



House of Commons  
Treasury Committee

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**The 2008 Budget:  
Government Response  
to the Committee's  
Ninth Report of  
Session 2007–08**

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**Tenth Special Report of Session  
2007–08**

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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.

### Current membership

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Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)  
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Mr Mark Todd MP (*Labour, South Derbyshire*)  
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### Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No. 152. These are available on the Internet via [www.parliament.uk](http://www.parliament.uk).

### 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) are on the Internet at [www.parliament.uk/treascom](http://www.parliament.uk/treascom).

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

### Committee staff

The current staff of the Committee are Colin Lee (Clerk), Sïan Jones (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young and Jay Sheth (Committee Specialists), Phil Jones (Committee Assistant), Caroline McElwee (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

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# Tenth Special Report

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The Treasury Committee published its Ninth Report of Session 2007–08, *The 2008 Budget*, on 7 April 2008, as House of Commons Paper No. 430. The Government Response to this Report was received on 9 June 2008, and is appended below:

## Appendix: Government Response

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### The economy

#### *Economic outlook and the resilience of the economy*

1. We note that the lower boundaries of the Treasury's forecasts for economic growth in 2008 and 2009 remain above the average of outside forecasters, and we are concerned that the Treasury has provided little evidence of analysis of upside or downside risk and specifically may have given insufficient weight to the risks of continued financial market turbulence and has failed to be more specific about the risks associated with such continued turbulence. The Treasury's optimism is based on its contention that the UK economy is better placed than other OECD economies in the face of market turmoil. We remain concerned that some of the economy's characteristics that have proven beneficial during past crises (rapidly rising residential property prices, close links with the US and an increasing reliance on the financial services industry, for example) might prove to be conduits through which the current problems in global financial markets are transmitted to the United Kingdom real economy.

At the time of the Budget 2008 forecast, it was judged that the degree of uncertainty about economic outcomes was exceptional. In recognition of this uncertainty, and acting on the Committee's recommendations following the 2007 Pre-Budget Report, Chapter B of the 2008 Financial Statement and Budget Report included a more detailed discussion of risks to the central economic forecast than has previously been the case. As well as an extended risks section from paras B.93 to B.104, there was also discussion of risks and uncertainties as a theme throughout the Chapter.

For example, Budget and Pre-Budget Reports always identify key forecast risks and uncertainties, but Budget 2008 goes further in discussing the processes by which these risks could materialise and the mechanisms through which they could affect the wider economy. In terms of the risks related to the ongoing disruption in financial markets, which the Committee specifically highlights, Box B5 sets out how this could impact on growth, both through demand effects (on consumption and investment) and through supply effects (on firms' costs). In terms of risks relating to residential property markets, Box B7 discusses recent external research on the relationship between house prices and consumption. Chapter B also highlighted in a number of places, including Box B8 and B9, some of the areas where data uncertainties could intensify.

In addition to the enhanced discussion of risks, the Treasury presented econometric analysis of the resilience of the UK and other OECD economies in Treasury Economic

Working Paper No.2 (published alongside Budget 2008), and summarised in Box B4 of Chapter B. While remaining the subject of ongoing research, the Treasury analysis found evidence that the UK economy has become significantly more resilient relative to the past. The evidence suggests that the same trend towards greater resilience can be observed in other OECD economies, while the UK is estimated to have been the most resilient of the economies studied in the period from 1994 to 2005. The evidence of greater resilience over time is important to the Treasury's judgement that the UK's flexible economy will be able to facilitate absorption and adjustment to the shock to global financial markets that continues to unfold.

### ***The property market and housing finance***

#### ***Housing market finance***

**2. We note the establishment of a Working Group to examine market-led initiatives to improve liquidity in the mortgage-backed securities market. We expect to continue to monitor developments in asset-backed securities markets and their impact on housing finance. We believe that the Working Group should also consider any need for new mortgage support schemes for low-income homeowners in difficulty. We look forward to the Working Group reporting back to the Chancellor of the Exchequer in the Summer and producing a final report at the time of the 2008 Pre-Budget Report.**

The Government announced on 9 April 2008 that Sir James Crosby would lead the working group to provide advice to the Government on options for improving the functioning of mortgage finance markets. Sir James will report initially to the Chancellor later this summer and present proposals at the 2008 Pre-Budget Report.

Improving the functioning of the mortgage finance markets is key to improving the supply and affordability of mortgages for consumers. In addition, the Government is taking steps to support vulnerable households unable to meet their interest payments by improving financial capability and providing debt advice and through DWP's support for Mortgage Interest (SMI). The Government has also announced further measures to ensure that financial advice and support is available for borrowers in difficulty, including an additional £9 million extra funding for face-to-face debt advice provided by third sector partners including Citizens Advice. The Government welcomes the Council of Mortgage Lender's statement, published 8th February 2008, which sets out the steps the industry is taking to help avoid repossessions. These include joint working with debt advisers, proactive identification of at-risk borrowers, and only considering repossession as a last resort.

**3. We expect to continue to monitor endeavours by the Government and the Financial Services Authority to promote the supply of, and demand for, long-term fixed-rate mortgages.**

The Housing Finance Review published alongside Budget 2008 set out how long-term fixed-rate mortgages can benefit some borrowers by helping manage mortgage risks by protecting them from unexpected interest rate rises over a long period.

The Government is therefore inviting views on options for a UK framework, to deliver more affordable and flexible long-term fixed rate mortgages, including lessons learned from international markets and institutions and will update at the 2008 Pre-Budget Report.

## The public finances

### *The state of the public finances*

**4. There has been a further weakening of the Treasury's forecasts of the current budget balance from 2008–09 onwards since last year and the latest forecasts for the fiscal position are based on forecasts for economic growth that are subject to considerable downside risks.**

The Budget 2008 forecast assumed that the negative impact on growth from financial market disruption would be somewhat larger and more prolonged than expected in the 2007 Pre-Budget Report. Therefore, Budget 2008, in line with the fiscal framework, provides support to the economy in the short term while taking action to maintain sound public finances in the medium term, thereby contributing to the Government's overall objective of maintaining economic stability.

The Budget 2008 economic forecast was made against a backdrop of exceptional uncertainty. The risks and uncertainties surrounding the forecast were the subject of detailed discussion in Chapter B of the Financial Statement and Budget Report.

The use of cautious assumptions audited by the National Audit Office (NAO) builds a margin into the public finance projections to guard against unexpected events. A complete list of these assumptions is set out in Box C1 of the Financial Statement and Budget Report. One of the key audited assumptions is that for the trend rate of GDP growth, which is assumed to be  $\frac{1}{4}$  per cent below the neutral view. This means that the rate of economic growth used to forecast the public finances is the bottom end of the projection range.

Since Budget 2008, the provisional outturn from the Office for National Statistics (ONS) for 2007–08 show the current deficit, net borrowing and net debt lower in 2007–08 than expected in Budget 2008. The current deficit is provisionally £5.7 billion compared to the Budget 2008 estimate of £7.9 billion. Net borrowing in 2007–08 is provisionally £34.3 billion compared to the Budget 2008 estimate of £36.4 billion and net debt is 36.7 per cent of GDP, compared to the Budget 2008 estimate of 37.1 per cent of GDP.

### *The golden rule*

**5. In our previous recommendations in our Reports on the 2007 Budget and 2007 Pre-Budget Report, we argued that the Government should review the golden rule such that it becomes more forward looking and less dependent upon the dating of the economic cycle. The current inability of the Treasury to date the end of the economic cycle works against the positive attributes of a fiscal rule founded on judgements about economic cycles. We continue to believe that the golden rule should be more forward-looking, but, even on the Treasury's own current formulation, it appears to us to be premature for the Treasury to state that it is "on course" to meet the golden rule in the next economic cycle, given the lack of an end date for the previous economic cycle.**

A key feature of the golden rule is that it is measured over the economic cycle to allow fiscal policy the flexibility to respond in support of monetary policy to accommodate shocks and smooth the path of the economy.

On dating of the economic cycle, Budget 2008 set out that evidence from the cyclical indicators monitored by the Treasury and the latest National Accounts data suggest that the economy passed up through trend in the second half of 2006. As the Committee noted, because output was judged to be close to trend at the end of 2007, growth forecast to slow to below trend rates in 2008 and 2009 and there are National Accounts revisions outstanding, it remains too soon to make a judgement about the end of the economic cycle.

It would be wrong to conclude that data uncertainty around National Accounts and its implications for the output gap affect fiscal policy decision making. Fiscal policy decisions in Budget 2008 were made in a forward looking manner, supporting the economy in the short term while taking action to maintain sound public finances in the medium term.

### *The sustainable investment rule*

**6. The Government has forecast that it will meet the sustainable investment rule over the period up to 2012–13. However, the margin by which it is now forecasting that it will meet the rule is extremely tight, especially considering the uncertainty surrounding the overall economic situation.**

Fiscal policy in Budget 2008 supports the economy, with an increase in borrowing concentrated in the years in which tighter credit conditions are assumed to have their largest negative impact on the economy. A tighter fiscal stance would have run risks with the economy while the impact of global financial market disruption is still playing out in the UK. To ensure sound public finances in the medium term, policy measures introduced in the Budget underpin sustainable public finances as the economy moves back towards trend, so that by the end of the projection period the margin on the sustainable investment rule is widening. The IMF noted that “the 2008 budget judgment was appropriate, as was its commitment to fiscal tightening over the next few years”.

An increase in borrowing in the short term to support economic stability has been possible because of the discipline imposed on the public finances through the fiscal framework. Debt was cut over the economic cycle which began in 1997–98 from 43.3 per cent at the end of 1996–7 to 36.6 per cent in 2006–07.

The fiscal rules remain protected, as the public finances are forecast using cautious, NAO-audited assumptions. This builds additional contingency into the headline fiscal numbers in addition to explicit margins against the rules, intended to help to protect the rules from the impact of unexpected events.

### *International Financial Reporting Standards*

**7. It seems highly likely that, following the move to International Financial Reporting Standards for central government, the sustainable investment rule as currently defined and interpreted will be breached in 2009–10 as a result of the reclassification of PFI projects. As such, the delay announced in Budget 2008 in the implementation of International Financial Reporting Standards gives the Government a chance to announce in advance whether and how it proposes to revise the sustainable investment rule in the light of the implementation of International Financial Reporting Standards. We recommend that the Government publish in the 2008 Pre-Budget Report any**

**proposed changes to the sustainable investment rule and its interpretation arising from classification changes resulting from International Financial Reporting Standards.**

The Government notes the recommendation of the Committee. There remain significant uncertainties around the impact of the introduction of IFRS on public sector net debt. As 2009–10 will be the first year that IFRS will be applied, the implications of any new standard for individual deals will need to be worked through, and this will also take time. Also, it is the independent Office for National Statistics (ONS) that decides on what is inside the public sector boundary for public sector net debt. The ONS have said that the IFRS approach to PFI is not conceptually consistent with ESA95, which are the standards for the National Accounts used to calculate fiscal aggregates, introducing further uncertainty.

*Northern Rock*

**8. We accept that Northern Rock's inclusion within calculations of Public Sector Net Debt should not influence decision-making under the fiscal framework. It is nevertheless important that the Government reports transparently on the effects of Northern Rock in its forecasts of Public Sector Net Debt as a proportion of GDP.**

The Government agrees that it is important to report transparently on the effects of Northern Rock on public sector net debt (PSND). Therefore the Government will report on PSND both including and excluding Northern Rock in any future Budgets and Pre-Budget Reports in which the company remains classified as a public corporation. As noted by the Committee, the Government will assess performance against the SIR using a measure of PSND excluding Northern Rock's impact. Northern Rock is temporarily in public ownership and its liabilities are fully backed by other financial assets held by the company, and therefore its impact on PSND does not reflect future calls on the taxpayer. Any economic profit or loss on the Government's relationship with the company will count against both measures of PSND (and thus within the sustainable investment rule) when that profit or loss crystallises for central government.

ONS are working on bringing Northern Rock into the statistics, but this has been delayed by the need to assemble the required data, quality assure this and incorporate into the public sector finances compilation system. In addition checks will need to be made to ensure that commercially sensitive information is not disclosed. Once all this has been done the Government will be in a better position to prepare forecasts of PSND both including and excluding Northern Rock in any future Budgets and Pre-Budget Reports in which the company remains classified as a public corporation.

**9. As we have noted already, the forecasts for the state of the public finances show further deterioration from 2008–09 onwards, and there are significant downside risks to the forecasts for economic growth. Should those risks crystallise, the Government would have extremely limited scope, under the fiscal rules as currently defined, to take further fiscal measures to support monetary policy. We expect to examine the role of the golden rule and of the sustainable investment rule in more detail in our inquiry into the 2008 Pre-Budget Report.**

The two key objectives of fiscal policy, as noted in the Committee's report, are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

The fiscal policy settings in Budget 2008 are in line with these objectives. Budget 2008 accommodates a short-term non-discretionary loosening, caused by the disruption in global financial markets, concentrated in the years in which tighter credit conditions are assumed to have their largest negative impact on the economy. In the medium term, discretionary fiscal tightening, as the economy returns to trend, protects the sustainability of the public finances, and leaves borrowing in line with that forecast at the Pre-Budget Report by 2012–13.

The fiscal rules have enabled the appropriate response in terms of short-term support and medium-term sustainability in this period of significant economic uncertainty.

## Child poverty, fuel poverty and the poverty trap

### *Child poverty*

#### *Prospects for meeting the 2010–11 child poverty target*

**10. We welcome the measures in the 2008 Budget on child poverty, which will make an important contribution towards reducing child poverty. We recommend that the Government, in its response to this Report, clarify the targets that have been set relating to child poverty since the pledge to eliminate child poverty in a generation was first made and report on performance against each of those targets in each financial year. We further recommend that that response set out the Government's estimate of each effect of each measure relating to child poverty in this year's Budget on progress towards the 2010–11 target in each financial year from 2008–09 to 2010–11. We remain concerned that the Government has yet to provide a clear explanation of the linkage between its target to halve child poverty by 2010–11 and the proposed deployment of resources to meet that target. It is of crucial importance that the Government makes it clear that the necessary resources to meet the 2010–11 target are available and that the Government is committed to deploying those resources directly to support low-income families. It is also important that the Government sets out the policy instruments under consideration to meet this target.**

In 1999 the then Prime Minister pledged to eradicate child poverty within a generation. The 2000 Spending Review included a Public Service Agreement target to make substantial progress towards eradicating child poverty by reducing the number of children in poverty by at least a quarter by 2004, held jointly by HM Treasury and the Department for Social Security. The 2002 Spending Review consolidated these ambitions as a shared HM Treasury and Department for Work and Pensions PSA target: to reduce the number of children in low-income households by at least a quarter by 2004–05, as a contribution to the broader target of halving child poverty by 2010 and eradicating it by 2020. The 2004 Spending Review and the 2007 Comprehensive Spending Review both included PSA targets to: halve the number of children in poverty by 2010–11, on the way to eradicating child poverty by 2020.

Over this period the equivalisation scale used in measuring child poverty changed. Equivalisation describes the process of adjusting income to take into account variations in both the size and composition of the household. Equivalisation is needed in order to make sensible income comparisons between households. The SR02 target was set using the McClements Equivalisation scale. However, in 2003, DWP consulted extensively on how to measure child poverty; the consultation concluded that the Modified OECD equivalence scale will promote consistency with the EU methodology and will allow direct comparison with other EU member states. As a result the SR04 and CSR07 targets used the modified OECD equivalence scale instead of the McClements Equivalisation scale.

The baseline year is 1998/99. Under the McClements Equivalisation scale there were 3.1 million children in poverty in 1998-99 before housing costs (BHC). Under this scale in each financial year:

- In 1999/00 there were 3.0 million children in poverty;
- in 2000/01 there were 2.7 million children in poverty;
- in 2001/02 there were 2.6 million children in poverty;
- in 2002/03 there were 2.6 million children in poverty;
- in 2003/04 there were 2.6 million children in poverty and;
- in 2004-05 child poverty fell to 2.4 million children representing a 23% fall over the period.

The SR04 and CSR07 target use the modified OECD equivalence scale. Under this scale, in 1998-99 there were 3.4 million children in relative low-income poverty (BHC). Under this scale:

- In 1999/00 there were 3.4 million children in poverty
- In 2000/01 there were 3.1 million children in poverty
- In 2001/02 there were 3.0 million children in poverty
- In 2002/03 there were 2.9 million children in poverty
- In 2003/04 there were 2.9 million children in poverty
- In 2004/05 there were 2.7 million children in poverty
- In 2005/06 (latest data available) there were 2.8 million children in poverty

Between 1998–99 and 2005–06 the number of children in relative low-income poverty using the modified OECD scale fell by 600,000 children.

Taken together reforms announced in Budget 2007, the 2007 Pre-Budget Report and Comprehensive Spending Review, and Budget 2008 will lift around 500,000 children out of poverty. The split across the last three fiscal events is around 40 per cent, 20 per cent and 40 per cent respectively. Analysis suggests that around over half of the estimated impact of Budget 2008 reflects the disregard of Child Benefit in Housing and Council Tax benefits

from October 2009, with the remainder reflecting increases in the child element of the Child Tax Credit and Child Benefit first rate in April 2009. However, all such estimates are subject to significant uncertainties; set against the likely error margins, the Government believes that the child poverty impacts are most reliably viewed at the level of the whole package of measures announced over the last year.

Decisions on the level of financial support to families will continue to be set at Budget and Pre-Budget reports in the usual way. The Government keeps under review a wide range of options to the tax and benefit system.

### **Fuel poverty**

**11. It is important that the Government continues to tackle fuel poverty through a combination of targeted and universal measures. We look forward to a constructive outcome to continuing discussions between the Treasury and the energy supply companies, particularly with regard to lowering the differential in charges between those with pre-payment meters and those making other forms of payment. In view of the importance of measures announced in Budgets and Pre-Budget Reports to the progress of the targets to eradicate fuel poverty set by the Government itself and by the devolved administrations, we recommend that the Government report in Budgets and Pre-Budget Reports on the effect of any measures announced at that time on progress towards meeting fuel poverty targets. We further recommend that, in the 2008 Pre-Budget Report, the Government report specifically on:**

- **the outcome of its discussions with the energy supply companies;**
- **any legislative measures in this area under consideration; and**
- **its assessment of the effectiveness of the one-off increase in the winter fuel allowance for Winter 2008-09 in terms of progress in meeting its obligations relating to fuel poverty.**

**We expect to examine during our inquiry into the 2008 Pre-Budget Report whether the increase in the winter fuel allowance for 2008–09 and the additional measures proposed for the Winter of 2009–10 will be effective in reducing fuel poverty in line with the Government’s targets.**

Further discussions with the six largest energy companies have taken place following the Chancellor’s announcement in the Budget. The Government announced on 11 April that these companies have agreed to increase their collective annual spend on social assistance to £150 million by 2011. This represents an additional £225m of spending on social assistance programmes over three years, on top of the existing social assistance already provided by the companies.

The impact of this additional funding on the number of households in fuel poverty numbers will depend on how it is directed. If used to offset bills and equally distributed amongst the poorest households, it could help to remove up to 100,000 from fuel poverty, though other scenarios may bring different benefits—for example, energy efficiency measures may benefit fewer but provide longer term benefits. The Government will be

working with energy companies to ensure those most in need benefit and it is likely that a range of measures will be implemented.

The Government has also recently announced further measures to help vulnerable customers, including seeking changes in the law to allow data-sharing with energy suppliers and providing funding for a roll out of Ofgem's national Citizens Advice Bureau awareness campaign on social assistance for the vulnerable.

The Government reports annually on progress against its fuel poverty targets including the impact of the measures it has taken, and the 6th annual report will be published later this year. The Government will consider the Committee's recommendation that it report in the Pre Budget Report, although in the light of this existing process it may not prove necessary to do so.

The additional one-off payment for over 60s and over 80s households announced in the Budget is being made to reflect the pressures such as higher energy bills faced by pensioners. In due course its impact on pensioner incomes will be factored into the Government's assessment of fuel poverty but at this stage the Government does not intend to make a separate assessment, isolated from the impact of other influences on pensioner incomes and fuel prices, of its impact on fuel poverty.

## Marginal deduction rates and the poverty trap

### *High marginal deduction rates*

**12. The increase in the number of people facing marginal deduction rates of between 60% and 70% is a direct consequence of decisions made by Government as to how the tax and benefit system will work. We acknowledge that such decisions are finely balanced between the overall cost of a benefit, and the rate at which it is withdrawn. We recommend that the Government undertake further research into how the design of the tax credit system, in conjunction with the overall tax and benefit system, is enhancing or impeding progress on the Government's welfare to work objectives, and report on such work in the 2008 Pre-Budget Report. We recommend that, as a basic principle, the Government ensure that high marginal deduction rates are limited wherever possible, and we will continue to keep this matter under review.**

The Government has made a significant effort to reduce the unemployment trap by making work pay. Inevitably, given the generosity of tax credits, more households will see support withdrawn as their income rises. Lowering the numbers of households affected or MDRs for those that are would necessarily involve reduced or less well-targeted support, illustrating the difficult policy trade-offs in this area. The increase in number of families facing marginal deduction rates (MDRs) between 60% and 70% since 1997 reflects significantly more generous support to low income families under tax credits. On the other hand, the number of families facing the highest MDRs (above 70%) has fallen by over half a million since 1997.

MDRs also suffer a number of limitations that make interpretation difficult. For example, they ignore some key features of the tax and benefit system, such as the effect of the £25,000 disregard in tax credits, which allows people to increase their income without having their tax credits withdrawn immediately. Also, MDRs also look at very small

changes of income; in reality, changes of income are larger and can move people off the tax credit taper or make them eligible for additional support (e.g. through the 30 hour element of WTC).

A number of published studies have assessed the labour market impacts of the Government's tax and benefits reforms. These studies, for example, suggest that the reforms have increased the lone parent employment rate by around 5 percentage points. There is no evidence of any reduction of working hours for working parents. In fact, average working hours are estimated to have risen for lone mothers, perhaps reflecting enhanced incentives to cross 16 and 30 hour tax credit thresholds.

The Government will nevertheless continue to look at improving work incentives.

The Government will also continue to provide information on the effects of its reforms on high marginal deduction rates in the Budget Report (see Table 4.2. and Box 4.4. in the Budget Report 2007 and Box 4.2. in the Budget Report 2008). While the Government does not plan to undertake any further detailed research before the Pre-Budget Report beyond the continuous and ongoing assessment of the effects of the tax and benefit system on the labour markets, the Treasury is in the process of procuring a new behavioural model of labour supply which will permit better assessment of the effects of the tax and benefit system on labour market transitions, the need for further research will be kept under review. The Government is committed to evidence-based policy-making and seeks to ensure that it has the latest information and analysis available.

### *Tax credit take-up rates*

**13. Those most affected by the abolition of the 10 pence rate of income tax appear to be those below the age of 65 with an income under £18,500 who are in childless households. The effect is greatest on those households where no individual is above the age of 60 because the household does not then benefit from the higher winter fuel allowance. We accept that there are benefits in tax simplification and that there are merits to focus on both the needs of children and motivation to work. However, the group of main losers from the abolition of the 10 pence rate of income tax seem an unreasonable target for raising additional tax revenues to fund these and other initiatives.**

As the Committee will be aware, the Chancellor wrote to the Chair of the Commons Treasury Select Committee on 23 April welcoming your review and stating the Government's intention to do more to help low-income households, in particular low-paid workers without children and pensioners under 65.

The Government submitted a memorandum to the Treasury Select Committee, and has provided written and oral answers to the further questions raised. This has outlined the progress that the Government has made in tackling poverty, and providing support for low-income households since 1997. It explains the rationale for the personal tax changes announced in Budget 2007, and the further announcement made by the Chancellor on May 13 along with the detailed distributional impacts of these changes.

The increase in the personal allowance for the 2008–09 tax year from £5,435 to £6,035 will help many low-income households, including the majority of those who lost out from the

Budget 2007 changes. It is worth £120 for a basic rate taxpayer, which is equivalent to the average household loss from the Budget 2007 reforms.

Around 22 million basic-rate taxpayers will benefit from this change, and the number of households that lose from the Budget 2007 reforms will be reduced from 5.3 million to 1.1 million, whilst the remaining losers will be at least halved.

The Chancellor has made clear that people will see the benefit from this change in their take-home pay from September.

**14. We are concerned by the poor take-up rate of working tax credit among eligible families without children, especially given that working tax credits are intended to mitigate for low-income households the effect of the removal of the 10 pence starting rate of income tax. We expect the Treasury and HM Revenue & Customs to galvanise their efforts in this area in coming months and years. We recommend that the Government report regularly in Budgets and Pre-Budget Reports, starting with the 2008 Pre-Budget Report, on progress in increasing the take-up rates of working tax credits for those sections of society with particularly low take-up rates. We further recommend that the Treasury commission research into whether the withdrawal of the 10 pence income tax band and high marginal deduction rates are creating disincentives that could frustrate the Government's welfare to work objectives.**

Overall, tax credit take-up is high and is significantly higher than that of comparable predecessor forms of support. Take-up rates for low-income families with children is around 90 per cent, much higher than in the early days of Family Credit, around 57 per cent, and the Working Families' Tax Credit, 62–65 per cent. These high levels of take-up demonstrate the benefit so many families derive from tax credits.

In addition, take-up of the Working Tax Credit is high: 61 per cent in 2005–06 with over 82 per cent of the money being claimed. However, while take-up among childless individuals is increasing, it remains lower than for households with children and increasing take-up among this group is a key priority.

To determine the best way of targeting people without children, HMRC has undertaken research to explore why they have not claimed tax credits. This identified a lack of awareness of the Working Tax Credit and HMRC has therefore run specific advertising campaigns to encourage them to apply. These campaigns included delivering 2.8 million leaflets to homes in 35 selected areas targeting postcodes where there are high levels of eligibility for the Working Tax Credit, but where take-up is currently low. In addition, the campaign included radio advertising in 20 of the 35 selected areas, reaching around 7.5 million potential customers. To further increase awareness HMRC has also worked in partnership with employers in sectors with high levels of eligibility; with trades unions; and with Jobcentre Plus. HMRC plans to repeat the campaign later this year, increasing its intensity. Over the next 12 months, HMRC will double expenditure on the Working Tax Credit campaign, and take-up among this group is expected to continue to rise.

While the tax credit “snapshot” data is different from the annual statistics underlying the take-up data, this also indicates strong growth in the numbers receiving tax credits. The numbers of childless families claiming Working Tax Credit has increased significantly

from around 323,000 in December 2006 to 376,000 in April 2008—up nearly 10 per cent since April last year, indicating that the number taking up tax credits is increasing.

Take-up rates for the Child and Working Tax Credits are published annually by HMRC on their website. The 2006–07 take-up rates will be published in spring 2009.

## Public expenditure issues

### *International Financial Reporting Standards*

#### *Implementation timetable*

15. We are disappointed that the Government has been forced to delay the implementation of International Financial Reporting Standards for the public sector until 2009-10, but not altogether surprised. The proposed timetable of one year for implementation was over-ambitious, and considerably more stretching than the five-year transition period enjoyed by the private sector. The Treasury appears to have misjudged the scale and complexity of the issues involved in the transition to International Financial Reporting Standards, in particular the issue of accounting for private finance initiative assets

#### *Shadow accounts*

16. It is important that momentum towards the implementation of International Financial Reporting Standards is maintained and, in that context, we welcome the Treasury's assurance that those departments in a position to do so will produce shadow accounts on an International Financial Reporting Standards basis from 2008-09. It is important that momentum towards the implementation of International Financial Reporting Standards is maintained and, in that context, we welcome the Treasury's assurance that those departments in a position to do so will produce shadow accounts on an International Financial Reporting Standards basis from 2008-09. We recommend that the Government, in its response to this Report, state whether those shadow accounts will be reviewed by the National Audit Office and whether the opinions of the National Audit Office on those shadow accounts will be made public.

All central government departments will be required to prepare International Financial Reporting Standard based shadow accounts, except where they seek special dispensation from the requirement.

The National Audit Office has notified the Government that it will review the International Financial Reporting Standards based shadow accounts. It is for the National Audit Office to decide whether their opinion on the shadow International Financial Reporting Standards accounts will be made public.

#### *Accounting treatment of PFI assets*

17. We are concerned about the potential for arbitrage between Financial Reporting Standard 5A and the Treasury's Technical Note 1 on accounting for private finance initiative (PFI) assets, creating the potential for different interpretations of appropriate PFI accounting treatment. We recommend that the Treasury, in consultation with the Financial Reporting Advisory Board, seek to ensure that PFI accounting under International Financial Reporting Standards is implemented across the public sector in a consistent, effective and transparent manner.

The Treasury is in consultation with the Financial Reporting Advisory Board and the Chartered Institute of Public Finance and Accountancy (in respect to Local Authorities),

and is committed to ensure that PFI accounting under International Financial Reporting Standards is implemented across the public sector in a consistent, effective and transparent manner from 2009 10.

## **Efficiency**

### *The 2004 Spending Review efficiency programme*

18. In reporting the final outcome of the 2004 efficiency programme, it will be crucial that the Treasury provides convincing evidence that the gains reported as ‘final’ have been achieved without a diminution of service standards. The credibility of such evidence would be enhanced by the reporting of instances where savings have not been included within the final reported total because such evidence has not been provided. The completeness and transparency with which the final outcome of the programme is reported will be an important test of whether HM Treasury can perform the roles of challenge and oversight in relation to the programme previously undertaken by the Office for Government Commerce.

We note the Committee’s concern and will publish transparent and detailed information on the conclusion of the Gershon Efficiency Programme in the autumn once final figures have been fully verified. We will take on board the Committee’s specific recommendations.

### *Measuring efficiency in the period 2008–09 to 2010–11*

19. There are a number of unresolved measurement issues relating to the efficiency programme for the period from 2008–09 to 2010–11. We recommend that, in its response to this Report, the Government—

- set out the value for money baselines for each department;

<b>Department</b>	<b>Baseline (£m)</b>
Attorney-General’s Department	730
Cabinet Office	350
Department for Business, Enterprise and Regulatory Reform	3,170
Department for Children, Schools and Families	48,430
Department for Culture, Media and Sport	1,600
Department for Environment, Food and Rural Affairs	3,360
Department for Innovation, Universities and Skills	16,530

Department for International Development	5,310
Department for Transport	10,280
Department for Work and Pensions	7,680
Department for Communities and Local Government	5,750
Department for Health	87,970
Foreign and Commonwealth Office	1,550
HM Revenue and Customs	4,420
HM Treasury	240
Home Office	15,250
Local Government	53,000
Ministry of Defence	29,410
Ministry of Justice	9,230
Northern Ireland Office	1,000

- **explain whether a consistent method is used for calculating “counter-factual” expenditure increases and, if not, why not;**

All departments use a consistent methodology for calculating VFM gains. All initiatives are based on HMT measurement guidance and all use a consistent method to score savings against counterfactual spending. In all cases the VFM saving is the difference between actual spend and counterfactual spend.

In all cases the counterfactual reflects what would have happened to costs in the absence of the VFM initiative. In the majority of cases this is simply based on the GDP deflator.

- **set out the circumstances in which it is appropriate to treat reductions in service as efficiency savings; and**

The CSR Value for Money programme will release £30 billion of cash-releasing savings to further invest in improving public services. Throughout the three-year period, improvements in the quality of public services will be demonstrated through progress towards meeting Departmental Strategic Objectives (DSOs) and streamlined set of Public Service Agreements (PSAs).

We expect all VFM initiatives to support the delivery of PSAs and DSOs.

- **clarify the circumstances in which a net reduction in expenditure arising from a transfer of costs to the private sector by charging or other means constitutes an efficiency saving.**

VFM savings may be claimed when sustained changes in the way services are delivered result in subsidies being reduced and users paying a greater portion of the cost of a service.

**We further recommend that the Government invite the National Audit Office to examine the published Value for Money Delivery Agreements and that the Government consider the case for publishing updated and improved Agreements in the light of such examination.**

NAO have agreed to audit reported VFM gains on a departmental basis during the CSR programme. We feel this approach, of auditing reported gains, is likely to offer greater value than auditing Delivery Agreements and we are therefore not convinced that the National Audit Office should spend time formally examining the published VFM Delivery Agreements, which could be better spent challenging progress.

We will take on-board the Committee's recommendation to publish updated Agreements, and will provide departments with the flexibility to do this if their programmes evolve significantly during the CSR period.

### ***The Saving Gateway***

**20. We continue to believe that there is a strong case for matching under the Saving Gateway at the level of 50 pence for every pound invested by the individual, possibly with support for the opening months at the pound-for-pound level. We recommend that, in advance of a final decision on matching rates, the Government publish estimates of the cost of implementation based on different levels of matching and associated estimates of take-up rates.**

The Government welcomes the Committee's continued support for the Saving Gateway and notes the recommendation on the match rate for the national scheme. As the Committee notes, the Saving Gateway seeks to promote saving through Government matching (making a contribution for each pound saved into an account). The match rate in the first pilot was fixed at £1 for every £1 saved. The second pilot tested different match rates (20p, 50p or £1 for every £1 saved); different monthly contribution limits (£25, £50 or £125); the effect of an initial endowment (£50); and support from a wider range of community financial education bodies. The second pilot demonstrated that the match did not have to be as high as pound-for-pound to incentivise individuals to save and found that the initial endowment offered in some areas had little effect on saving levels.

The Government is further considering the match rate, which will affect the associated costs for the national scheme. Final decisions on the match rate will take account of the lessons from the pilot. In addition, the Government will consider the match rate against overall affordability.

In addition to the match rate, costs for the Saving Gateway will be affected by a number of other factors. These include the parameters of the scheme (such as eligibility criteria), take-up rates—as noted by the committee—and the final design of the scheme. The Government will consider publication of the costs of implementation when the final parameters of the scheme have been defined.

**21. We believe that, should the Saving Gateway be extended in future, the first priority should be to extend to those who would qualify initially in terms of income but not in receipt of a qualifying benefit or tax credit. The initial availability of the Saving Gateway only to those claiming qualifying benefits and tax credits reinforces the importance of Government efforts to increase take-up of tax credits to which we referred earlier. We recommend accordingly that the Government consider measures to link promotion of the Saving Gateway with the wider promotion of the availability of tax credits.**

The Government notes the Committee's recommendation. As set out in the consultation document published alongside the Budget, access to the Saving Gateway will be passported from qualifying benefits and tax credits. This will give an eligible population of around 8 million individuals. Passporting access to the scheme provides the simplest and most cost effective way of reaching the target population. The scheme will be aimed at people on working age benefits and tax credits; other forms of support are in place for those who are retired and on low incomes, such as the Pension Credit and the Winter Fuel Allowance. Students are able to access financial support through student loans and maintenance grants.

The Government will consider the case for extending the Saving Gateway. The Government will also be considering the promotion and marketing of the scheme prior to the introduction of the Saving Gateway in 2010. The Government will take account of the committee's recommendation at that time.

**22. We recommend that the Government set out, in its response to our Report, its proposed methods for ensuring the Saving Gateway does not operate so as to provide incentives for financial providers, particularly unregulated financial providers, to lend money at high interest rates to encourage those eligible simply to borrow in order to save in Saving Gateway accounts.**

The Government notes the Committee's recommendation. Saving Gateway accounts will be designed as far as possible so as to minimise the opportunities for fraud and misuse. In the Saving Gateway pilots, which ran between 2001 and 2007, there was no evidence of unregulated providers encouraging individuals to borrow to save. The Government is considering issues such as this and will keep them under review. The Government is also consulting on the operation and administration of the national scheme. The consultation period ends on 4th June 2008.

**23. Although we accept that many of those with Saving Gateway accounts will not be required to pay tax on the interest earned, we believe that both the simplicity of operation and the appeal of the Saving Gateway would be assisted if it were offered on a tax-free basis. To assist the public debate on this matter, we recommend that, alongside the cost estimates that we have previously called for, the Government set out its forecasts of the total tax receipts from interest on Saving Gateway accounts.**

The Government notes the Committee's recommendations, and will take it into account when finalising the design of Saving Gateway accounts.

The Government will legislate on matters such as the tax treatment of accounts in due course.

## Tax measures

### *Capital gains tax*

24. We welcome the announcement of the entrepreneur's relief, which responds to some of the concerns which we voiced in our Report on last year's Pre-Budget Report. However, we believe that significant new record-keeping challenges could be posed by the new relief, and that it is important that HM Revenue & Customs gives full and early advice to potential beneficiaries of the relief and their advisers about these challenges. We note that the entrepreneur's relief does not resolve all the problems created as side-effects by the changes to the capital gains tax regime. We believe that, if the Government is seeking further to simplify taxation for small businesses, it will need to undertake a broader review and consultation which examines the fundamentals of the tax regime.

People who make qualifying disposals will claim entrepreneurs' relief when they make their Self Assessment return. Individuals will be required to keep note of a cumulative total of how much relief they have claimed. This record-keeping requirement will be as minimal as is necessary for the relief to be operated as intended and is entirely in line with the Self Assessment system. HM Revenue & Customs are engaged in ongoing discussions with tax practitioners and will issue final guidance for taxpayers and their advisers once the legislation receives Royal Assent.

The Government keeps all taxes under review and continues work on small business taxation. Currently, as part of the broader tax simplification programme the Government announced at the Budget that it will be undertaking a review of corporation tax calculations and returns for smaller companies, in partnership with business.

### *The tax treatment of residence and domicile*

25. We are concerned that, as a result of the focus on wealthy individual non-domiciles, there has been insufficient consideration of the possible impact of tax changes announced in the Budget on the middle and lower income groups of non-domiciled taxpayers. Due to the complex nature of the policies on domicile and residence, and the distinction between how liability is incurred for the annual £30,000 charge and the loss of personal tax allowances, we are concerned that the new policies will create a group of non-domiciled taxpayers who would be unwittingly in breach of the new law. We are also not convinced that sufficient consideration has been given to the possible further burden that the measure will place on HM Revenue & Customs. We recommend that the Government, in its response to this Report, summarise the steps being taken by HM Revenue & Customs to deal with the potentially large number of foreign workers who may be seeking tax advice, following the implementation of the new policy. We intend to monitor the tax domicile regimes now proposed to be, or actually, created in a number of other tax jurisdictions. We believe that the Government should undertake a wider review of the off-shoring of both individuals and companies.

The Government continues to believe that the changes contained in the Finance Bill make the system fairer while maintaining competitiveness of the UK economy.

In answer to the issue of the impact of the measures on low paid migrants, the Government has taken significant steps to ensure that most low paid non-domiciled individuals will not be affected by the reforms. The de minimis threshold for unremitted offshore income, after which remittance basis users lose access to personal allowances or are affected by the charge, has been doubled since The Pre-Budget Report to £2,000.

Low income migrant workers who have more than £2,000 unremitted foreign income and gains for the year are unlikely to pay more tax as a result of the new rules on domicile because even if they move to the arising basis they will be able to claim relief for foreign tax paid under double taxation agreements.

Turning to the subsequent concern that there is a risk that low-income migrant workers will become unintentionally non-compliant with this legislation, it should be noted that HMRC applies a risk-based approach to compliance. Low-income migrant workers are likely to be relatively low risk.

As regards managing enquiries from migrant workers, HMRC is also currently developing specific guidance and support, and working with external stakeholders, to encourage compliance by low income migrant workers. HMRC will also monitor the impact of the new rules and develop new procedures as necessary to support this group of customers.

It is important to note that not all people who have a foreign domicile or come from abroad fall under the category of non-domiciles under the tax system. The vast majority of those with a foreign domicile do not claim the remittance basis, and would get no financial benefit from doing so, unless they have significant foreign-source income and gains. These people are not affected by the changes and this will remain the case.

Turning to the possibility a further review of off-shoring, the Government has made a clear commitment that the tax rules on residence and domicile will not be revisited for the rest of this Parliament or the next. The Government published a consultation paper *Paying a fairer share: a review of residence and domicile in October 2007 on the tax regime for UK investors, including individuals and companies, investing into offshore funds.*

### ***Income shifting***

**26. We welcome the Chancellor of the Exchequer's decision to undertake a further consultation on the issue of income shifting. However, we are concerned that this proposed legislation would place an additional tax burden on small businesses and we note that it caused widespread concern during the previous consultation period. We recommend that the terms of the consultation be widened to constitute a full review of the principles of small business taxation to ensure that the taxation system rests on practical, workable rules for the small business community.**

In keeping with the principle of independent taxation the Government firmly believes it is unfair that some individuals can arrange their affairs to gain a tax advantage by shifting part of their income to another person who is subject to a lower rate of tax. The Government considered the responses received to the recent consultation and believes that a further period of consultation will ensure that legislation in this area provides clarity and certainty for businesses and their advisers.

The Government keeps all taxes under review including those that relate to small business. In Budget 2007 the Government refocused incentives for small business towards growth and investment and introduced measures to tackle the issue of tax-motivated incorporation.

The Government believes that prompt action is required on income shifting in order to maintain fairness within the tax system and protect the Exchequer.

### ***Double taxation treaties***

**27. We welcome steps taken by the Government to prevent tax avoidance through the misuse of double taxation treaties by UK residents. We are concerned by the suggestion that the Government has known about this abuse for some time and yet has failed to act. We recommend that the Government set out, in its response to this Report, when it was first alerted to the abuse, why action was not taken earlier and why it considers a 21-year period of retrospection appropriate. We expect the Government to move swiftly to close future abuses of the tax system that are disclosed to them.**

Tax avoidance is unfair on the vast majority of taxpayers who pay their fair share. We are pleased that the Committee welcomes the steps taken by the Government to close off this highly artificial tax avoidance scheme whose users deliberately sought to frustrate the intention of Parliament.

The Inland Revenue first learned of a scheme in 2001, successfully settling their enquiries with one of the original promoters of the scheme who in 2003 ultimately accepted that the income should be taxed in the UK. Despite this early success, the scheme use continued to grow and during 2007 both the number of disclosures and amounts of tax involved reached a level which led the Government to decide that a retrospective legislative response was now appropriate.

The retrospection is in fact indefinite. The legislation amends other legislation that was enacted 21 years ago, also with indefinitely retrospective effect. The reason for retrospection is to ensure that the scheme does not undermine Parliament's action taken in 1987 to restore the intended effect of tax treaties. In this way retrospection therefore preserves the legitimate expectations of the majority that tax will be applied fairly and in accordance with the clearly expressed will of Parliament.

While the legislation will be deemed to have always taken effect, in practice, it will only take effect in relation to income earned from 2001/2 onwards because HMRC have not seen any treaty claims made before that time.

There is always a judgement to be made as to whether it is sufficient to challenge a scheme in the courts, or whether legislative action is also required. The government recognises the damage to the tax system that is caused by tax avoidance and in recent years has shown itself ready to take decisive anti-avoidance action where necessary, including the introduction of disclosure rules in 2004 to improve Government's knowledge of avoidance activity.