



House of Commons
Treasury Committee

**The 2007 Pre-Budget
Report: Government
Response to the
Committee's Second
Report of Session 2007–08**

Seventh Special Report of Session 2007–08

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Seventh Special Report

The Treasury Committee published its Second Report of Session 2007–08, *The 2007 Pre-Budget Report*, on 26 November 2007, as House of Commons Paper No. 54-I. The Government response to this Report was received on 12 March 2008, and is appended below.

Appendix 1: Government response

The 2007 Pre–Budget Report

The real economy

1. We acknowledge that the Government has downgraded its forecast for economic growth in 2008 due to the effects of both rises in interest rates in the first half of 2007, and the recent disturbance in financial markets. However, the risk remains that the credit crunch will have a greater macroeconomic effect than expected. (Paragraph 6)

Uncertainties surrounding economic forecasts typically present both upside and downside risks, and the prospective effects of disruption in global financial markets are no exception. Annex A of the 2007 Pre–Budget Report set out how considerable uncertainty surrounded the timing and extent to which it might affect the wider economy. However, the Pre–Budget Report also highlighted that the UK economy has proved resilient to a number of shocks over the past decade, demonstrating the pay–off to the Government’s macroeconomic framework and promotion of open and flexible labour, product and capital markets.

2. The Treasury has forecast a stronger economy for 2009 partly on the basis that there will be only a temporary weakening in the financial sector due to the current problems in financial markets. There nevertheless remains a risk that the financial sector will remain subdued for longer than expected. We feel that the Treasury’s optimism that the growth rate should revert to trend in 2009 has not been adequately explained. (Paragraph 9)

The Pre–Budget Report clearly stated that the disruption in global financial markets had made economic prospects more uncertain, and that events would need to unfold further before the impact on the economy could be rigorously quantified. The Government’s latest forecasts have been set out today in Budget 2008 as normal.

As stated in the Pre–Budget Report, the UK’s innovative financial sector was relatively quick to recover from periods of financial market disruption in 1998 and 2001:

- growth in the sector slowed from $4\frac{3}{4}$ per cent in 1998 to $2\frac{3}{4}$ per cent in 1999 before picking up to $6\frac{1}{4}$ per cent in 2000; and
- financial sector growth slowed to $3\frac{1}{2}$ per cent in 2001, but then picked up to 4 per cent in 2002 and $6\frac{3}{4}$ per cent in 2003.

In terms of overall GDP, the UK economy proved resilient to both periods of financial market disruption. Growth remained strong following the 1998 disruption, at 3 per cent in 1999. GDP growth slowed from $2\frac{1}{2}$ per cent in 2001 to 2 per cent in 2002 following the stock market declines of 2001, and exacerbated by the impact of the 11 September terrorist attacks, but picked up to its trend rate of $2\frac{3}{4}$ per cent in 2003. Growth has averaged over $2\frac{3}{4}$ per cent since the start of the current cycle in 1997.

3. We note concerns expressed by some observers about the Treasury's presentation of the risks associated with the economic forecasts outlined in the 2007 Pre-Budget Report. We recommend that the Treasury recast the way in which it presents the risks to the economic forecasts in both Pre-Budget and Budget reports. Quantification of the effects of such risks, should they crystallise, on the Treasury's economic forecasts would be especially useful, so that the order of importance in which the Treasury regards such risks can be assessed. (Paragraph 13)

The economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges represent the neutral case view of economic prospects, and are anchored around a neutral assumption for trend output growth of $2\frac{3}{4}$ per cent a year, which is in line with the average growth since the beginning of the current cycle in 1997.

Consistent with past practice, projections for the public finances are based on the lower end of the economic forecast ranges, which are consistent with a deliberately cautious assumption for annual trend output growth a $\frac{1}{4}$ percentage point lower than the neutral view. The upper end of the forecast ranges is symmetrical, illustrating the potential for stronger growth based at least in part on the Government's policies to raise productivity, increase employment opportunity and maintain stability.

The forecast ranges do not represent general forecast uncertainties: the key short-term risks are described throughout Annex A of the Pre-Budget Report, and are summarised in paragraphs A.78 to A.83. In accordance with the principle of transparency set out in the *Code for fiscal stability*, the Government will continue to enhance the discussion of its detailed economic forecasts and the risks surrounding them. The Government keeps its approach to the presentation of economic forecast risks and uncertainties under review.

The Treasury's forecasts for GDP growth since 1997 have, on average, outperformed the independent consensus. They continue to compare well against a sample of forecasters that includes leading international organisations (IMF, OECD, EC), research institutes

(Oxford Economics, NIESR) and private sector forecasters (Goldman Sachs, HSBC, JP Morgan).

4. The housing market finally appears to be slowing, with house price inflation expected to fall. Despite this, the Treasury is not forecasting a fall in nominal house prices. A risk remains that a fall in nominal house prices could occur, posing a potential risk to households' consumption and confidence, and we will continue to monitor the situation. (Paragraph 16)

The Treasury's view on house price prospects was set out in paragraph A.56 of the Pre-Budget Report, with an easing of house price inflation expected over the year. The resilience of the labour market underpins the judgement that any adjustment in house prices will occur gradually rather than abruptly, though naturally there are both downside and upside risks to this view.

5. While we acknowledge that most household debt is secured, and that interest payments on household debt have not reached the level of 1990, we remain aware of the risk as identified in the Pre-Budget Report 2007 that a rise in effective interest rates might have more of an effect on the disposable incomes of households than in the past due to the increase in household debt levels. (Paragraph 19)

Developments in household balance sheets and what affect this may have on household disposable income is set out in Box A2 of the Pre-Budget Report. At the macroeconomic level, changes in interest receipts and payments as a result of changes in effective interest rates will tend to have a broadly offsetting effect on disposable income. However this depends on the extent to which interest rates on borrowing and saving move in step.

At an individual level, for a small minority of households excessive debt can become a problem. The Government has identified five specific areas for action in this area, as set out in Box 5.2 of the Pre-Budget Report.

6. The current difficulties in the United States housing market remain a concern but we acknowledge that a more diverse global economy may mean that the emerging markets will remain buoyant in the face of a greater than expected slow-down in the United States. (Paragraph 21)

Annex A of the 2007 Pre-Budget Report set out how prospects for the US economy reflect a more protracted contraction in residential investment than expected at the time of Budget 2007, and the effects of recent financial market disruption. Against this, while growth in some emerging markets is expected to ease somewhat from the very high rates of recent years, they are projected to remain strong. Emerging markets are expected to continue to account for the majority of world growth. Emerging Asia is expected to continue growing strongly this year and next, continuing the pattern of recent years. The Chinese economy grew by more than 11 per cent in 2006, and the growth rate

picked up further in the first half of 2007. In Russia, output in 2007 is expected to grow by more than 6 per cent for the fifth consecutive year.

The public finances

7. The apparent correlation between forecast errors and the economic cycle suggests that as the economy approaches trend, a reduction in forecast errors can be expected. While the recent reduction in the size of forecast errors is welcome, it is not clear whether this reduction reflects improvements in the forecasting process or the current stage of the economic cycle. We expect the Treasury to continue to exercise vigilance in addressing errors in its forecasts of the public finances. (Paragraph 26)

The Treasury intends to continue to exercise vigilance in minimising public finance forecast errors. To this end:

- public finance forecasts are based on cautious assumptions, audited by the National Audit Office;
- forecasting methods are assessed in the light of forecast errors; and
- an *End of year fiscal report* is published alongside the Pre-Budget Report. This provides explanations for differences between forecast and outturn for the year-ahead fiscal forecasts.

8. We note that the risk of a downturn in the financial sector that is deeper and more prolonged than expected poses a consequential downside risk to tax revenues in 2007-08 and 2008-09. We will continue to monitor this situation. (Paragraph 28)

Box 2.3 in the Pre-Budget Report noted that ‘while the effect on the public finances of current global financial market disruption is uncertain, the projections in this Pre-Budget Report allow for an impact on receipts from corporation tax and income tax and NICs’. The Government acknowledges the Committee’s intention to monitor this risk to tax receipts.

9. As a result of the difficulty in dating the economic cycle, it is difficult to tell for some years after the event whether the Government has been successful in meeting the golden rule. We reiterate the recommendation, made in our Report on the 2007 Budget, that the Government review the golden rule such that it becomes more forward-looking and less dependent upon the dating of the economic cycle. (Paragraph 31)

The *Code for fiscal stability* sets out the importance of ensuring stability in terms of the impact of fiscal policy on the economy. It is vital that the form of the fiscal rules does not compromise the inbuilt capacity of fiscal policy to smooth the path of the economy in response to changing economic circumstances. As set out in the 2007 PBR and CSR, setting the fiscal rules over the economic cycle allows fiscal policy to support monetary policy in maintaining macroeconomic stability. The fiscal balances are allowed to vary

between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely. Responsible management of the public finances, in line with the Government's objectives, has enabled fiscal policy to effectively support monetary policy over the current cycle. The IMF noted "the shallowness of the UK growth slowdown during the last global downturn", which they attributed in part to fiscal responsiveness.¹

Fiscal policy is made in a forward looking way, as is made clear by the extensive use of projections in the 2007 Pre-Budget Report, covering the five years to 2012-13. In the Pre-Budget Report, the Government also reports on whether the golden rule, using cautious assumptions, is set to be met after the current cycle ends. It also reports on projected performance against the golden rule in a cautious case of trend output being lower by 1 percentage point to stress test the projections.

The fiscal rules provide a clear measure of success that plays a vital role in ensuring the credibility and accountability of the fiscal framework.

10. We recommend that, in its response to this Report, the Government sets out details of when it intends to provide its view on the end of the current economic cycle. (Paragraph 33)

In accordance with the principle of transparency, as set out in the *Code for fiscal stability*, the Government remains committed to the timely provision of information regarding analysis of the economic cycle to inform public scrutiny and debate on the issue. Chapter 2 and Annex A of the Pre-Budget Report gave the Government's latest assessment of the economy's cyclical position and dating of the economic cycle, noting that the economy appears to have passed through trend towards the end of 2006, but that it is too soon to assess whether or not the economic cycle has ended. Budget 2008 provides an updated economic assessment, including assessment of the cyclical position of the economy.

Taxation issues

11. The Chancellor of the Exchequer did not refer in his oral evidence to us to the possible introduction of a specific retirement relief for owners of business assets. We wish any proposal in this area to be the subject of early consultation. (Paragraph 40)

See combined response to (11) and (12).

12. We are concerned that the Treasury appears not to have consulted explicitly on the withdrawal of taper relief prior to the publication of the 2007 Pre-Budget Report. Despite this lack of consultation, the Chancellor of the Exchequer has made it clear that he is not prepared to reverse his decision to replace taper relief with a flat tax rate for capital gains. He has, however, expressed his willingness to discuss the

¹ *United Kingdom: Staff Report for the 2006 Article IV Consultation*, IMF, March 2007, page 4

details of the changes to capital gains tax policy with those affected. We recommend that the Government, in its response to this Report, clarify on which points it is prepared to consider the representations of affected parties, in good time before the 6 April 2008 date for implementing these reforms. (Paragraph 41)

The Government does not generally consult on changes to tax rates. However following the announcement of capital gains tax changes at the Pre-Budget Report a dialogue was entered into with a wide range of interested parties. HM Revenue & Customs immediately engaged with individuals in the accounting and tax professions in order to inform the eventual legislative approach. HM Treasury received representations from a number of groups and hosted constructive discussions with representatives of the business community on different aspects of the proposed changes.

13. We note the evidence we received that the private equity industry could be expected to absorb the changes to the capital gains tax and carry on with its business. (Paragraph 46)

See combined response to (13) and (14).

14. The 2007 Pre-Budget Report and the Chancellor of the Exchequer's statement to the House of Commons clearly link the reforms of the capital gains tax regime to the aim of ensuring that the private equity industry pays a fairer share of tax, although the Government has denied that this was the primary motivation for the reforms. (Paragraph 47)

As stated in the Pre-Budget Report, the Government is confident that “the reform of capital gains tax... establishes a system that is more sustainable, straightforward for taxpayers and internationally competitive” and that “this will increase the fairness of the tax system, including for individuals in the private equity industry”.

However, and as is clear from evidence given by officials to the Committee at its hearing on 17 October 2007, the changes to capital gains tax did not have the tax treatment of the private equity industry as their primary motivation. The changes proposed at the Pre-Budget Report are primarily intended to reform and simplify the capital gains tax regime and to put it on a more sustainable basis.

The details of the capital gains tax reform proposals were recorded in Chapter 5 of the Pre-Budget Report document (fairness and opportunity for all) whereas those measures specifically aimed at private equity were located in Chapter 4 (sustainable growth and prosperity). Chapter 4 states “one of the effects of the [capital gains tax] reform will be that private equity managers and partners pay a higher rate on their capital gains”. This comment acknowledges the read-across of the changes to capital gains tax regime to the recent debate about the taxation of private equity individuals.

15. Discussing the private equity industry, in an interview in July 2007, the Chancellor of the Exchequer stated he would not make any quick changes to capital gains tax that “could result in unintended consequences and undesirable consequences”. Despite this, the reform of the capital gains tax regime announced in the 2007 Pre-Budget Report will affect small businesses and employee shareholders and could affect longer-term investment. The Chancellor of the Exchequer’s evidence to us suggested that he regards such unintended consequences as inevitable effects of the progression towards the goal of simplification of the tax system. We appreciate the benefits that tax simplification can bring and its desirability for all taxpayers, particularly small businesses and entrepreneurs. However, we are concerned about the possible detrimental effects that the withdrawal of taper relief could have on small businesses, employee shareholders and longer-term investment. There is a possibility that the absence of transitional arrangements might give rise to unfair costs in cases where a contract was entered into in good faith before the 2007 Pre-Budget Report announcement but where the contract terms will not be fulfilled until after April 2008. We are particularly concerned at the proposal to withdraw taper relief without adequate notice. This will particularly penalise those planning to sell their businesses and retire within the next two years. We therefore recommend that the Government, in its response to this Report, set out how it proposes to mitigate the effects of the withdrawal of taper relief, particularly for those already within the two-year qualifying period and with especial reference to small businesses. Such a statement should assist with the discussions on the details of the capital gains tax reforms that the Government has said it is prepared to have with interested parties. (Paragraph 56)

On 24 January 2008 the Chancellor of the Exchequer announced that the capital gains tax reform proposals included in the Pre-Budget Report will be complemented by a new entrepreneurs’ relief.

The entrepreneurs' relief will provide a special 10 per cent tax rate for the first £1 million of qualifying gains. Gains made on different occasions will qualify for the 10 per cent rate up to a cumulative lifetime total of £1 million of gains. Gains in excess of this will be taxed at the standard rate of 18 per cent. The special 10 per cent rate will be available on the disposal of all or part of a trading business carried on by an individual, either alone or in partnership. It will also be available to individuals disposing of shares in a trading company, provided that the individual is an officer or employee of the company and takes a minimum five per cent stake in the business.

The entrepreneurs’ relief will benefit the owners of small businesses when they choose to sell their business. It will also benefit business angels and other business investors who take a five per cent or greater stake in the company concerned. This proposal remains in line with the Government's objective of keeping the tax system as simple as possible, and is very much in accordance with representations from small business.

16. We recommend that the Government provide an explanation of the link between the Treasury's figures for projected increases in tax revenue resulting from capital gains tax reform as compared with its figures for the projected gain resulting from the immediate abolition of taper relief, in its response to this Report. (Paragraph 59)

The capital gains tax proposals announced in the Pre-Budget Report were scored in Table B4 (page 164) at £0 in 2007–09, +£350m in 2008–08, +£750m in 2009–10 and +£900m in 2010–11. This represents the additional tax receipts expected over and above the yield already forecast from a CGT regime that remained unchanged.

The estimated cost of taper relief is published in Table 7 (page 15) of the Tax Ready Reckoner, at £6,300m in 2006–07 and £7,200 in 2007–08. By convention the estimated cost of taper relief is given relative to the prevailing headline CGT rates (of 10, 20 and 40 per cent for starting, basic and higher rate taxpayers respectively) and assuming no change in taxpayer behaviour if the relief were withdrawn. The footnotes to the table note that these figures are subject to a margin of error.

The proposals announced at the Pre-Budget Report include a number of changes other than the withdrawal of taper relief—in particular a change to the headline rate of charge. The figures published in the Pre-Budget report also include an adjustment for expected changes in taxpayer behaviour. This explains why the figures presented in the Pre-Budget Report are not the same as the published cost of taper relief.

17. The Chancellor of the Exchequer has said that twelve million couples and three million widows and widowers would be eligible to take advantage of the £300,000 increase in the inheritance tax threshold. This implies that there may be large numbers of people who have not previously taken advantage of the existing rules on inheritance tax but who may now choose to utilise the transferable thresholds under a simplified regime. (Paragraph 65)

See combined response to (17) and (18)

18. Uncertainty about the number of people who have taken advantage of the existing inheritance tax rules makes it difficult to assess the likely impact of the proposed changes to inheritance tax on the Government's finances. Without further information about the basis of the Government's forecasts of the cost of the inheritance tax reforms, we are unable to assess the plausibility of these forecasts. We recommend that the Government clarify its projections for the cost to the Exchequer resulting from the proposed inheritance tax reforms and the assumptions about taxpayer behaviour that underpin those projections. (Paragraph 66)

The Pre-Budget Report announced that, in order to make the inheritance tax system fairer, if a person's tax-free allowance is not used on their death, it can be transferred to their surviving spouse or civil partner for use on their death.

This provides the certainty and reassurance of a double allowance for all twelve million married couples and civil partners. The same entitlement is also extended to all three million widows, widowers and bereaved civil partners.

The measure allows ordinary married couples and civil partners to benefit automatically from both partners' tax-free allowances alongside spouse and civil partner relief, without the need for complex financial and legal arrangements which may not be the right choice for every couple.

The forecast costs of the measure are set out in the Pre-Budget Report document. The costings were calculated using HMRC data on how many married individuals use up their individual allowance on death together with data on mortality rates and assumptions about the evolution of wealth between the two deaths to forecast how much extra allowance will be claimable in future years. All forecasts of future costs inevitably involve an element of uncertainty. The Pre-Budget Report costings use the best available information in line with standard practice.

19. We recommend that the Government set out the extent to which changes to the rules applicable to non-domiciled taxpayers are open to consultation. If the changes are to take effect from 6 April 2008, the Government will need to ensure that consultation with interested parties takes place in the near future. We further recommend that the Government make it clear whether people who have been resident in the United Kingdom for more than ten years will pay a higher charge. (Paragraph 72)

On 6 December the Government announced the launch of a consultation on the residence and domicile rules and practices that govern personal taxation.

The Government's package of reforms presented at the Pre Budget Report sought to balance the call for increased fairness and the need to ensure continued competitiveness. *Paying a Fairer Share: A Consultation on Residence and Domicile* considered whether more could be done to increase fairness without damaging competitiveness by looking at a number of approaches which would require people who have been resident in the UK for longer than ten years to make a greater contribution.

The consultation closed on 28 February and the Government's response is published today.

The role of the Pre-Budget Report

20. We re-state our conclusion that it is important that the Pre-Budget Report retains a focus on consultation on fiscal measures that may be included in the forthcoming Budget. We continue to support the principle set out in the *Code for Fiscal Stability*, that the Pre-Budget Report should be consultative in nature, and should include, so far as reasonably practicable, proposals for any significant

changes in fiscal policy under consideration for introduction in the Budget. (Paragraph 76)

The Government continues to use Pre-Budget Reports to prepare the way for Budgets. Consultations on significant policy proposals were announced in the 2007 Pre-Budget Report and Comprehensive Spending Review, including replacing airline passenger duty with a per plane duty rather than per passenger, in addition to the publication of a summary of response on modernising tax relief of business expenditure on cars. In addition, a number of reviews and Regulatory Impact Assessments were published alongside the 2007 Pre-Budget Report and Comprehensive Spending Review—for example the three tax simplification reviews—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.

21. We acknowledge that the circumstances surrounding the notice given to the House of this year's Pre-Budget Report were exceptional. We trust that both the lack of formal notice to the House and the extremely short period of notice will not be treated as a precedent for future years. (Paragraph 78)

The Government notes the Committee's recommendation. As the Government has previously set out in its responses to the Treasury Select Committee's reports, the date of the Pre-Budget Report (and Budget) will be announced at the earliest convenient opportunity. Almost seven weeks' notice was given to the House of Commons of the date of the 2008 Budget.