in the *Child Poverty Review*, published alongside the 2004 Spending Review. This strategy encompasses financial support for families, promoting work for those who can, and excellent public services to tackle material deprivation now and address cycles of deprivation. The Government reports progress against its poverty and social exclusion agenda annually in *Opportunity for All*. The Government will continue to make decisions on the levels of financial support in Budget and Pre-Budget reports.

19. The announcement in the Pre-Budget Report that child benefit will be extended to every mother-to-be from week 29 of her pregnancy will lead to a welcome boost in

income for all mothers-to-be. However, we are concerned that the changes to child benefit will not come into effect until April 2009. Both universal and means-tested benefits have a legitimate contribution to make towards the Government meeting its target to halve child poverty by 2010–11. If the Government is to meet the 2010–11 target, it will need to channel additional resources directly to low-income families, for example by increasing the child element of the child tax credit or the Sure Start maternity grant. Such measures would allow the Government to achieve its aim of assisting parents financially in the final weeks of pregnancy: eligibility for the child element of child tax credits could be extended to 29 weeks, and the Sure Start maternity grant is already available from week 29 of pregnancy. (Paragraph 72)

The extension of Child Benefit to pregnant women represents an important policy change. To ensure that the policy is in place, the Government needs to:

- make the necessary legislative changes, which will require primary legislation;
- put in place the administrative arrangements, including changes to the IT system, to deliver the new entitlement; and
- develop compliance procedures to ensure that this extension of Child Benefit is only paid to those genuinely entitled.

The Government therefore announced an implementation date of April 2009. This is similar to previous lead times for Child Benefit policy announcements. For example, in March 2004, the Government announced its proposal to extend Child Benefit to the parents of unwaged trainees. This new entitlement came into effect in April 2006.

The Sure Start Maternity Grant is available to low-income women to help towards the costs of a new baby, and may be claimed from the 29th week of pregnancy. It is worth £500 per child. Low-income women may also claim Healthy Start vouchers, to be spent on milk, fruit and vegetables, from the 10th week of pregnancy. Mothers-to-be may claim one voucher per week, worth £2.80.

The Government has committed to increasing the child element of Child Tax Credit in line with earnings for the rest of the Parliament. Further decisions will continue to be taken in future Budgets and Pre-Budget Reports.

20. We have previously noted the significant reduction in households facing marginal tax rates of 70% or more between 1998 and 2006–07, while recommending further Treasury analysis of the characteristics and income distributions of households facing marginal tax rates in the region of 60% to 70%. We are disappointed that the Treasury appears to have taken no action about this recommendation. At the very least, we expect the Treasury to notify us if it does not intend to act on one of our recommendations, giving reasons why. We intend to return to the issue of high marginal deduction rates when we examine the 2007 Budget, by which time we expect the Treasury to have published the findings called for in our earlier recommendation. (Paragraph 74)

Effective marginal tax rates in the region of 60 per cent to 70 per cent mainly arise where an individual pays income tax at the basic rate (annual income from £7,185 to £33,300 in

2006/07) plus employee National Insurance contributions, combined with withdrawal of tax credits against family income. The range for family income over which withdrawal of tax credits occurs depends on family type, the number of children, and other factors such as the costs of childcare. However, published HMRC tax credits statistics¹¹ show that they are most likely to be families with children who have incomes under £20,000, even if a small number have incomes of over £30,000.

Estimates published in Pre-Budget and Budget reports show that the extension of in work support under tax credits has increased the number of families facing marginal tax rates in the region of 60 per cent to 70 per cent, but this has been combined with a significant reduction in the numbers facing the highest deduction rates. External research¹² has been published evaluating the possible impacts of this, and other tax and welfare reforms, particularly on labour market participation and working hours. HMRC has actively promoted research in this field.

Delays in improvements to the tax credits regime

21. We are concerned to learn that HM Revenue & Customs has failed to meet its original timetable of applying, from November 2006, automatic limits on recovery of excess amounts paid in cases where tax credits awards are adjusted in-year following a reported change. We will be watching closely to see whether HM Revenue & Customs manages to comply with the Paymaster General's instruction to introduce such automatic limits in April 2007. We are concerned by the Paymaster General's announcement that the timetable for migrating the remaining 330,000 families who receive income support or jobseeker's allowance—some of the poorest families in the country—to the child tax credit has slipped yet again, given that these families were due to be migrated from April 2004. We intend to take these matters up with the Government in the first half of 2007, when we follow up our June 2006 Report on The administration of tax credits. (Paragraph 79)

As set out in the Paymaster General's Written Ministerial Statement of 6 December 2006, from February 2006 HMRC have widened the availability of additional payments to claimants experiencing hardship following an in-year adjustment to their tax credit payments. In January 2007, HMRC successfully introduced an enhanced manual process to identify cases where a restriction is appropriate and apply a restricted rate of recovery without the claimant having to ask for this. The Paymaster General has instructed HMRC to introduce an IT solution to ensure that from April 2007 claimants will benefit from reduced rates of recovery without them having to ask for this service.

The Government shares the Committee's concerns that the interests of the most vulnerable families should be protected. This is why the Government will not begin migration of the remaining IS/JSA recipients with children to the Child Tax Credit in 2007.

11 Child and Working Tax Credit Statistics, HMRC, December 2006
www.hmrc.gov.uk/stats/personal-tax-credits/cwtc_annual_dec06.pdf

12 The poverty trade-off: work incentives and income redistribution in Britain, October 2006 www.jrf.org.uk

Other taxation issues

22. The scale of Missing Trader Intra-Community fraud appears to have tripled between 2004–05 and 2005–06, to between £3.5 billion and £4.75 billion in 2005–06, with an estimated negative impact on VAT receipts during the year of between £2 billion and £3 billion. We welcome the Chancellor of the Exchequer's announcement that the United Kingdom Government has reached an agreement with France to secure a derogation from European Union VAT law to combat such fraud. We trust that the European Union will now act promptly upon this measure and we will make our own representations to our opposite members in other national parliaments. The Government has predicted that the reverse charge will move the mechanism for stealing VAT from around 90% of the goods currently traded in Missing Trader Intra-Community fraud. Following the implementation of the measure, we will look for the emergence of evidence that the Government's prediction has in fact been borne out. (Paragraph 88)

As explained in "*Measuring Indirect Tax Losses–2006*", which was published alongside the 2006 Pre-Budget Report, following changes to the way the fraud operates, the methodology used to produce HMRC's previously published estimates of Missing Trader Intra Community (MTIC) VAT fraud no longer provides a reliable estimate of MTIC fraud, and has been discontinued. It is not possible to make a direct comparison between the estimates produced under the previous methodology and those produced for 2005–06.

However, the Government acknowledges that attempted fraud levels rose rapidly during the second half of 2005–06 and into 2006–07. HMRC took proportionate steps to address this attack on the VAT system, strengthening both the civil and criminal elements of their strategy, including the verification of a greater number of suspect VAT repayment claims from traders operating in and profiting from supply chains associated with MTIC frauds. As a result, operational indicators suggest a significant fall in MTIC activity during 2006–07, with the latest trade figures (based on data supplied by HMRC) showing a reduction of around 90 per cent in the level of MTIC-related activity since April 2006.

The Government welcomes the Committee's support for the UK's derogation from EU VAT law, to allow the introduction of reverse charge VAT accounting for specified goods commonly used in MTIC frauds. The Government will continue to keep the Committee informed about its progress in combating MTIC fraud.

23. We welcome the measured way in which the Government is consulting on and taking forward proposals for a Planning-gain Supplement. (Paragraph 91)

The Government welcomes the Committee's recognition.

The Leitch Review on skills

24. We welcome the Leitch Review Final Report's aspiration of making the United Kingdom a world leader in skills by 2020. We expect to comment further on the economic importance of skills training when we report on the outcome of our inquiry into Globalisation: its impact on the real economy. (Paragraph 93)

The Government has welcomed the Leitch Review of Skills, accepting both the higher skills ambitions for 2020 and the principles it recommends to underpin the delivery of the world-class skills ambition. The Government is considering its full response to the recommendations as part of the 2007 Comprehensive Spending Review process.

The role of the Pre-Budget Report

Fiscal consultation

25. We welcome the Government's decision to commission and publish a range of reviews informing future economic policy, including tax policy. However, it is important that the Pre-Budget Report retains a focus on consultation on fiscal measures that may be included in the forthcoming Budget. Although the 2006 Pre-Budget Report is accompanied by a considerable volume of material on technical tax changes, there is less discussion on more substantive tax measures under consideration for inclusion in the Budget. We wish to see such consultation more to the fore in future Pre-Budget Reports. (Paragraph 95)

The Government continues to use Pre-Budget Reports to prepare the way for Budgets, and to publish the results of consultation on substantive policy issues as well as consultative documents to inform future policy decisions.

Consultative documents on significant policy proposals, which were published alongside the 2006 Pre-Budget Report and will conclude before the 2007 Budget, include *Tackling Managed Service Companies*, *Tax Relief for pensions: lifetime allowance test*, and two further consultations on Planning-gain Supplement. Responses to consultations, including on Carbon capture and storage and Planning-gain Supplement, were also published alongside the 2006 Pre-Budget Report. These consultations will all help inform policy decisions at Budget. In addition, a number of reviews and Regulatory Impact Assessments were published alongside the 2006 Pre-Budget Report, which provided further summaries of consultation and stakeholder views and considerations.

The Government remains committed to consultation, including through the Budget and Pre-Budget Report process. However, to prevent creating distortions in behaviour it is not always possible to consult prior to the announcement of major policy changes, and so—as the Code for Fiscal Stability sets out—consultation will not necessarily appear in the Pre-Budget Report or Budget prior to policy decisions.

Notice

26. We continue to believe that the effectiveness of the Pre-Budget Report as an instrument of fiscal consultation would be enhanced if Parliament and the public were given greater notice of the date of the Pre-Budget Report. We re-state our recommendation that the Treasury announce the date of the Pre-Budget Report at least four weeks before the statement is due to be made and, in any case where the target is not met, give an account of the reasons. (Paragraph 96)

The Government notes the Committee's recommendation. However, it may not always be possible to give four weeks notice. As the Government has previously set out in its

responses to the Treasury Committee's reports, the date of the Pre-Budget Report (and Budget) will be announced at the earliest convenient opportunity.

The implementation of new rates of Air Passenger Duty

27. Where tax changes carry a significant risk of forestalling activity or could distort market behaviour, it is often appropriate for those changes to come into effect immediately upon their announcement, even if formal parliamentary approval cannot be granted for some time thereafter. However, we have received no evidence to suggest that such considerations apply to the changes to the rates of Air Passenger Duty announced in the 2006 Pre-Budget Report. As a general rule, we consider that, where increases in rates of duties or taxes are proposed in the Pre-Budget Report, those increases should not come into force until after the House of Commons has had an opportunity to come to a formal decision on the proposed increase following the Budget. We draw the attention of the House of Commons to the unusual timing of the implementation of the increases in Air Passenger Duty, for which the Treasury has not cited any relevant precedents. (Paragraph 100)

The changes to air passenger duty announced in the 2006 Pre-Budget Report will secure resources in the coming spending round for our priorities on the environment and on transport.

The way in which the Government has announced and is implementing the rise is in line with the conventions of the House. As the Financial Secretary told the House on 25 January 2007, the same approach was taken in 2005 following the announcement of an increase in the rate of the supplementary charge on North sea oil in the 2005 Pre-Budget Report, which was introduced with effect for accounting periods from 1 January 2006. The Budget resolutions were laid alongside the Budget that followed and that was legislated for in the Finance Bill. The Government is following precisely the same precedent and procedure with the proposals for the increase in air passenger duty.

It's common practice for the rate changes to all the major taxes to have immediate or near immediate effect. Pre-Budget Report and Budget decisions need to respond flexibly to changing economic, environmental and social factors.

HM Treasury

21 March 2007