



House of Commons  
Treasury Committee

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# The 2007 Pre-Budget Report

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**Second Report of Session 2007–08**

*Volume I*

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House of Commons  
Treasury Committee

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# The 2007 Pre-Budget Report

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**Second Report of Session 2007–08**

*Volume I*

*Report, together with formal minutes*

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### Contacts

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

# Contents

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<b>Report</b>	<i>Page</i>
<b>Summary</b>	<b>3</b>
<b>1 Introduction</b>	<b>5</b>
<b>2 The real economy</b>	<b>6</b>
Economic performance and forecasts	6
Uncertainty	8
Household sector balance sheet	9
House prices	9
Household debt	11
The world economy	11
<b>3 The public finances</b>	<b>13</b>
The current budget balance	13
Revenue receipts	14
The golden rule	15
The sustainable investment rule	16
<b>4 Taxation issues</b>	<b>18</b>
Reform of capital gains tax	18
Background	18
Capital gains tax reform in 2007 Pre-Budget Report	18
Consultation on changes to capital gains tax	19
Impact on the private equity industry	21
Other effects of capital gains tax reforms	23
Projected revenues from the reforms of capital gains tax	26
Changes to inheritance tax	27
New rules for non-domiciled taxpayers	29
<b>5 The role of the Pre-Budget Report</b>	<b>33</b>
Nature of the Pre-Budget Report	33
Prior announcement of date of Pre-Budget Report	34
<b>Conclusions and recommendations</b>	<b>35</b>
<b>Formal minutes</b>	<b>39</b>
<b>Witnesses</b>	<b>41</b>
<b>List of written evidence</b>	<b>42</b>
<b>List of unprinted evidence</b>	<b>42</b>



## Summary

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### *Introduction*

In this Report we consider the state of the United Kingdom economy, the public finances, individual tax measures in the 2007 Pre-Budget Report and the consultative nature of the Pre-Budget Report.

### *The economy*

The Government has down-graded its forecast for economic growth in 2008 since the 2007 Budget. We identify some downside risks to this forecast, particularly if the wider effects of the credit crunch are greater than currently expected. We also note some risks going forward to the Treasury's forecast that the economy will return to trend growth in 2009 and conclude that the Treasury's optimism that the growth rate should revert to trend in 2009 has not been adequately explained.

### *The public finances*

The Treasury has recently reduced the scale of errors in its forecasts for the public finances. This may be related to the current stage in the economic cycle. We expect the Treasury to continue to exercise vigilance in addressing errors in its forecasts of the public finances. We note risks to the public finances from a deeper or more prolonged downturn in the financial sector than currently forecast. We reiterate our recommendation that the Government review the golden rule such that it becomes more forward-looking and less dependent upon the dating of the economic cycle.

### *Taxation issues*

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. We call for the Treasury to clarify the points on which it is prepared to consider the representations of affected parties. We recommend that Government, in its response to this Report, set out how it proposes to mitigate the effects of the reforms of capital gains tax, particularly the effects of the withdrawal of taper relief for those already within the two-year qualifying period and with especial reference to small businesses.

We recommend that the Government clarify its projections for the cost to the Exchequer arising from the proposed inheritance tax reforms and the assumptions about taxpayer behaviour that underpin those projections.

We call for clarification on the extent to which changes to the rules applicable to non-domiciled taxpayers are open to consultation, and also for clarification on whether people who have been resident in the United Kingdom for more than ten years will pay a higher charge.

*Nature of the Pre-Budget Report*

The Pre-Budget Report is intended to be largely consultative in nature, and we conclude that it should retain its focus on consultation on fiscal measures.

# 1 Introduction

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## Our inquiry

1. The Chancellor of the Exchequer, the Rt Hon Alistair Darling MP, delivered his first Pre-Budget Report on 9 October 2007.<sup>1</sup> In accordance with our past practice, we have undertaken an inquiry into the Pre-Budget Report. We held three evidence sessions in the fortnight following the Pre-Budget Report—from outside experts on 15 October,<sup>2</sup> from Treasury officials on 17 October and from the Chancellor of the Exchequer on 25 October. We also received a range of written evidence, most of which is published with this Report and the remainder of which has been reported to the House and is available for public inspection.<sup>3</sup> We are most grateful to all those who gave evidence.

## Other relevant inquiries

2. The 2007 Pre-Budget Report was published alongside the 2007 Comprehensive Spending Review. We conducted our inquiry into the 2007 Pre-Budget Report in parallel with an inquiry into the 2007 Comprehensive Spending Review. We are reporting separately on issues relating to the Comprehensive Spending Review, including child poverty.<sup>4</sup>

3. Some matters raised during evidence on the 2007 Pre-Budget Report were relevant to our inquiry on Climate change and the Stern review: the implications for HM Treasury policy on tax and the environment.<sup>5</sup> We will examine these matters in more detail in our Report on that inquiry.

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1 HC Deb, 9 October 2007, cols 167–175; HM Treasury, *Meeting the aspirations of the British people: 2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007, Cm 7227 (hereafter *Pre-Budget Report and Comprehensive Spending Review 2007*)

2 Mr Robert Chote, Institute for Fiscal Studies, Ms Bridget Rosewell, Volterra Consulting, Dr Martin Weale, National Institute of Economic and Social Research, Professor Colin Talbot, Manchester Business School, and Mr John Whiting, PriceWaterhouseCoopers.

3 For a list of published written evidence and a list of other evidence reported to the House, and details of how such evidence may be inspected, see p 42.

4 Treasury Committee, First Report of Session 2007–08, *The 2007 Comprehensive Spending Review*, HC 55

5 “New inquiry: Climate change and the Stern review: the implications for HM Treasury policy on tax and the environment”, Treasury Committee press notice 14, 14 December 2006

## 2 The real economy

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### Economic performance and forecasts

4. The Government has downgraded its forecast for GDP growth in 2008, from 2½% to 3% at the time of the 2007 Budget, to 2% to 2½% in the 2007 Pre-Budget Report.<sup>6</sup> The 2007 Pre-Budget Report explained that the downgrade was in part due to the Bank of England's Monetary Policy Committee raising interest rates "by more than financial markets expected at [2007] Budget time", and that such increases in interest rates would "be expected to impact on growth in 2008".<sup>7</sup> As well as this unexpected rise in interest rates, the 2007 Pre-Budget Report also highlighted the recent disruption in financial markets, stating that "For the purposes of the economic forecast, it has been assumed that there will be some feed-through to tighter credit conditions and to household and company spending in the short term".<sup>8</sup> Despite this, the Government's forecast for GDP growth in 2009 remained the same at 2½% to 3%.<sup>9</sup>

5. Dr Martin Weale, Director of the National Institute of Economic and Social Research, when asked whether he agreed with the Treasury's forecast, told us that:

My view of next year is slightly more pessimistic than that presented here [in the 2007 Pre-Budget Report] but I would not say sharply more pessimistic.<sup>10</sup>

He did however warn that "the credit crunch could turn out worse than they are expecting and I am expecting".<sup>11</sup> Dr Weale then told us he expected growth in 2009 to be up to half a percentage point lower than that expected by the Treasury.<sup>12</sup> Ms Bridget Rosewell, Chairman of Volterra Consulting, expressed more significant concerns about the Government's forecast for economic growth in 2009, telling us:

I am particularly concerned that the position from 2009 that they are forecasting is rather optimistic compared to what may happen in 2008. In 2008 we are already getting a slowdown in the economy and we have had interest rate increases. Forget the financial credit crunches and all of that and just think about the underlying pattern. We were all forecasting a slowdown in the economy, but again, never mind the financial crisis; this is a very small slowdown, you know, a small accident, not many dead as far as this forecast is concerned, and if you look at either inflation or output growth they have returned to business as usual very quickly. It is the reasons why that is going to happen which I do not think are very well explained [by the 2007

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6 *Budget 2007*, Table B4, p 252; *Pre-Budget Report and Comprehensive Spending Review 2007*, Table A3, p 144

7 *Pre-Budget Report and Comprehensive Spending Review 2007*, para A.47, p 144

8 *Ibid.*

9 *Pre-Budget Report and Comprehensive Spending Review 2007*, Table A3, p 144; *Budget 2007*, Table B4, p 252

10 Q 3

11 *Ibid.*

12 Q 44

Pre-Budget Report]. We get a lot about 2008 but not much about the period beyond and yet that matters quite a lot.<sup>13</sup>

6. In downgrading their economic forecasts to take account of the recent disturbance in financial markets, Treasury officials told us that they had “made a cautious assessment of [the shock to financial markets] impact in 2008 by revising down our range for growth for 2008 from 2.5% to 3%, which was what we had at Budget time, to 2% to 2.5%”.<sup>14</sup> However, on a more positive note for the economy, they also told us that there had recently been “a lot of momentum in the economy”,<sup>15</sup> with the FTSE 100 “pretty close to record levels”.<sup>16</sup> Looking further into the future, Treasury officials told us that “Our assessment is that [the disruption in financial markets] will be a shock with a temporary impact in 2008 and we see good reasons for expecting growth to strengthen in 2009 back to trend”.<sup>17</sup> **We acknowledge that the Government has downgraded its forecast for economic growth in 2008 due to the effects of both the 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.**

7. One element of the change to the economic forecast has been the effect of the recent financial markets disruption on the financial services industry. The 2007 Pre-Budget Report noted that, while the current financial market disruption would affect the financial sector, “it is notable that the UK’s innovative financial sector was relatively quick to recover following periods of financial market disruption in 1998 and 2001”.<sup>18</sup> The 2007 Pre-Budget Report outlined the potential risks to this important part of the United Kingdom’s service sector:

In relative terms, the UK has a larger financial sector than in most advanced economies. If the recent disruption were to persist, the direct impact of slower growth in the financial sector could be larger than assumed. However, if the UK’s innovative financial sector, and flexible economy in general, were to absorb the shock more quickly than has been assumed, growth could be stronger than forecast.<sup>19</sup>

8. Dr Weale supported the idea that the financial markets, while slowing from the strong growth seen in the first half of this year, would continue to be an important part of the UK economy, telling us that “that the financial sector has shown itself to be remarkably innovative in thinking of new things to do”.<sup>20</sup> Ms Rosewell told us that she thought there were other, more important international risks, such as political changes in the Far East, than the recent credit disruptions.<sup>21</sup> Treasury officials confirmed to us the position as stated in the 2007 Pre-Budget Report and told us that, while each shock to the financial system

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13 Q 3

14 Q 133

15 Q 131

16 *Ibid.*

17 Q 133

18 *Pre-Budget Report and Comprehensive Spending Review 2007*, para A.71, p 152

19 *Ibid.*, para A.82, p 154

20 Q 17

21 *Ibid.*

might be different, “the resilience and responsiveness shown by the financial sector has been quite similar”.<sup>22</sup> They added that:

We think there will be a short-term impact running through the rest of this year and into 2008, but we believe that [the financial sector] will bounce back. That is why we forecast a range of 2½% to 3% for 2009 because we think that the financial sector will strengthen.<sup>23</sup>

**9. 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.**

## Uncertainty

10. Given the disturbance to the smooth running of international financial markets that has occurred since 9 August 2007, we examined the risks associated with the economic forecasts presented in the 2007 Pre-Budget Report. The 2007 Pre-Budget Report itself considered several potential risks to the Treasury’s forecasts for economic growth—both on the upside and the downside. One feature common to several of the risks identified in the 2007 Pre-Budget Report is the uncertain effect of the disruption in financial markets; other potential risks include weaker than expected growth in the United States, a potentially more resilient euro area economy and the effects on inflation of food and energy price movements.<sup>24</sup>

11. In regard to the overall level of uncertainty surrounding the economic forecasts in the 2007 Pre-Budget Report, Mr Chote told us that:

I would be reluctant to say that the uncertainty surrounding this forecast is greater than normal. The factors may be different but there are always factors, they always seem specific to the occasion, and I am sure like all forecasts it will be revised. I find the numbers for both next and the year after perfectly plausible, although, as I say, for 2009 I have a gloomier view.<sup>25</sup>

Treasury officials took a different view. Mr Nicholas Macpherson, Permanent Secretary to the Treasury, told us that at “this time I think there is more uncertainty than [there has been] for several years”.<sup>26</sup> He went on to say that the Treasury’s forecast had “tried to anticipate some effect from the credit events, but there is uncertainty. Inevitably, both the downside and upside risks are higher around our central forecast than they were at Budget

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22 Q 152

23 *Ibid.*

24 *Pre-Budget Report and Comprehensive Spending Review 2007*, paras A.78–A.83, p 154

25 Q 45

26 Q 131

time.”<sup>27</sup> The Chancellor of the Exchequer told us that “we are going into a period of uncertainty which is why I revised downwards my growth forecast for next year”.<sup>28</sup>

12. In discussing the Treasury’s presentation of the risks associated with the economic forecasts in the 2007 Pre-Budget Report, Ms Rosewell highlighted her thoughts on the weaknesses in the Treasury’s description of the risks:

that to have about two-thirds of the page on forecast issues and risks in Annex A is not really a very good appreciation of the riskiness of the current situation, particularly given financial disruption and the potential for change and some view as to how serious those risks are either on the upside or the downside, actually, because there are potential upside risks in the world economy for that matter—China and India continue to do very well—and I think some appreciation of the scope outside the relatively narrow central range that they have got in the [Pre-Budget Report] would have been very helpful.<sup>29</sup>

Dr Weale also told us that there was “no real quantification of the sorts of things that could go wrong with the British economy and that might therefore adversely affect public borrowing and the fiscal position”.<sup>30</sup> Treasury officials explained to us their presentation of the risks to the economic forecasts contained in the 2007 Pre-Budget Report, telling us that:

We do not publish confidence intervals around our forecasts, so in that respect we are different from the Bank [of England]. We have stuck to the same forecast ranges as we have used in the past, but try to highlight in the text of the document, both in chapter 2 and [Annex] A, the increased uncertainties we face looking ahead.<sup>31</sup>

**13. 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.**

## Household sector balance sheet

### *House prices*

14. Residential buildings remain the dominant asset on the balance sheet of households.<sup>32</sup> Movements in house prices are therefore important in determining the overall wealth of households. The 2007 Pre-Budget Report stated that “there is ... evidence that house price

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27 Q 131

28 Q 270

29 Q 3

30 Q 2

31 Q 132

32 Office for National Statistics, *The Blue Book 2006*, Table 10.10

inflation is easing, with monthly increases averaging 0.4% since May 2007, compared with 1.0% during the first four months of the year”.<sup>33</sup> Looking forward, the 2007 Pre-Budget Report stated that “house price inflation is expected to continue to ease over the coming year”.<sup>34</sup> Ms Rosewell told us that she was unsure that “the risk of a sharper house price correction [had] increased since the Budget”.<sup>35</sup> Outlining her reasoning, she told us that “if you look at most bits of the housing market, unemployment is still low so people can finance their mortgages, and that is really what matters when it comes to sharp house price corrections”.<sup>36</sup>

15. Treasury officials acknowledged that their past forecasts had been, “in terms of the range of outside forecasters ... towards the optimistic end on house prices”.<sup>37</sup> Although officials told us “house prices have continued to exceed even our expectations”, they noted that “for the first time in this PBR we have some evidence that they are beginning to slow down”.<sup>38</sup> Officials cautioned against a more pessimistic outlook than that outlined in the 2007 Pre-Budget Report, saying that “we certainly do not expect a disorderly correction in the housing market or house prices, although we must acknowledge that there will be regional differences”.<sup>39</sup> Officials were keen to point out the differences between the United States and United Kingdom’s housing markets, highlighting that “our sub-prime sector, which is really the big issue for the US, is much smaller; most estimates put it at about 0.6% or 0.7% rather than the double-digit size in the US”.<sup>40</sup> They also pointed out that, while housing supply was limited in the United Kingdom, “housing supply is much more elastic in the US which means that potentially one gets a much greater effect in terms of quantity and price” from shocks to the housing market.<sup>41</sup> Finally, Treasury officials were keen to stress that the link between a house price fall and consumption might not be as strong now as it has been at other times:

The other comment in terms of the scenarios is that if one looks at the underlying fundamentals in the past when there has been a closer link between house prices and consumption it is usually because something else is going on, for example how the labour market is performing or household finances. If one looks at the labour market, it is pretty strong. Unemployment is still falling and employment is at record levels. Therefore, the link that one saw sometimes in the past between house prices and consumption might be more to do with wider economic and labour market conditions and instability in the economy. We do not really have any of that at the moment.<sup>42</sup>

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33 *Pre-Budget Report and Comprehensive Spending Review 2007*, para A.56, p 148

34 *Ibid.*

35 Q 5

36 *Ibid.*

37 Q 134

38 *Ibid.*

39 *Ibid.*

40 Q 135

41 *Ibid.*

42 *Ibid.*

16. **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.**

### **Household debt**

17. Another risk identified by the 2007 Pre-Budget Report was the effect of the rise in household debt levels should interest rates also rise. The Report stated that “if the effective interest rates received and paid by households and companies were to rise, the impact on disposable incomes could be larger than would have been the case in the past due to the growth of private sector balance sheets”.<sup>43</sup> In other words, the rise in the level of household debt means that, should interest rates rise, households would see more of their income spent on interest repayments. Dr Weale was sanguine about the immediate effects of the potential increase in effective interest rates, telling us that “interest rates might be slightly higher, some people will be squeezed, but although I can see the consumer household sector wanting to rebuild its savings rate I cannot see a sharp fall in consumption growth coming”.<sup>44</sup>

18. The Chancellor of the Exchequer commented on the structure of household debt, observing that “if I look at household debt, most of that debt is secured debt, it is mortgages; the unsecured debt, credit cards and so forth is coming down”.<sup>45</sup> He suggested that current levels of household debt were affordable, saying that “if you look at the household sector, its interest payments are about 9.8% of their disposable income, they were about 15% in 1990, so I think we are in a rather better position than we were 17 years ago”.<sup>46</sup>

19. **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.**

### **The world economy**

20. One potential risk to the economic forecast outlined in the 2007 Pre-Budget Report is the effect on the United Kingdom's economy of material changes in the economic outlook of the United Kingdom's trading partners. While the 2007 Pre-Budget Report stated that “growth in the US could slow further if the effects of the weaker housing market were to spread to the wider economy”, it also noted that “the monetary policy response in the US could reduce the extent of that slowdown”.<sup>47</sup> At the same time, the 2007 Pre-Budget Report

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43 *Pre-Budget Report and Comprehensive Spending Review 2007*, para A.83, p 154

44 Q 23

45 Q 270

46 Q 271

47 *Pre-Budget Report and Comprehensive Spending Review 2007*, para A.79, p 154

highlighted potential upside risks to the world economic outlook, stating that “macroeconomic fundamentals in many emerging markets have improved”, and that “the euro area economy could prove more resilient to the US slowdown than forecast”.<sup>48</sup> Ms Rosewell clarified the advantages of a more diversified global economy, stating that if “the US goes into recession, before all the moves to greater globalisation or diversity of global growth, there was probably a 100% chance we would go into recession and now there is only a 70–80% chance of going into a recession”.<sup>49</sup> Dr Weale noted that “[the] immediate response of weaker growth or a recession in the United States is less demand for United Kingdom and European exports and therefore a weaker overall economy”, but that “the world economy is perhaps in better shape to cope with weakness in the United States than it was at the turn of the millennium”.<sup>50</sup>

21. Discussing the outlook for the United States economy, the Chancellor of the Exchequer told us that there was “a great deal of uncertainty”.<sup>51</sup> On the downside, the Chancellor of the Exchequer highlighted the current problems in the US housing market, both from the fallout of the sub-prime mortgages crisis and increased numbers of unsold houses.<sup>52</sup> But, he noted that “commentators are still talking about the US economy growing, perhaps at a slower rate than they thought a year or so ago but still growing”, and thought that the recent cuts in United States interest rates by the Federal Reserve ought to counter some of the recent economic problems.<sup>53</sup> The Chancellor of the Exchequer also pointed out the benefits of a more diversified global economy, noting that, while the “euro market ... has slowed down”, people were confident that the emerging markets would “continue to grow at quite a rapid rate and that is important too”.<sup>54</sup> **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.**

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48 *Pre-Budget Report and Comprehensive Spending Review 2007*, para A.79, p 154

49 Q 19

50 *Ibid.*

51 Q 284

52 *Ibid.*

53 *Ibid.*

54 *Ibid.*

## 3 The public finances

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### The current budget balance

22. The Treasury's forecast of the current budget deficit for 2007–08 in the 2007 Pre-Budget Report was £8 billion, compared to a forecast deficit of £4 billion for that year in the 2007 Budget and a forecast deficit of £1 billion for that year in the 2006 Pre-Budget Report. In the 2007 Pre-Budget Report, the Treasury also revised its forecast of the current budget balance for the financial year 2008–09, from a forecast surplus of £3 billion in the 2007 Budget, to a forecast deficit of £4 billion. Since 2001, the Treasury's forecasts of the current budget balance for one year ahead have been consistently over-optimistic.<sup>55</sup> We discussed this issue previously in our Report on the 2005 Pre-Budget Report and concluded that it was "important that official forecasts for tax receipts avoid any systemic bias either to exaggerate or underestimate revenue".<sup>56</sup> Referring to the fiscal forecasts in evidence to us, Mr Macpherson said:

The fiscal aspect is a challenge. Forecasting revenues in a global economy is difficult. We seek to learn from our experience and we are confident that these forecasts are realistic.<sup>57</sup>

23. The weaker budget balances now forecast for 2007–08 and 2008–09 in part reflect the expected impact of recent financial market turbulence on broader economic growth and, therefore, receipts. The expected rebound in the budget balance from 2008–09 onwards is partly dependent upon a timely recovery in the financial sector such that economic growth quickly returns to trend. Discussing the vulnerability of the public finances to uncertainty surrounding the GDP forecasts, Dr Weale said:

If ... the current revenue weakness persists and real GDP growth in 2009 is slower than the Treasury hopes, then the current budget will probably not move back into surplus until 2010 or 2011. This does not in any sense imply that the current proposals are unsustainable or that the country faces a fiscal crisis. But at a time of economic boom with output above trend, as the Treasury recognises, one would expect a current surplus rather than a current deficit ...<sup>58</sup>

24. Table 1 demonstrates that 2006–07 is the first financial year for five years where the outturn for the current budget balance is better than forecast in the preceding Budget.

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55 HM Treasury, *End of year fiscal report 2007*, Chart 2.4, p 10

56 Treasury Committee, Second Report of Session 2005–06, *The 2005 Pre-Budget Report*, HC 739, para 61

57 Q 133

58 Ev 51

**Table 1: HM Treasury projections of current budget surpluses, £ billion**

Year	Bud 03	PBR 03	Bud 04	PBR 04	Bud 05	PBR 05	Bud 06	PBR 06	Bud 07	PBR 07
01-02	9.9									
02-03	-11.7	-11.8	-12.3							
03-04	-8.4	-19.3	-21.3	-21.1	-20.4					
04-05	-1	-8	-11	-12.5	-16.1	-19.9	-19			
05-06	2	-5	-5	-7	-6	-10.6	-11.4	-15.1	-15	
06-07	6	0	0	1	1	-4	-7	-7.9	-9.5	-4.7
07-08	9	4	4	4	4	0	1	-1	-4	-8.3
08-09			9	9	9	7	7	4	3	-4
09-10					12	11	10	7	6	3
10-11							12	10	9	9
11-12									13	14

Key:  Outturn     Estimate     Projection

Sources: Budgets 2003–2007, Table C2; Pre-Budget Reports 2003–2007, Table B2

25. As we noted in our Report on the 2007 Budget, forecast errors tend to be correlated with the economic cycle.<sup>59</sup> Treasury officials commented on our earlier conclusions:

As the Committee has highlighted before, there seems to be a pro-cyclicality in our forecasting record, so during the late 1990s when the economy was growing very strongly our receipts forecasts were consistently over-pessimistic. Table 2 in the Committee's Report on the 2007 Budget draws this out very well. We had very big positive errors up until 2001-02 and then went through five years when, as your account describes, we had errors in our borrowing forecasts driven largely by errors on receipts.<sup>60</sup>

26. **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.**

## Revenue receipts

27. The turbulence in financial markets since August 2007 is likely to have a negative impact on the public finances, particularly on corporation and income tax receipts, reducing the forecast level of receipts and increasing the degree of uncertainty surrounding

<sup>59</sup> Treasury Committee, Fifth Report of Session 2006–07, *The 2007 Budget*, HC 389–I, para 22

the forecast. The 2007 Pre-Budget Report explained how developments in financial markets would impact on the public finances:

The performance of the financial sector also impacts on the public finances, most directly through financial company corporation tax and income tax and NICs<sup>61</sup> on bonuses, where receipts from the sector are significant. While the effect on the public finances of current global financial market disruption is uncertain, the projections for the public finances in this Pre-Budget Report allow for an impact on receipts from corporation tax and income tax and NICs, along with other factors.<sup>62</sup>

Table 2 shows revisions to estimates of corporation and income tax receipts since the 2007 Budget for 2007–08 and 2008–09.

**Table 2: Current receipts: changes since estimates made in Budget 2007**

£ billion		2007–08 (estimate)	2008–09 (projection)
Income tax*	PBR 2007	154.1	161.8
	Change since Budget 2007	-2.8	-4.2
National insurance contributions	PBR 2007	96.5	101.0
	Change since Budget 2007	+1.4	+0.2
Corporation tax**	PBR 2007	46.8	51.5
	Change since Budget 2007	-3.3	-3.0

Source: *Pre-Budget Report and Comprehensive Spending Review 2007*, table B.8, p 168

\* Gross of tax credits

\*\* National Accounts measure: gross of enhanced and payable tax credits.

28. The 2007 Pre-Budget Report explained that the forecast for non-North Sea corporation tax receipts assumed that “the financial sector recovers, consistent with the sector maintaining its international competitiveness and capacity for innovation”.<sup>63</sup> However, Mr Chote questioned the Treasury’s expectation that revenues would rebound as quickly as it hoped, drawing parallels with the last bout of instability in the financial sector, where the shock to revenues had been greater than the Treasury had expected.<sup>64</sup> **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.**

## The golden rule

29. Since 1997, the Government has sought to adhere to a new fiscal policy framework set out in the Code for Fiscal Stability. The Code requires the Government to state the rules through which fiscal policy will be operated. There are currently two fiscal rules—the sustainable investment rule, which is discussed further below, and the golden rule. The golden rule states that, over the economic cycle, the Government will borrow only to invest and not to fund current spending. Compliance with the golden rule is evaluated by

61 National insurance contributions.

62 *Pre-Budget Report and Comprehensive Spending Review 2007*, Box 2.3, p 23

63 *Pre-Budget Report and Comprehensive Spending Review 2007*, para B.42, p 169

64 Q 4

calculating the average of the Government's annual current budget balances as a percentage of GDP over the economic cycle. The current budget balance represents the difference between current receipts and current expenditure, including depreciation. The 2007 Pre-Budget Report assessed compliance with the golden rule in the following terms:

The economy appears to have passed through trend [that is, the output gap moved from negative to positive] in the final quarter of 2006. On this basis, and on the basis of cautious assumptions, the Government would have met the golden rule with a margin of £18 billion, higher than estimated at Budget 2007 ... With the economy appearing to have passed through trend in the final quarter of 2006, Pre-Budget Report projections show that the current budget moves into surplus in 2009–10, with the surplus rising to 1.1 per cent of GDP by 2012–13. At this early stage, and based on cautious assumptions, the Government is therefore on course to meet the golden rule in the next economic cycle.<sup>65</sup>

30. According to the 2007 Pre-Budget Report, the economic cycle that began in 1997–98 ended in the fourth quarter of 2006, slightly sooner than the forecast of early 2007 made in the 2007 Budget. However, the Treasury stated that it is “too soon to assess whether or not the economic cycle has ended”.<sup>66</sup> The complexity of dating the cycle was explained by Dr Weale:

The difficulty that the Treasury is having is that the 2004 peak at the moment is possibly slightly higher than the 2007 peak. If the 2004 peak is raised further by a revision then it would be difficult to avoid the conclusion that the cycle had ended in 2004–05, which would, of course, mean that in the current cycle the golden rule has not been met. Data revisions can move cycles around and this is well known. There has been substantial academic literature on this. They can move cycles around for quite long periods, so my response to that is that it demonstrates why the current policy structure is not usable as a way of assessing the Government's fiscal performance.<sup>67</sup>

**31. 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.**

## The sustainable investment rule

32. The objective of the sustainable investment rule is to ensure that the Government maintains sound public finances in the medium term. In order to meet the sustainable investment rule in the current economic cycle, the Government aims to maintain net debt below 40% of GDP in each and every year of the economic cycle.<sup>68</sup> In the 2007 Pre-Budget

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65 *Pre-Budget Report and Comprehensive Spending Review 2007*, paras 2.35–2.36, p 27

66 *Ibid.*, para B.6, p 158

67 Q 31

68 *Pre-Budget Report and Comprehensive Spending Review 2007*, para 2.13, p 20

Report, the Treasury forecast that the sustainable investment rule would be met over the current and new economic cycle, peaking at 38.9% of GDP in 2010–11 before falling back in subsequent years. In the 2007 Budget, the Treasury forecast that net debt would stabilise at 38.8% of GDP in 2009–10 before falling in 2011–12.

33. In our Report on the 2007 Budget, we recommended that the Government “give an account of the circumstances in which it would change its current interpretation of the sustainable investment rule for the next economic cycle”.<sup>69</sup> In its response to our Report, the Government stated that it would “set out in the normal way the details of the fiscal position under the framework over the next cycle when it provides its view on the end of the current cycle”.<sup>70</sup> **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.**

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69 HC (2006–07) 389-I, para 33

70 Treasury Committee, Fifth Special Report of Session 2006–07, *The 2007 Budget: Government Response to the Committee's Fifth Report of Session 2006–07*, HC 696, p 6

## 4 Taxation issues

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### Reform of capital gains tax

#### *Background*

34. Capital gains are calculated by subtracting the original cost of the asset indexed up to its value at the point of sale, called the “indexation allowance”, from the receipts of the sale. In 1997, the present system of capital gains tax (CGT) was established, with the introduction of taper relief as its central feature.<sup>71</sup> The aim of taper relief was, as the then Chancellor of the Exchequer, the Rt Hon Gordon Brown MP, stated in the 1999 Budget, to “reward committed long-term investment”.<sup>72</sup> Taper relief reduced the taxable proportion of the capital gain, depending on how long the asset had been held by the seller and whether the assets were classified as “business” or “non-business” assets. Business and non-business assets were defined as follows:

- business assets: shares in a company held by employees; shares in unquoted trading companies; anything used in a business. Business assets had taper relief of 25%, where only 25% of the value of the calculated capital gain was taxable.
- non-business assets: all other items which are liable for CGT—for example, antiques, second homes, jewellery. Non-business assets had a maximum of 60% relief, after 10 years of ownership, operating on a stepped scale. However, in contrast with business assets, the first 5% of the taper relief commenced only after the third complete year of ownership.<sup>73</sup>

#### *Capital gains tax reform in 2007 Pre-Budget Report*

35. Presenting the 2007 Pre-Budget Report to the House, the Chancellor of the Exchequer announced that:

The capital gains tax regime here has continued to encourage investment and enterprise. I now propose reforms to make the system more straightforward and sustainable; to ensure that it sets consistent incentives for investment and enterprise; and to ensure that it remains internationally competitive ... I can tell the House that the changes that I propose to capital gains tax also, taken together with the tax loopholes that I am closing, will ensure that those working in private equity pay a fairer share. So from April next year I will withdraw the capital gains tax taper relief and in its place there will be just one rate of 18 per cent.—one of the most competitive single rates of any major economy.<sup>74</sup>

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71 There are also a number of other calculations within CGT, including indexation allowance, halving relief, share identification rules and the kink test.

72 HC Deb, 9 March 1999, col 178

73 HM Revenue & Customs, *Worksheet on Capital Gains for the year ended 5 April 2007*, CGN 18

74 HC Deb, 9 October 2007, cols 170–171

The 2007 Pre-Budget Report contained further detail:

For disposals on or after 6 April 2008 there will be a single CGT rate of 18 per cent, resulting in a more straightforward system for taxpayers. As part of this new system the annual exempt amount (currently £9,200) will remain in place, but taper relief and indexation allowance will be withdrawn. HMRC have today published further details of the reform package, and will immediately begin discussion on implementation with interested parties.<sup>75</sup>

Hence, from 6 April 2008, the complex calculations involved in many CGT transactions will be removed and replaced with a rate of 18%, applicable to all CGT transactions, irrespective of the length of the period of ownership or the type of asset.

### ***Consultation on changes to capital gains tax***

36. We received evidence about the extent to which Treasury had consulted with business organisations in advance of announcing changes to CGT. Mr John Whiting of PricewaterhouseCoopers told us that he broadly agreed with many of the tax simplification policies introduced by the Chancellor of the Exchequer in the 2007 Pre-Budget Report. He explained that CGT was “widely recognised as an extremely complex tax with lots of anomalies” and that, consequently, there had been considerable consultation on simplifying it in various respects. However, there had been no discussion of such “radical changes” as the withdrawal of taper relief, and the announcement that taper relief was to be abolished was a source of considerable surprise to those involved in the consultation.<sup>76</sup> When asked whether there was still time for the Chancellor of the Exchequer to rethink the withdrawal of taper relief, Mr Whiting explained that “he could leave taper relief in place for defined taxpayers, although that starts to create its own complexities and boundary issues”.<sup>77</sup> He suggested that the Chancellor of the Exchequer might compromise by reintroducing retirement relief to allow owners of small businesses to get out with a tax-free gain, but admitted that this did not mitigate the changes for all parties.<sup>78</sup> When we asked whether the Chancellor of the Exchequer might sensibly put the withdrawal of taper relief on hold whilst further consultation took place, Mr Whiting told us that such a move would be to all parties’ advantage:

... not only would that be a technical consultation as to the problem but [it would] also allow [the Chancellor of the Exchequer] to talk to the business groups and, if appropriate, explain in advance why this is under consideration.<sup>79</sup>

Mr Chote agreed with this and added that the six-month hiatus before the reforms take effect should also provide a time for consultation. Dr Weale, while agreeing that the

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<sup>75</sup> *Pre-Budget Report and Comprehensive Spending Review 2007*, para 5.79, p 90

<sup>76</sup> Q 54

<sup>77</sup> Q 72

<sup>78</sup> *Ibid.*

<sup>79</sup> Q 75

Chancellor of the Exchequer could still carry out consultation, did warn that further consultation on CGT would create more uncertainty.<sup>80</sup>

37. The suggestion that the Treasury had failed to consult adequately was also made by the British Chambers of Commerce (BCC), the Federation of Small Businesses (FSB), the Confederation of British Industry (CBI) and the Institute of Directors (IoD), who, in an open letter to the Chancellor of the Exchequer published on 15 October 2007, described the announcement as “a bolt out of the blue”.<sup>81</sup> They stated that none of their organisations had ever suggested ending taper relief as a desirable step, nor had the Treasury signalled, at any point, that such a change was in prospect.<sup>82</sup>

38. Treasury officials denied that the changes to CGT had been unexpected:

Capital gains tax has been the subject of continuing debate among those interested in the tax system, and the changes we have made are in large part a response to a strong feeling that capital gains tax was over-complicated ... I do not think that those who are interested in reform of the tax system would see reform of capital gains tax as “a bolt out of the blue” but as a fairly natural development in the context of the Government's continuing reforms of the tax system ... there have been many representations arguing the need for simplification.<sup>83</sup>

When we asked whether there had been a specific consultation about the withdrawal of taper relief, Treasury officials responded that the Treasury did “not consult on changes to tax rates”, but pointed to “a debate out there in the country among people who are interested in the tax system and this particular tax where the issue about the complexity of taper relief has been a very live one”.<sup>84</sup>

39. The Chancellor of the Exchequer described the reform of CGT as “essentially a rate change” and said that the concept of capital gains had “been with us since 1965”.<sup>85</sup> When we put it to him that the key issue was not the change of tax rate but the abolition of taper relief, on which there had been no consultation with those who would be most affected, he said only that “sometimes the Treasury consults on these things and sometimes it does not”.<sup>86</sup> Commenting on his recent meeting with the BCC, FSB, CBI and IoD to discuss the withdrawal of taper relief, the Chancellor of the Exchequer set out the extent to which he was prepared to engage in further consultation:

When I met the [industry bodies] earlier this week, I made it clear that I think the course of action which I set out is the right one. Of course I am willing to talk to them about how in detail we can improve things. Remember that the rate is internationally competitive, people still have their personal allowance of £9,200 so

80 Qq 71–75

81 ‘Open Letter to the Chancellor of the Exchequer’, 15 October 2007; available on the CBI Website, [www.cbi.org.uk/ndbs/press](http://www.cbi.org.uk/ndbs/press)

82 *Ibid.*

83 Qq 157, 159, 198

84 Qq 199, 201

85 Q 269

86 Q 304

most people in share option schemes, for example, are unlikely to be realising a gain of more than that. We have still got rollover relief, we have still got the incentives for enterprise investment schemes and so on ... a simpler system of tax instinctively must be the right direction to go ... What I am wary about, as I said to the CBI and others when I met them this week, of course I am happy to talk about details but what I do not want to do is reinvent all the complexities so you end up where you started because I do not think that is the right thing to do.<sup>87</sup>

The Chancellor of the Exchequer also appeared to rule out a phasing out of taper relief over a longer period, on the grounds that “any complexity you introduce into a system, whether it is a taper or any other allowance, necessarily adds to complexity”.<sup>88</sup> When we asked him whether he was prepared to compromise to some extent on taper relief, he responded:

I believe that a simple tax system is very, very important and I do not want to start reintroducing any complications. I said I would talk to the businesses about the detail in relation to that. I have got the opportunity to do that because this needs primary legislation but I really do not want to get into the situation where - and I must make this quite clear - we go back to where we were.<sup>89</sup>

**40. 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.**

**41. 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 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.**

### ***Impact on the private equity industry***

42. The 2007 Pre-Budget Report and the Chancellor of the Exchequer’s accompanying statement to the House of Commons linked the CGT reforms to the private equity industry. The Chancellor of the Exchequer told the House that “the changes that I propose to capital gains tax also, taken together with the tax loopholes that I am closing, will ensure that those working in private equity pay a fairer share”.<sup>90</sup> The CGT reforms were also referred to in the section on private equity in the 2007 Pre-Budget Report.<sup>91</sup>

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87 Q 292

88 Q 319

89 Q 344

90 HC Deb, 9 October 2007, col 171

91 *Pre-Budget Report and Comprehensive Spending Review 2007*, paras 4.57–4.59, pp 63–64

43. In our recent Report on the private equity industry, we noted that partners in private equity firms typically contributed no more than 1.5% to 5% of the equity in a fund in return for the carried interest, and that there was a case to answer as to whether the carried interest was genuinely a capital gain. But we also accepted that great care would be needed in making any changes to the tax treatment of carried interest, in order to avoid damaging an important part of the UK economy.<sup>92</sup> Shortly prior to the publication of our Report on private equity, in an interview with the Financial Times in July 2007, the Chancellor of the Exchequer had appeared to play down expectations that changes would be made to the CGT regime as a consequence of concerns about the private equity industry. According to the Financial Times' account of the interview, he:

... ruled out an immediate clampdown on tax privileges used by the private equity industry, fearing that any sudden changes might have undesirable effects ... Asked about the campaign to change the tax treatment for private equity he said he ... would not make quick changes to capital gains tax or the taxation of individuals not domiciled in the UK, even if it would gain him favourable headlines ... "I think we should be very, very wary indeed of a knee jerk reaction or a reaction to a day's headlines into making a tax change that could result in unintended consequences and undesirable consequences."<sup>93</sup>

44. Experts saw the reforms announced in the 2007 Pre-Budget Report as being connected to the private equity industry. For example, discussing the reaction of the private equity industry to the abolition of taper relief, Mr Whiting said that:

I think in many ways the rate chosen, the 18% rate, is quite shrewd because clearly the industry was expecting a change, expecting some change, and the speculation as to what changes there should be were many and wide-ranging. What we seem to have is a rate that is reasonably competitive internationally and obviously the industry is very aware of international competition, so all being well, particularly if the signal is clearly put out and clearly understood that this is it, there are no more changes, then I think the industry will absorb it and carry on.<sup>94</sup>

45. Treasury officials denied that the changes to CGT were primarily motivated by concerns about private equity, telling us that "private equity was not the main motivation for introducing these reforms".<sup>95</sup> The Chancellor of the Exchequer described the CGT reforms as "not principally aimed at private equity", although he acknowledged that "if you have a higher rate than 10 pence, the 18 pence rate, that will mean that people in private equity will pay a higher share than they would otherwise do".<sup>96</sup> He justified the reforms to us in the following terms:

If you look at [the CGT reforms] together with some of the changes we are making in relation to closing some of the tax loopholes, I think that will help ensure there is a

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92 Treasury Committee, Tenth Report of Session 2006-07, *Private equity*, HC 567-I, para 88

93 Financial Times, 'Darling eases buy-out fears', 4 July 2007

94 Q 57

95 Q 205

96 Q 289

fairer system. The main reason, the driving force if you like, behind the capital gains tax [reform] was on the merits of having a simpler system. I have made it clear during the couple of interviews I have done on private equity I think it is important that we have a fair tax system.<sup>97</sup>

46. 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.

**47. 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.**

### *Other effects of capital gains tax reforms*

48. We also discussed the likely impact of the CGT reforms on groups of taxpayers other than the private equity industry. Summarising those whom he considered to be the 'winners' and 'losers' of the changes to CGT, Mr Whiting told us:

The winners do seem to be those with second homes, other assets that rank for capital gains tax, quoted shareholdings, providing they are not losing out too much when indexation is abolished. The losers are clearly those who are seeing their tax rate climbing, which can include entrepreneurs, small businesses who also feel a bit blooded with the Arctic Systems agenda, employee shareholders who in some cases will see their tax rate will go up from 5% to 18%. There is quite a range of losers ... some of the winners are people generally who will find capital gains tax easier to understand because I would not discount the advantages of having a nice, simple flat rate system.<sup>98</sup>

49. The open letter to the Chancellor of the Exchequer from the BCC, FSB, CBI and IoD addressed what these organisations perceived to be the impact on the 'losers':

The net effect will be to set back the growth of the economy over coming years, by discouraging longer-term investment and risk-taking. Owners of small enterprises, who have toiled over years to build up an asset, are now faced with selling up before April or facing a substantial dent to their investment. The 1.7 million ordinary employees who are in company share schemes could also face an 80% increase in their tax bill and a serious disincentive to taking up and retaining share options in the future ... Business angels and venture capital funds say they too will be discouraged from taking risk and investing for the long game. Many of those affected have already made investment decisions. The retroactive nature of this move has undermined their reasonable expectations.<sup>99</sup>

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<sup>97</sup> *Ibid.*

<sup>98</sup> Qq 52, 59

<sup>99</sup> Open Letter to the Chancellor of the Exchequer, 15 October 2007; available on the CBI Website, <http://www.cbi.org.uk/ndbs/press>

50. Treasury officials considered the likely effect on small businesses and entrepreneurs to be minimal:

Capital gains tax is paid in any one year by only about 250,000 [taxpayers]; it is paid by people who sell businesses ... I do not think you can look at this in terms of winners and losers because, as I have said, only 250,000 people dispose of assets and pay capital gains tax in any one year.<sup>100</sup>

When we put it to the Treasury officials that this would mean 1.25 million people would be affected in the course of a five-year Parliament, they thought that this would “by no means necessarily” be the case, “because many of those people may dispose of assets in successive years”.<sup>101</sup>

51. One group of potential ‘losers’ identified in the open letter from the industry bodies was employee shareholders. Under the current system of taper relief, shares held by employees in their own company are classified as “business assets” and, as such, only 25% of the chargeable capital gain is taxable. IFS ProShare, an organisation established by the Treasury, the London Stock Exchange and a number of FTSE 100 companies to promote the benefits of employee share-ownership, commented:

The new rate of 18% applies equally to basic rate and higher rate taxpayers and to business and non-business assets. Previously, higher rate taxpayers who held their shares for at least 2 years would have been subject to 10% CGT (the change means such shareholders will now be 8% worse off.) Basic rate taxpayers who held their shares for at least 2 years would have been subject to 5% CGT (the change means such shareholders will now be 13% worse off). In contrast, non-employee shareholders could be up to 22% better off having previously been liable to a maximum 40% charge. It is somewhat perverse that employees who have contributed to the success of their employer are now going to be worse off than under existing legislation whilst non-employee shareholders who have not done so are to have their CGT liabilities substantially reduced.<sup>102</sup>

IFS ProShare acknowledged that “the majority of employees participating in their employers’ share plan are doing so via a SIP (Share Incentive Plan) which shield employees from any capital gains” and thus probably would not be affected by the CGT reforms. However, it estimated that a significant number of the 1.7 million employees on “share as you earn” schemes would suffer from the changes.<sup>103</sup>

52. In response, Treasury officials explained to us that:

Our analysis is that there will be very little impact. The great majority of [employee shareholders] will be able to take advantage of the continuing exempt amount, which is £9,200 in 2007–08. They will continue to have the tax benefits that come with these schemes—income tax and NICs exemption—and when the assets come out of the

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100 Q 164

101 Q 165

102 Ev 58

103 *Ibid.*

scheme they are CGT-exempt, too. Therefore, our analysis is that very few people will be affected by it ... Very few of them will dispose of shares that realise gains in excess of the £9,200 exempt amount.<sup>104</sup>

The Chancellor of the Exchequer added that, “in relation to incentives to encourage shareholders, we already have a number [of incentives] not just for the tax system but also in relation to the money that Government spends as well. I do want to encourage people ... It is terribly important that we do that.”<sup>105</sup>

53. We also discussed with witnesses the message sent by the abolition of taper relief, in terms of investment and decision-making. Noting that one of the main stated aims of the introduction of taper relief was to encourage longer-term investment in unquoted companies, Mr Whiting told us that:

certainly the perception from talking to businesses small and large is that a relief that was brought in to encourage entrepreneurship and, indeed, to encourage long-term planning has gone, so is this a signal that we are not supposed to do it? I think we would say that business is asking the question.<sup>106</sup>

54. Treasury officials acknowledged that “the introduction of taper relief did have a positive impact in signalling a new hospitality to entrepreneurship”, but argued that the simplification agenda signalled by the CGT reforms was more important.<sup>107</sup> The Chancellor of the Exchequer responded to concerns that a move towards short-term investment would have potentially deleterious effects on new businesses and entrepreneurs in the following terms:

We introduced [taper relief] ... because the prevailing rate was 40% up until we formed the Government in 1997 and in addition to that, mainly because of the economic turbulence of the 1980s and 1990s, one of the big problems that people complained about was instability and the whole culture was very short-termist. We introduced that [taper relief] regime, it was the right thing to do ... However, it also makes sense from time to time to look, as we do, to all tax regimes and say, “What is best for the future?” ... I am very enthusiastic and keen to encourage people to take the long-term. The economic climate against which people now plan is completely different from what it was 10 years ago but I think it is also right to ask ourselves at each and every stage whether or not the tax system is the right one. Nothing we do precludes changes at any time in the future on any tax.<sup>108</sup>

55. The Chancellor of the Exchequer repeatedly emphasised to us that the focus of the changes to the CGT regime was to simplify the tax system. When ruling out any continuation of taper relief, even in the short-term, he stated that “by definition any complexity or qualification you put in a simple concept adds to its complications”.<sup>109</sup> In

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104 Qq 166, 168

105 Q 307

106 Q 63

107 Q 222

108 Q 341

109 Q 320

terms of what he was prepared to accept for the sake of the simplification agenda, the Chancellor of the Exchequer explained:

... once you have systems about what is good, what is bad, what you want to encourage, what you want to discourage and so on, of necessity you start to introduce a whole series of complications ... When we look at the thing, we know where the tax taper comes from and where money is not collected. I accept whenever you change things there will be some people who will gain and some people who will lose. I think the challenge before us is to try and get a simpler tax system, which is a prize worth pursuing.<sup>110</sup>

**56. 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.**

### ***Projected revenues from the reforms of capital gains tax***

57. The 2007 Pre-Budget Report estimated that the move to a universal 18% rate should generate increased revenue, as set out in Table 3:

**Table 3: Projections of increases in tax revenue resulting from the capital gains tax reforms**

Cost (£m)	2007-08	2008-09	2009-10	2010-11	Total
Capital Gains reform – 18% rate	0	+350	+750	+900	+2,000

Source: 2007 Pre-Budget Report, Table 1.2, p. 11

58. In evidence to us, Treasury officials stated that the figures were provided by HMRC, but could not be broken down because:

it is notoriously difficult to decompose these measures simply because whichever component one starts with, there is a different answer ... you can cost out individual elements but if you then add them together, some of the parts may be different from the individual components.<sup>111</sup>

The Treasury subsequently submitted further analysis to us, explaining that, currently, indexation allowance was estimated to cost the Exchequer £300 million and taper relief was estimated to cost £6.3 billion, on an annual basis. The Treasury's analysis did not explain the connection between this figure of £6.3 billion annually and the figures in the 2007 Pre-Budget Report, which showed an increased revenue of £2 billion over three years.

**59. 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.**

## Changes to inheritance tax

60. In his 2007 Pre-Budget Report statement to the House of Commons, the Chancellor of the Exchequer set out changes to the inheritance tax (IHT) regime:

I want to ensure that husbands and wives can benefit from each other's unused inheritance tax exemptions, so I will raise the total amount of inheritance for married couples on which no tax is paid, and this will apply to civil partnerships, too. I can announce that, from today, the combined tax-free allowance for their estates will not be the current £300,000, but up to £600,000. By 2010, the combined tax-free allowance for couples will rise to £700,000 ... Those changes mean certainty for up to 12 million married couples ... and the same entitlement for 3 million widows and widowers. That allowance is worth more than the value of 97 per cent. of homes in this country.<sup>112</sup>

61. The 2007 Pre-Budget Report set out the precise details of the new policy as follows:

The inheritance tax (IHT) spouse relief rules mean that there is no IHT paid on assets passing between married couples or civil partners. Many people therefore leave

<sup>111</sup> Qq 187, 191

<sup>112</sup> HC Deb, 9 October 2007, col 174

all their assets to their spouse or civil partner, and do not make use of their individual tax-free allowance of £300,000. The Government will therefore make the IHT system fairer by ensuring that if a person's tax-free allowance is not used on their death, it can be transferred to their surviving spouse or civil partner, enabling every married couple or civil partnership to benefit from double the tax-free allowance—£600,000 this year—in addition to spouse relief. Furthermore, to ensure that people who have lost a spouse or civil partner prior to today can also benefit, the Government will extend this entitlement to the three million existing widows, widowers and bereaved civil partners ... Following the announcement made at this year's Budget and the changes announced today, the IHT allowance will rise by April 2010 to £350,000 for individuals and £700,000 for couples. In future years the Government will consider both house prices and retail price inflation when setting the appropriate IHT allowance.<sup>113</sup>

According to the 2007 Pre-Budget Report, the proposed changes will cost the Exchequer an estimated £3.7 billion between 2007–08 and 2010–11. The figures are set out in Table 4:

**Table 4: Estimated cost of the changes to inheritance tax policy**

Cost (£m)	2007/08	2008/09	2009/10	2010/11	Total
Transferable inheritance tax allowances	-100	-1,000	-1,200	-1,400	<b>-3,700</b>

Source: Pre-Budget Report, Table 1.2, p. 11

62. We discussed with Mr Whiting the extent to which the proposed changes to IHT would make a real difference to the way in which those eligible arranged their affairs. He explained that, even before this policy change,

if you took advice and arranged your affairs in a certain way then you could make sure husband and wife, or civil partners, could take advantage of both nil rate bands. I am sure the Committee is well aware of nil rate band discretionary will trusts, which has been the typical route to follow. However, it is well said that many will not take advantage of that, many did not like to, particularly as it involved splitting the ownership of the family house in many circumstances. So although the route was there, many thousands of couples would not take that route, and ... what has come through with this proposal is a much simpler route that obviates the need for doing complex planning.<sup>114</sup>

Mr Whiting outlined the main groups who would be affected by the new inheritance tax policy:

the change that we are seeing coming through on inheritance tax will particularly benefit the couple with the typical £300,000 to £600,000 house and very little else, which clearly is a lot of value, but in London and the South East and many other

113 Pre-Budget Report and Comprehensive Spending Review 2007, paras 5.76–5.78, p 90

parts of the country it is a relatively ordinary property and it is those who have few other assets who cannot do a lot with planning.<sup>115</sup>

63. Mr Chote explained the implications of the estimated costs contained in the 2007 Pre-Budget Report:

If ... anybody who really wants to take advantage of this will already have done so, then it is going to cost, I presume, considerably less than the [£]1.4 billion by 2010–11. ... What assumptions are they [the Treasury] making about the proportion of people who would be in a position to benefit from this sort of arrangement but are not doing so simply because they do not want to go through the planning.<sup>116</sup>

64. We asked Treasury officials whether the Government's changes to IHT represented a fundamental shift in Government policy. Treasury officials explained that:

What we have done has not changed the fundamental underpinnings of the system. The allowances remain the same, but what we have done is make it possible for those allowances to be transferable between partners.<sup>117</sup>

In response to further questioning about whether the changes to IHT undermined stability or certainty in the IHT regime, Treasury officials reiterated that “the allowances are unchanged and that the changes had not subtracted any certainty at all”.<sup>118</sup>

**65. 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.**

**66. 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.**

## **New rules for non-domiciled taxpayers**

67. Presenting the 2007 Pre-Budget Report to the House of Commons, the Chancellor of the Exchequer announced that the Government proposed to introduce new rules for non-domiciled taxpayers:

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115 Q 127

116 Q 65

117 Q 230

118 Qq 232–233

I propose to close a number of loopholes which have allowed some people to avoid taxes that everyone else has to pay. Non-domiciled taxpayers already pay about £4 billion on their earnings. Any proposal for change has to be fair, workable and affordable. There are ... 115,000 registered non-domiciles ... I will now consult with a view to early legislation on an alternative route. As a first step, we will introduce a charge on non-domiciled tax-payers who have been in the United Kingdom for at least seven years, then a higher rate after 10 [years]. We will prevent people claiming that they are out of the country when they are actually here, from disguising income as capital and from claiming in effect two allowances; and for completeness we will introduce a flat-rate charge for everyone. Those measures will raise an average of £650 million.<sup>119</sup>

The 2007 Pre-Budget Report stated that the reforms to the non-domiciled tax regime would raise £800 million of revenue in 2009–10 and £500 million in 2010–11. The 2007 Pre-Budget Report set out further details of the policies:

The Government has concluded that the existing arrangements make an important contribution to the UK's competitiveness, by making the UK an attractive place for skilled people to come to work and do business and where non-domiciles contribute £4 billion of tax on UK earnings. Reforms are required to make the current arrangement operate fairly:

- firstly, from April 2008 resident non-domiciles who have been in the UK for longer than seven out of the past ten years will only be able to access the remittance basis of taxation on payment of an annual charge of £30,000, unless their unremitted foreign income or gains are less than £1,000; ...

The Government will consult on a wider range of options and specifically on whether people who have been resident in the UK for longer than ten years should make a greater contribution, and on the detail of these proposals before the changes are introduced to ensure non-domiciles pay their fair share of UK tax.<sup>120</sup>

The 2007 Pre-Budget Report also discussed the changes to the non-domicile regime in the context of the private equity industry:

The reform of capital gains tax to a single rate of 18 per cent ... along with measures to address loopholes and anomalies in the residence and domicile rules ... will increase the fairness of the tax system, including for individuals in the private equity industry.<sup>121</sup>

68. In evidence to us, Mr Whiting explained that non-domiciles could be classified into three groups for the purposes of the Government's new charge: those who have been in the country for fewer than seven of the last ten years; the very wealthy non-domiciles for whom £30,000 and the loss of personal allowances would have a negligible effect; and the middle section

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119 HC Deb, 9 October 2007, col 171

120 *Pre-Budget Report and Comprehensive Spending Review 2007*, paras 5.80–5.81, p 91

121 *Ibid.*, para 4.59, p 64

who have significant interests abroad but will look at £30,000 and say, “This is actually quite a substantial fee” and they will also think it is £30,000 now but could it go up in the future because one of the concerns that this sends is that the UK is trying to make more money out of the non-domiciled person ... it is that middle cadre of people that we are unclear on, of whether a lot will go off to somewhere like Switzerland, who will just do a deal, or who will stay.<sup>122</sup>

69. Witnesses pointed out that problems could arise from the reforms. Dr Weale spoke of the potential impact on business:

I understand the argument that you should have higher taxes on sources of revenue that will not be scared off and, therefore, you might worry about the new rules for non-domicile taxpayers scaring off successful business and so on.<sup>123</sup>

Mr Whiting expressed concern that draft legislation effecting the changes had yet to be published, particularly given the retrospective nature of the reform:

clearly as of 6 April next year a number of people will find themselves in the new system and to that end it is disappointing we have not got some draft legislation which we can start working on the practicalities of, but it is to be hoped we will see that very soon.<sup>124</sup>

70. We asked Treasury officials to explain the basis of the revenues forecast to arise from the proposed reforms. Officials told us:

We estimate that there are about 20,000 non-domiciled citizens who are in the UK for more than seven years ... based on the information we have about their earnings we forecast that about 4,000 will have sufficient unremitted foreign income to make it worth their while paying the charge.<sup>125</sup>

We asked Treasury officials how confident they were that the tax changes affecting non-domiciles—with 4000 non-domiciled citizens paying £30,000 each—would produce the £800 million revenue predicted to arise in 2009–10. Officials explained that the £800 million was expected to come from the revenue raised by the charge combined with the closure of relevant loopholes and removal of tax allowances.<sup>126</sup>

71. We asked the Chancellor of the Exchequer whether he was considering fixing the £30,000 annual charge for non-domiciles for, say, five or seven years to provide certainty that the charge would not significantly increase year on year. The Chancellor of the Exchequer responded by saying: “I will look at that ... because it is a new thing, we are consulting on how it might work ... I have not reached a view, whatever the charge is, on

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122 Q 68

123 *Ibid.*

124 Q 69

125 Qq 257–258

126 Q 259

how long it will prevail on. That is one of the things we will no doubt want to take up in the consultative exercise.”<sup>127</sup>

**72. 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.**

73. According to evidence we received from the Treasury, only 4,000 of the 20,000 non-domiciles who have been in the UK for more than seven of the last ten years would find it “worth their while” to pay the proposed £30,000 charge. The implication is that these 4,000 non-domiciles will be the sole source of the £800 million extra revenue expected in 2009–10.

## 5 The role of the Pre-Budget Report

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### Nature of the Pre-Budget Report

74. In our Report on the 2006 Pre-Budget Report, we discussed the nature of Pre-Budget Reports. We emphasised the importance of the Pre-Budget Report retaining a focus on consultation on fiscal measures that may be included in the forthcoming Budget, and called for consultation on substantive tax measures under consideration for inclusion in the Budget to be brought more to the fore in future Pre-Budget Reports.<sup>128</sup> Our comments were based on the requirements set out in the Code for Fiscal Stability, which was given statutory force in 1998 and which states that a Pre-Budget Report

shall be consultative in nature, and shall include, so far as reasonably practicable, proposals for any significant changes in fiscal policy under consideration for introduction in the Budget. However, the Pre-Budget Report shall not be taken as an indication of all tax policy areas where the Government may choose to act.<sup>129</sup>

75. As was the case following both the 2005 and 2006 Pre-Budget Reports, some witnesses questioned whether the Pre-Budget Report had retained its consultative character. Commenting on the extent to which Treasury had consulted with business organisations in advance of announcing changes to capital gains tax, Mr Chote stated that:

I am afraid that [the abolition of taper relief] is probably another example where this is a Pre-Budget Report which is always supposed to be about consultation and laying out potential areas of direction but just ends up looking more like a mini-Budget.<sup>130</sup>

Professor David Heald of Sheffield University described Pre-Budget Reports as “not genuinely Pre-Budgets, in the draft as opposed to environmental sense of ‘green’, but the first of an annual two-budget process”.<sup>131</sup>

76. We observed to the Chancellor of the Exchequer that the 2007 Pre-Budget Report outlined a number of tax decisions that appeared to be final in nature. The Chancellor of the Exchequer did not accept our suggestion that we had moved to a situation where we have “two Budgets a year”, arguing:

No, we have one Budget which is normally in the spring of the year. The purpose of a Pre-Budget Report ... partly it takes over from the Autumn Statement which we used to have every November which is a half way through the year reporting. We changed the system in 1997–98 when we wanted to have the opportunity to set out not just progress but also thought it would be an opportunity to float ideas. Some were more certain than others, as you can see from this Pre-Budget Report. I have made firm proposals in some areas, there are others which we are consulting on.<sup>132</sup>

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128 Treasury Committee, Second Report of Session 2006–07, *The 2006 Pre-Budget Report*, HC 115, para 95

129 HM Treasury, *The Code for Fiscal Stability*, November 1998, para 16

130 Q 76

131 HC (2007–08) 55, Ev 39

132 Q 268

The Chancellor of the Exchequer distinguished between the proposed changes announced to aviation taxation, on which the Government intends to consult, and the changes to capital gains tax, which the Government has been criticised for not consulting on. The Chancellor of the Exchequer justified the Government's different approaches to the two sets of reforms on the basis that the proposed changes to aviation taxation were "new in structure" and "essentially a new tax", and therefore "different from capital gains tax which is essentially a rate change and the concept of capital gains has been with us since 1965".<sup>133</sup>

**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.**

### Prior announcement of date of Pre-Budget Report

77. We have previously drawn attention to the advantages that would arise for the House of Commons from earlier notice of the date of the Pre-Budget Report. The House received 18 days' notice of the 2005 Pre-Budget Report and 20 days' notice of the 2006 Pre-Budget Report.<sup>134</sup> In our Reports on both the 2005 and 2006 Pre-Budget Reports, we recommended that the Treasury give at least four weeks' notice of the date of the Pre-Budget Report and that, in any case where this target was not met, the Treasury explain the reasons.<sup>135</sup>

78. The House of Commons was given very little notice of the date of the 2007 Pre-Budget Report. On 5 October 2007, the Treasury issued a press notice announcing that the Chancellor of the Exchequer would present the Pre-Budget Report and the outcome of the Comprehensive Spending Review to the House of Commons on Tuesday 9 October.<sup>136</sup> The House is ordinarily given advance notice of the date of the Pre-Budget Report by way of Written Ministerial Statement; such notice was not given this year. The Chancellor of the Exchequer had previously informed the House of Commons that he proposed "to present the Pre-Budget Report and the conclusions of the Comprehensive Spending Review in a single statement to the House in October".<sup>137</sup> **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.**

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133 Q 269

134 HC Deb, 17 November 2005, col 64WS; HC Deb, 16 November 2006, col 1WS

135 Treasury Committee, Second Report of Session 2005–06, *The 2005 Pre-Budget Report*, HC 739, para 3; HC (2006–07) 115, para 96

136 "2007 Pre-Budget Report and Comprehensive Spending Review", HM Treasury press notice 101/07, 5 October 2007

137 HC Deb, 25 July 2007, col 61WS

# Conclusions and recommendations

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## The real economy

1. We acknowledge that the Government has downgraded its forecast for economic growth in 2008 due to the effects of both the 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)
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)
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)
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)
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)
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)

## 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)

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)
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)
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)

### 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)
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 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)
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)
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)
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)

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)
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)
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)
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)

## 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)
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)

## Formal minutes

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*The following declaration of interest was made:*

### 15 October 2007

Mr Philip Dunne declared the following interests: a remunerated directorship (non-executive) and a registrable shareholding in Baronsmead VCT-4-PLC, a venture capital trust; a former partner in a business with a development capital arm; and Chairman and founder of a company which used venture capital.

### Tuesday 20 November 2007

Members present:

John McFall, in the Chair

Nick Ainger	Mr Andrew Love
Mr Graham Brady	Mr George Mudie
Mr Colin Breed	Mr Siôn Simon
Mr Philip Dunne	John Thurso
Mr Michael Fallon	Mr Mark Todd
Ms Sally Keeble	Peter Viggers

\* \* \* \* \*

### ***The 2007 Pre-Budget Report***

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

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

Paragraphs 1 to 8 read and agreed to.

Paragraph 9 read, amended and agreed to.

Paragraphs 10 to 29 read and agreed to.

Paragraph 30 read, amended and agreed to.

Paragraphs 31 to 39 read and agreed to.

A paragraph—(*Mr Philip Dunne*)—brought up, read the first and second time, amended and inserted (now paragraph 40).

Paragraph 40 (now paragraph 41) read, amended and agreed to.

Paragraphs 41 to 44 (now paragraphs 42 to 45) read and agreed to.

Paragraph 45 read, amended, divided and agreed to (now paragraphs 46 and 47).

Paragraphs 46 to 53 (now paragraphs 48 to 55) read and agreed to.

Paragraph 54 (now paragraph 56) read, amended and agreed to.

Paragraphs 55 to 62 (now paragraphs 57 to 64) read and agreed to.

Paragraph 63 (now paragraph 65) read, amended and agreed to.

Paragraphs 64 to 76 (now paragraphs 66 to 78) read and agreed to.

Summary amended and agreed to.

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

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

*Ordered*, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report.

Written evidence was ordered to be reported to the House for placing in the Library and Parliamentary Archives.

[Adjourned till Thursday 29 November at 9.30 am.]

# Witnesses

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## Monday 15 October 2007

Page

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

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

## Wednesday 17 October 2007

**Mr Nicholas Macpherson**, Permanent Secretary, **Mr Mark Neale**, Managing Director, Budget, Tax and Welfare, **Mr Dave Ramsden**, Managing Director, Macroeconomic and Fiscal Policy, **Mr Clive Maxwell**, Director, Financial Services, and **Mr Richard Hughes**, Team Leader, Comprehensive Spending Review, HM Treasury Ev 22

## Thursday 25 October 2007

**Rt Hon Alistair Darling MP**, Chancellor of the Exchequer, **Mr Nicholas Macpherson**, Permanent Secretary, **Mr Mark Neale**, Managing Director, Budget, Tax and Welfare, and **Mr Richard Hughes**, Team Leader, Comprehensive Spending Review, HM Treasury Ev 38

## List of written evidence

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1	Martin Weale, National Institute of Economic & Social Research	Ev 51
2	Ms Bridget Rosewell, Volterra Consulting	Ev 52
3	John Whiting, PricewaterhouseCoopers	Ev 55
4	Society of Trust and Estate Practitioners	Ev 58
5	IFS ProShare	Ev 58
6	easyJet	Ev 59
7	HM Treasury	Ev 62
8	HM Treasury, supplementary memorandum	Ev 64

## List of unprinted evidence

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The following memoranda have been reported to the House, but to save printing costs they have not been printed and copies have been placed in the House of Commons Library, where they may be inspected by Members. Other copies are in the Parliamentary Archives, and are available to the public for inspection. Requests for inspection should be addressed to The Parliamentary Archives, Houses of Parliament, London SW1A 0PW (tel. 020 7219 3074). Opening hours are from 9.30 am to 5.00 pm on Mondays to Fridays.

Professional Land Reform Group

Labour Land Campaign.

## List of Reports from the Treasury Committee during the current Parliament

<b>Session 2007–08</b>		Report
First Report	The 2007 Comprehensive Spending Review	HC 55
<b>Session 2006–07</b>		Report
First Report	Financial inclusion: the roles of the Government and the FSA, and financial capability	HC 53
Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50
Fifth Report	The 2007 Budget	HC 389
Sixth Report	The 2007 Comprehensive Spending Review: prospects and processes	HC 279
Seventh Report	The Monetary Policy of the Bank of England: re-appointment hearing for Ms Kate Barker and Mr Charlie Bean	HC 569
Eighth Report	Progress on the efficiency programme in the Chancellor's department	HC 483
Ninth Report	Appointment of the Chair of the Statistics Board	HC 934
Tenth Report	Private equity	HC 567
Eleventh Report	Unclaimed assets within the financial system	HC 533
Twelfth Report	The Monetary Policy Committee of the Bank of England: ten years on	HC 299
Thirteenth Report	Financial inclusion follow-up: saving for all and shorter term saving products	HC 504
Fourteenth Report	Globalisation: prospects and policy responses	HC 90
<b>Session 2005–06</b>		Report
First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	HC 525

Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111
Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	“Banking the unbanked”: banking services, the Post Office Card Account, and financial inclusion	HC 1717