Pre-Budget Report

December 2003

The strength to take the long-term decisions for Britain:

Seizing the opportunities of the global recovery

HM TREASURY

Cm 6042

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Pre-Budget Report

December 2003

Presented to Parliament by
the Chancellor of the Exchequer
by Command of Her Majesty

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The Economic and Fiscal Strategy Report and the Financial Statement and Budget Report contain the Government's assessment of the medium-term economic and budgetary position. They set out the Government's tax and spending plans, including those for public investment, in the context of its overall approach to social, economic and environmental objectives. This Pre-Budget Report includes, with other material, updated forecasts for the economy and projections for the public finances. Subject to the usual scrutiny and approval for the purposes of Section 5 of the European Communities (Amendment) Act 1993, these reports will form the basis of submissions to the European Commission under Article 99 (ex Article 103) and Article 104 (ex Article 104c) of the Treaty establishing the European Community.

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1

OVERVIEW

The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. From a platform of stability and sustained growth the UK is well placed to benefit from the opportunities that the global economic recovery will bring.

The Pre-Budget Report, *The strength to take the long-term decisions for Britain: Seizing the opportunities of the global recovery*, sets out updated forecasts for the economy and public finances, reports on how the Government's policies are helping to deliver its long-term goals, and describes the reforms that the Government is considering ahead of Budget 2004 and on which it will be consulting in the months ahead. The Pre-Budget Report:

- **shows that economic growth has strengthened in line with the Budget 2003 forecast and that the Government is on track to meet its fiscal rules over the economic cycle;**
- **confirms that the target for monetary policy will switch to a target based on a harmonised index of consumer prices, which the Office for National Statistics has named the Consumer Prices Index (CPI) for the UK. From today the target will be 2 per cent CPI inflation;**
- **sets out reforms which will promote business and enterprise across the UK, by improving access to finance for small business, reducing red tape and boosting the role of local authorities in encouraging enterprise;**
- **takes further steps to extend employment opportunity for all, through measures which focus help on disadvantaged groups and deprived areas;**
- **tackles child and pensioner poverty, by increasing the child element of the Child Tax Credit by £180 a year, and provides further help with childcare and help to ensure security in retirement;**
- **promotes fairness in the tax system by ensuring that everyone fairly contributes to the extra investment in public services; and**
- **introduces further measures to improve the environment, including proposals to tackle climate change, reduce waste and protect Britain's natural resources.**

INTRODUCTION

1.1 The Government's economic objective is to build a strong economy and a fair society, with opportunity and security for all.

1.2 Over the past three years recession has spread across many of the world's major industrialised economies, including the US and much of the euro area. Sound economic fundamentals and a robust macroeconomic policy framework have allowed the UK to avoid recession and to continue to grow steadily.

1.3 While risks remain there are now clear signs that world economic activity is strengthening. From a platform of stability and sustained growth, the UK is well placed to benefit from the global economic recovery. This Pre-Budget Report builds on past reforms to ensure the UK is in a position to take advantage of the opportunities that the global recovery will create. The Government is determined to build prosperity by promoting a wider and deeper entrepreneurial culture across the whole country, and to increase the flexibility of the labour market to build full employment in every region. Flexibility must be matched with fairness, so that everyone has the opportunity to fulfil their potential in the economy.

I.4 The Government will put stability first, taking no risks with inflation or the public finances. The 2004 Spending Review will ensure the sustainability of the public finances, while locking in improved levels of investment, particularly in health, education and transport.

I.5 Economic stability provides the platform for building prosperity, achieving social justice with security and opportunity for all, and maintaining investment in public services. In this Pre-Budget Report, the Government sets out the steps it is taking to advance its long-term goals of:

- maintaining macroeconomic stability, ensuring that the fiscal rules are met at all times and that inflation remains low;
- raising the sustainable rate of productivity growth through reforms that promote enterprise across the whole economy and enhance the flexibility of product and capital markets;
- ensuring a flexible labour market, which sustains a higher proportion of people in employment than ever before, providing employment opportunity for all;
- combining flexibility with fairness, by tackling child and pensioner poverty, providing opportunity for all children, effective choices for parents and delivering security for all in retirement;
- establishing world class public services, with extra investment tied to reform and results; and
- addressing the environmental challenges of climate change, poor air quality and environmental degradation in urban and rural areas.

MAINTAINING MACROECONOMIC STABILITY

I.6 The Government's long-term economic goal is to maintain stability, ensuring that the fiscal rules are met and that inflation remains low. Chapter 2 describes how the Government is working to achieve this goal and summarises prospects for the UK economy and the public finances, full details of which are set out in Annexes A and B.

The policy framework

I.7 The Government's macroeconomic framework is designed to maintain long-term economic stability. Large fluctuations in output, employment and inflation add to uncertainty for firms, consumers and the public sector, and can reduce the economy's long-term growth potential. Stability allows businesses, individuals and the Government to plan more effectively for the long term, improving the quality and quantity of investment in physical and human capital, and helping to raise productivity.

I.8 The macroeconomic framework is based on the principles of transparency, responsibility and accountability. The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term. The fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

1.9 On 9 June 2003, the Chancellor announced that he intended to change the basis of the inflation target in the remit for the Bank of England's Monetary Policy Committee (MPC). This Pre-Budget Report confirms that the operational target for monetary policy will switch to a target based on the harmonised index of consumer prices, which the National Statistician has named the Consumer Prices Index (CPI) for the UK. The Chancellor has written to the Governor of the Bank of England setting out the new remit. The level of the new CPI inflation target is being set at 2 per cent and the switch to the new target will apply from today. The new target is 0.5 percentage points below the previous RPIX-based target, reflecting differences in the way that CPI and RPIX inflation are measured. The level of the new target is set to be consistent with the old target in two years' time – the typical forecast horizon for monetary policy.

Economic prospects

1.10 At the start of 2003, global uncertainties weighed heavily on short-term prospects for the world economy. Confidence and demand in the global economy were affected by geo-political uncertainties, volatility on international financial and exchange rate markets and uncertainty regarding growth prospects in major economies, in particular the euro area.

1.11 As an open economy, the UK is inevitably affected by these global developments. However, the domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well in a challenging global economic environment. Demand and activity has strengthened as geo-political uncertainties have receded. GDP grew by 0.6 per cent in the second quarter of 2003 and by 0.7 per cent in the third quarter.

1.12 While risks remain there are now clear signs that world economic activity is strengthening. Sound fundamentals mean the UK economy is forecast to build on recent positive developments with GDP accelerating through into 2004:

- GDP is expected to grow by 2.1 per cent in 2003 and by 3 to 3½ per cent in both 2004 and 2005 in line with the Budget 2003 forecasts. Growth is expected to fall back to its trend rate by early 2006 as slack in the economy is absorbed and output returns to its trend path; and
- CPI inflation is expected to rise slowly from early next year to reach its 2 per cent target in 2005 as the effects of recovery in the global economy and this year's depreciation of sterling feed through to higher import prices.

The public finances

1.13 The Pre-Budget Report provides updated projections for the public finances. These represent an interim forecast update and are based on a series of cautious, audited assumptions that help to build a margin against unexpected events.

1.14 The projections for the public finances take into account all firm decisions announced in this Pre-Budget Report, consistent with the requirements of the *Code for fiscal stability.* This includes the commitment to carry forward the £2 billion unallocated special reserve into 2003-04 and add a further £500 million. A further £300 million will be added in 2004-05 to ensure that the Government is able to meet its international commitments in Iraq and elsewhere in the war against terrorism.

1.15 The economy is expected to grow by 2.1 per cent this year and by 3 to 3½ per cent in both 2004 and 2005, in line with the Budget 2003 forecast. The composition of growth, however, is forecast to be different from that projected at the time of the Budget. In particular, growth in wages and salaries this year is forecast to be lower than projected, reducing receipts from income tax and national insurance contributions.

1.16 The Government has always remained vigilant to the uncertainties inherent in forecasting the public finances and created a margin against unexpected events through the use of cautious, audited assumptions and the cautious case. Combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, the Government can now draw on this margin to safeguard the increase in investment in priority public services, fully meet the UK's international commitments and allow the automatic stabilisers to work in full following a period of global economic uncertainty, while remaining on track to meet the fiscal rules.

Table 1.1: Meeting the fiscal rules

	Per cent of GDP						
	Outturn[1]	Estimate			Projections		
	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Golden rule							
Surplus on current budget	–1.1	–1.7	–0.7	–0.4	0.0	0.3	0.6
Average surplus since 1999-2000	1.0	0.4	0.3	0.2	0.1	0.2	0.2
Cyclically-adjusted surplus on current budget	–0.6	–0.8	–0.1	–0.1	0.0	0.3	0.6
Sustainable investment rule							
Public sector net debt	30.9	32.8	33.8	34.6	35.1	35.4	35.5

[1] *The 2002–03 figures were estimates in Budget 2003.*

The fiscal rules

1.17 The projections show that the Government is on track to meet its strict fiscal rules over the economic cycle. Table 1.1 shows that the average surplus on the current budget since 1999-2000, which is the Government's provisional judgement on the start of the economic cycle, is positive throughout the projection period. The average annual surplus on the current budget over the whole cycle up to 2005-06 is around 0.2 per cent of GDP, equivalent to a margin or surplus in this cycle of £14 billion. The Government is therefore on track to meet the golden rule. Public sector net debt is projected to stabilise at 35½ per cent of GDP by the end of the projection period – £64 billion below the 40 per cent level and comfortably meeting the sustainable investment rule.

1.18 While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. An improved and updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the *Long-term public finance report*. The report shows that, based on reasonable assumptions, the public finances are sustainable in the longer term, and that the UK is well placed to meet the challenges of an ageing population relative to many other countries.

MEETING THE PRODUCTIVITY CHALLENGE

1.19 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. The UK has historically experienced low rates of productivity growth by international standards, as macroeconomic instability and market failures restricted competition, enterprise and innovation, and discouraged long-term investment in capital and skills. Productivity growth requires a flexible economy which promotes enterprise and entrepreneurship. The Government's long-term goal is for Britain to achieve a faster rate of productivity growth than its main competitors, through boosting enterprise and by promoting greater flexibility in labour, product and capital markets.

Action so far **1.20** Chapter 3 describes the steps the Government is taking to meet the productivity challenge, including measures to promote enterprise and flexibility. Annex C sets out progress on flexibility in labour, product and capital markets. The Government's approach focuses on five key drivers of productivity performance:

- **improving competition,** which promotes flexible markets and increases business efficiency and consumer choice. The Government has worked to ensure that the UK competition regime ranks among the best in the world. The Enterprise and Competition Acts have strengthened the powers of the Office of Fair Trading, which has made progress in promoting competition in a number of specific markets;
- **promoting enterprise** through measures aimed at increasing flexibility by removing barriers to entrepreneurship and developing an enterprise culture. Reforms to the business tax regime have helped small and growing businesses, as have measures designed to increase access to finance for small business. Enterprise Areas have been designated in the most deprived communities of the UK, with additional support made available for small businesses in these areas. The Government has also provided resources to promote the development of an enterprise culture in schools and the further education system;
- **supporting science and innovation** through increases in funding for science and promoting stronger collaboration between business and universities. Improvements to research and development (R&D) tax credits have enabled more businesses to claim a wider range of relief;
- **raising UK skills** to create a more flexible and productive workforce. Increased resources have been made available to improve standards in schools and in the further and higher education system. The Government has launched the Employer Training Pilots based on a partnership between Government, employers, employees and training providers and packages of training support for small businesses; and
- **encouraging investment** to increase the stock of physical capital supported by stronger, more efficient capital markets. The Government has introduced new proposals and undertaken reviews to increase flexibility in the housing market and to improve the planning regime. It has also followed through earlier reviews into institutional investment and long-term savings to promote greater flexibility in capital markets.

Next steps **1.21** The Pre-Budget Report describes the next steps in the Government's strategy to promote productivity growth through a more enterprising and highly skilled economy, including:

- **reforms to reduce the regulatory burden on enterprise,** including improvements to the VAT flat-rate scheme to ensure more businesses can benefit fully from compliance savings;
- **measures to overcome barriers to raising finance for small business,** including a pathfinder round of Enterprise Capital Funds and proposed enhancements to Venture Capital Trusts and the Enterprise Investment Scheme;

- **launching an independent review of the Small Firms Loan Guarantee,** to ensure its effectiveness;
- **measures to support regional growth,** including details of the Local Authority Business Growth Incentives scheme, which will boost the role of local authorities in promoting growth, and in Enterprise Areas, a Business Premises Renovation Allowance;
- **measures to promote a step change in the UK's enterprise culture,** including supporting a national campaign by Enterprise Insight;
- a **new, clearer and more accessible R&D tax credit definition**, which will promote the development of science and innovation;
- **an extension of Employer Training Pilots** to encourage skills training for a third year and to cover more than a third of England;
- **publication of the interim report of the Barker Review** on the factors affecting housing supply in the UK; and
- **consulting on the most appropriate structure for tax transparent property investment trusts**, as recommended in the interim report of the Barker Review.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.22 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. Worklessness, particularly on a long-term basis, is a constraint on the economy's growth potential and a major cause of poverty and deprivation, entailing costs for individuals, households and society as a whole. Delivering full employment requires that everyone should be able to take advantage of the opportunities offered by a stable, enterprising economy. Achieving this aim requires a flexible labour market in which people are equipped to make effective labour market choices.

Action so far

1.23 Annex C sets out progress on flexibility in labour, product and capital markets. Chapter 4 describes the action the Government has taken to create a flexible labour market which provides opportunity and choice for all, through:

- empowering people to exercise real and effective labour market choices and equipping them to take advantage of employment opportunities. Active labour market policies provide the effective support needed to help people into work. Measures that make work pay, such as the National Minimum Wage and the Working Tax Credit, improve work incentives for families with children and those in low-paid work. Further measures aim to promote diverse forms of employment, facilitate labour market mobility and raise skills; and
- ensuring policy delivery is effective, efficient and responsive to individual and local circumstances by enhancing local flexibility and autonomy.

Next steps **1.24** The performance of the labour market over recent years has been strong by international and historical standards. At 5.0 per cent, UK unemployment is the lowest of the G7 economies. This Pre-Budget Report describes the further steps the Government is taking to build on this success by removing remaining barriers to opportunity and choice in the labour market, including:

- **extra support to help the unemployed**, by piloting mandatory short intensive work-focused courses at the six-month stage;
- **an extension of eligibility for the enhanced New Deal for partners**;
- **enhanced help for lone parents,** increasing the number of work-focused interviews lone parents with children aged 14 or over are required to attend and providing help with childcare costs in the week before starting work;
- **improving work incentives in London** by extending pilots of the £40 per week in-work credit to parents, including lone parents, who have been on certain benefits for a year or more;
- **continued reform of Housing Benefit**, beginning flat-rate Pathfinders in the social sector as soon as it is practical and aligning some of the rules of Housing Benefit and tax credits;
- **additional help for those on benefits to enter self-employment**;
- **an extension of back to work help for those aged 60 and over and on the Pension Credit by October 2004;** and
- **extra help for sick and disabled people** by enabling Jobcentre Plus personal advisers to provide additional voluntary support to Incapacity Benefit customers who want to return to work.

FAIRNESS FOR FAMILIES AND COMMUNITIES

1.25 The Government is committed to promoting fairness together with flexibility and enterprise so that everyone can take advantage of opportunities to achieve their full potential in a modern, dynamic economy. The tax and benefit system puts into practice the principle of progressive universalism, with support for all and more help for those who need it most, when they need it most. The Government is also at the forefront of global efforts to achieve the Millennium Development Goals for global poverty.

Action so far **1.26** The Government has undertaken a wide range of reforms to achieve its goals in these areas, including:

- **support for families and children** to lift children out of poverty and so ensure they have the opportunity to achieve their full potential. The Government has increased financial support through the tax and benefit system, with significant rises in Child Benefit and the introduction of the Child Tax Credit, as well as improvements in parental leave to help families balance work and family life;

- **support for pensioners** to tackle poverty and ensure security in retirement for all pensioners, with extra help for those who need it most and reward for those who have saved modest amounts. The Government has increased the basic state pension by more than inflation in each of the last three years, has introduced winter fuel payments and has extended to 52 weeks the period over which pensioners in hospital receive their full state pension. The Government has also introduced the Pension Credit, which rewards saving by pensioners on low and modest incomes; and

- **steps to encourage saving,** including through the introduction of the Child Trust Fund, stakeholder pensions and Individual Savings Accounts. The Child Trust Fund will provide an endowment for every child, with more for children in the poorest third of families, and will strengthen the saving habit of future generations. Saving Gateway pilots are testing Government-funded matched contributions to help people on low incomes develop a regular saving habit.

Next steps **I.27** Building on this programme of reform, this Pre-Budget Report sets out further steps to promote fairness, including:

- **increasing the child element of the Child Tax Credit by £180 to £1,625 a year from April 2004, equivalent to a weekly increase of £3.50.** This will benefit 7.2 million children and means the Government is on track to meet or exceed the target to reduce the number of children in low-income households by a quarter by 2004-05 on a before housing costs basis. The increase will enable the Government step by step to make progress towards the goal to halve child poverty by 2010 and eradicate it in a generation;

- **promoting the provision of employer supported childcare,** as part of the Government's ongoing commitment to help parents balance their work and family lives;

- **consulting further on detailed proposals to simplify radically the taxation of pensions**, increasing choice and flexibility for pension savers and promoting the take up of the Pension Credit, launched in October 2003, providing increased financial security for pensioners on low or modest incomes and helping to tackle pensioner poverty;

- **bringing all Sandler stakeholder medium-term products and life insurance products into the stocks and shares component of ISAs from 2005;** and

- **taking action to protect direct and indirect tax revenues** and modernise the tax system.

DELIVERING HIGH QUALITY PUBLIC SERVICES

I.28 World class public services are central to achieving the Government's goal of a stronger, more flexible economy and a fairer society. A healthy and educated workforce, modern and reliable transport network and an adequate supply of affordable housing promote productivity and flexibility and help to ensure opportunity and security for all. The Government's strategy is to deliver improvements in public services through sustained investment and reform to ensure that taxpayers receive value for money.

Action so far **1.29** Chapter 6 sets out the steps the Government has taken to deliver lasting improvements in the delivery of public services, including:

- **a new framework for managing public spending** that strengthens incentives for departments to plan for the long term, ensures that resources are used as effectively and efficiently as possible, and gives departments the flexibility they need to ensure improvements in public service delivery; and

- **significant extra resources for public services,** consistent with the fiscal rules. The 2002 Spending Review delivered substantial extra investment in key public service priorities with more than 75 per cent of planned additional spending allocated to the key priorities of health, education, criminal justice, housing and transport.

Next steps **1.30** The Pre-Budget Report describes how the Government is working to deliver reform of public services, including:

- **setting out the key issues which will guide the 2004 Spending Review,** concluding next summer, which will lock in the step change in funding for key public services delivered in previous Spending Reviews. The Review will determine new departmental spending plans for 2006-07 and 2007-08 and a new set of Public Service Agreements; and

- **reporting on progress on the Reviews announced in Budget 2003** to inform the outcome of the 2004 Spending Review, including the Lyons Review of public sector relocation, the Gershon Review of public sector efficiency and the Devolved Decision-Making Review.

PROTECTING THE ENVIRONMENT

1.31 Sustainable development is vital to ensure a better quality of life for everyone, today and for generations to come. Economic growth is key to rising national prosperity. However, growth must not come at the expense of the environment or social progress. The Government is pursuing a far-reaching strategy to deliver its long-term goal of tackling climate change and fulfilling its commitments under the Kyoto Protocol. To meet the challenge of sustainable development, it is also taking wider action to improve air quality, regenerate Britain's towns and protect the countryside.

Action so far **1.32** Chapter 7 describes the steps the Government has taken to deliver its environmental objectives, including:

- **tackling climate change and improving air quality,** by ensuring that the UK meets its international commitments under the Kyoto Protocol. The Energy White Paper, published in February 2003, restates the Government's commitment to its climate change goal and its aim to put the UK on the path to a 60 per cent reduction in greenhouse gas emissions from current levels by 2050;

- **improving waste management** so that resources are re-used or recycled to deliver economic value, resulting in greater resource efficiency and reducing the damaging environmental impact of waste. The landfill tax and the landfill tax credit are central to these aims; and

- **protecting Britain's countryside and natural resources** to ensure that they are sustainable economically, socially and physically. The aggregates levy is helping to tackle the environmental costs of quarrying and action has been taken to limit the environmentally damaging impact of agriculture.

Next steps **1.33** Further steps to protect the environment are set out in this Pre-Budget Report, including:

- **the establishment of an Alternative Fuels Framework to guide the duty regime for alternative fuels**, including a commitment to providing rolling three-year certainty on duty differentials for all alternative fuels. Consistent with this framework the Government is today announcing a gradual increase in the duty rate for Liquefied Petroleum Gas (LPG) to a level which better reflects its relative environmental benefits;
- the extension, subject to state aid approval and satisfactory negotiated agreements with the industry, of **relief from the levy for the aggregates used in processed products and virgin aggregate in Northern Ireland**;
- **announcing plans for changes to the eligibility criteria for climate change agreements** that will provide better incentives for businesses to encourage energy efficiency;
- **how it proposes to recycle landfill tax revenues** to businesses; and
- **a consultation in early 2004 on tackling diffuse water pollution**, including a consideration of the pros and cons of economic instruments.

PRE-BUDGET REPORT DECISIONS

1.34 Consistent with the requirements of the *Code for fiscal stability*, the updated public finance projections in the Pre-Budget Report take into account the fiscal effects of all firm decisions announced in the Pre-Budget Report or since Budget 2003, including the special reserve allocation in Departmental Expenditure Limits, increases to the Child Tax Credit and measures to protect tax revenues. The fiscal impact of these measures is set out in Table 1.2. Full details are provided in Annex B.

Table 1.2: Estimated costs of Pre-Budget Report policy decisions and others announced since Budget 2003[1]

	(+ve is an Exchequer yield)			£ million
	2003–04	2004–05	2005–06	2006–07
Raising productivity in an enterprise economy				
Improvements to the VAT flat-rate scheme	0	–10	–25	–30
Improvements to R&D tax credit schemes	0	–15	–25	–25
Capital allowances: increases in the thresholds defining SMEs	0	–100	–170	–125
Corporation tax reform: extension of relief for management expenses	0	–20	–35	–25
Corporation tax reform: transfer pricing and thin capitalisation	0	25	40	25
Interest and royalties directive	0	*	*	5
Increasing employment opportunity for all				
Housing benefit: social sector Pathfinders	0	0	–15	–30
Building a fairer society				
Child Tax Credit: increase above earnings commitment	0	–885	–925	–955
Employer supported childcare	0	0	–20	–25
Working Tax Credit for first time parents	0	–10	–10	–10
State pension: deferral; lump sum and increments	0	0	–10	–25
Modernising National Savings and Investments	0	0	5	5
VAT: cultural bodies	–20	–25	–25	–20
Protecting tax revenues				
Foreign earnings deduction for seafarers (FED)	0	20	50	40
Reform of the Construction Industry Scheme (CIS)	0	20	40	80
Modernising the taxation of trusts	0	40	105	100
VAT: abusive grouping	0	50	70	65
VAT: partial exemption special methods	0	50	55	50
VAT: assignment of bad debts	5	20	20	20
Tackling alcohol fraud	0	5	10	175
Total Pre-Budget Report measures	**–15**	**–835**	**–865**	**–705**
Additional Pre-Budget Report policy decisions				
Total special reserve allocation	–2500	–300	0	0
TOTAL POLICY DECISIONS	**–2515**	**–1135**	**–865**	**–705**
Extension of the VAT strategy[2]	–5	165	210	290
TOTAL DISCRETIONARY MEASURES	**–2520**	**–970**	**–655**	**–415**

** Negligible*

[1] Costings shown relative to an indexed base.

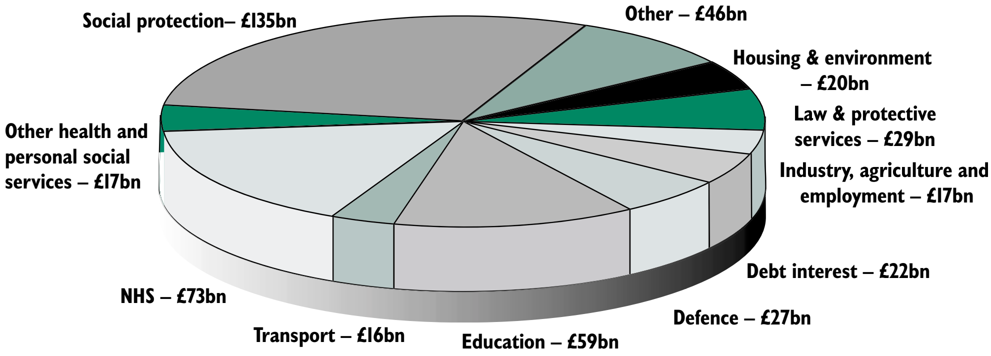
[2] Underlying assumptions audited by the NAO; net of additional resources allocated to HM Customs and Excise.

GOVERNMENT SPENDING AND REVENUES

1.35 Chart 1.1 presents public spending by main function. Total Managed Expenditure (TME) is expected to be around £460 billion in the current financial year, 2003-04. TME is divided into Departmental Expenditure Limits, shown in Table B15, and Annually Managed Expenditure (AME), shown in Table B13.

Chart 1.1: Government spending by function

Total managed expenditure: £460 billion

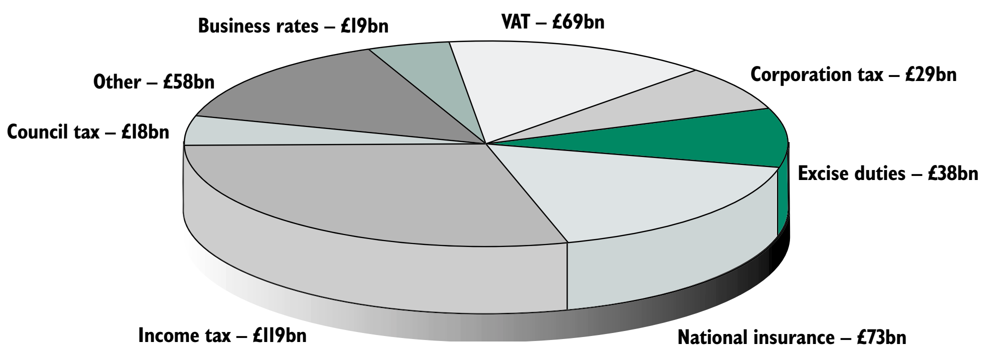


Source: HM Treasury, 2003–04 figures. Other expenditure includes spending on central administration; culture, media and sport; international cooperation and development; public service pensions; plus spending yet to be allocated and some accounting adjustments. Social protection includes tax credit payments in excess of an individual's tax liability, which are now counted in AME, in line with OECD guidelines. Figures may not sum to total due to rounding.

1.36 Chart 1.2 shows the different sources of government revenue. Public sector current receipts are expected to be around £423 billion in 2003-04. Table B11 provides a more detailed breakdown of receipts consistent with this chart.

Chart 1.2: Government receipts

Total receipts: £423 billion



Source: HM Treasury, 2003–04 figures. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts – for example, interest and dividends. Figures may not sum to total due to rounding.

2 MAINTAINING MACROECONOMIC STABILITY

Earlier this year, global confidence and demand was dampened by geo-political tensions, volatility on international financial and exchange rate markets and general uncertainty regarding prospects for growth, in particular in the euro area. Since then, as some key uncertainties have receded, international growth prospects have generally recovered, although this improvement has remained uneven across counties. In particular, activity in the euro area has remained subdued. Meanwhile, UK economic growth picked up strongly in the second and third quarters, as forecast in Budget 2003. This pick-up in activity is expected to continue into 2004, as the world recovery continues to gather momentum.

UK GDP is forecast to grow by 2.1 per cent this year, and between 3 and 3½ per cent in 2004-05, consistent with the Budget 2003 forecast.

The Pre-Budget Report confirms that the target for monetary policy will switch to a target based on the harmonised index of consumer prices, which the National Statistician has named the Consumer Prices Index (CPI) for the UK. The level of the new CPI inflation target is being set at 2 per cent and the switch to the new target will apply from today. The advantages of CPI as a measure of inflation for monetary policy purposes are set out in a paper published by the ONS today. The CPI is a better measure of inflation for the purposes of setting monetary policy, as it has a more realistic characterisation of consumer behaviour, a wider population coverage, is the most comparable measure of inflation internationally and represents international best practice.

The interim projections for the public finances included in this Pre-Budget Report show that the Government is on track to meet its strict fiscal rules over the economic cycle:

- **the average current budget since the start of the current economic cycle in 1999-2000 shows an average annual surplus up to 2005-06 of around 0.2 per cent of GDP, equivalent to a margin or surplus of £14 billion in this cycle, meaning the Government is on track to meet the golden rule on the basis of cautious assumptions. The current budget returns to balance by 2006-07, and the cyclically-adjusted current budget in the cautious case moves back to balance by the end of the projection period; and**
- **public sector net debt is projected to be low and stable over the next five years, stabilising at 35½ per cent of GDP and well below the 40 per cent ceiling set in the sustainable investment rule. The UK has the lowest ratio of debt to GDP in the G7.**

This report and the UK's annual convergence programme also show that the projections in this Pre-Budget Report are consistent with a prudent interpretation of the Stability and Growth Pact, which takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment.

An improved and updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2003 *Long-term public finance report*. This shows that on the basis of an expanded range of assumptions, the public finances are sustainable in the longer term, and that the UK is well placed relative to other countries to meet the challenges of an ageing population.

THE MACROECONOMIC FRAMEWORK

2.1 Earlier this year, global confidence and demand was dampened by geo-political tensions, volatility on international financial and exchange rate markets and general uncertainty regarding prospects for growth, in particular in the euro area. Since then, as some key uncertainties have receded, international growth prospects have generally recovered, although this improvement has remained uneven across countries. In particular, activity in the euro area has remained subdued. Meanwhile, UK economic growth picked up strongly in the second and third quarters, as forecast in Budget 2003. This pick-up in activity is expected to continue into 2004, as the world recovery continues to gather momentum.

2.2 The Government's macroeconomic framework is designed to maintain long-term economic stability. Large fluctuations in output, employment and inflation add to uncertainty for firms, consumers and the public sector, and can reduce the economy's long-term growth potential. Stability allows businesses, individuals and the Government to plan more effectively for the long term, improving the quality and quantity of investment in physical and human capital and helping to raise productivity.

2.3 The macroeconomic framework is based on the principles of transparency, responsibility and accountability.[1] The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term. The fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

Monetary policy framework

2.4 Since its introduction in 1997, the monetary policy framework has consistently delivered inflation close to the Government's target and allowed the Bank of England's Monetary Policy Committee (MPC) to mitigate the impact of global events on the UK economy. The framework is based on four key principles:

- clear and precise objectives. While the primary objective of monetary policy is to deliver price stability, the adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's inflation target;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system.

[1] Further details can be found in *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002.

2.5 These arrangements have removed the risk that short-term political factors could influence monetary policy and ensured that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target.

New inflation target

2.6 On 9 June 2003, the Chancellor announced that he intended to change the basis of the inflation target in the remit for the MPC. **This Pre-Budget Report confirms that from today the operational target for monetary policy will switch to a target based on the harmonised index of consumer prices, which the National Statistician has named the Consumer Prices Index (CPI) for the UK**. The Chancellor has written to the Governor of the Bank of England setting out the new remit. Attached to the letter is an annex explaining the new target, including the advantages of the CPI. In addition, the Office for National Statistics (ONS) has published a paper[2] setting out the technical and methodological basis of the CPI, the differences between the CPI and RPIX and the advantages of CPI for the purposes of setting monetary policy.

2.7 As discussed in the ONS paper, the CPI is a better measure of inflation for the purposes of setting monetary policy, as it:

- better allows for the substitution of cheaper for more expensive goods and services within expenditure categories when relative prices change and so it is a more realistic characterisation of consumer behaviour;
- has a wider population coverage and is more consistent with national accounts principles of consumer expenditure, so it shares a coherence with other economic statistics and gives a better picture of spending patterns in the UK; and
- is a more comparable measure of inflation internationally and represents international best practice.

2.8 **The level of the new CPI inflation target is being set at 2 per cent and the switch to the new target will apply from today.** The new target is 0.5 percentage points below the previous RPIX-based target, reflecting differences in the way that CPI and RPIX inflation are measured. The level of the new target is set to be consistent with the old target in two years' time, the typical forecast horizon for monetary policy purposes.

2.9 All other aspects of the monetary policy framework remain unchanged. If the rate of CPI inflation diverges by more than one percentage point above or below the target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected period of the deviation and how this approach meets the remit of the MPC.

2.10 Benefits will continue to be uprated by the RPI, or derivative indices, as before. Recipients will continue to receive assistance with housing costs through the housing costs element of the RPI or through help for housing costs targeted at low-income households.[3] The Government will continue to issue gilts linked to the RPI measure of inflation.

[2] *The New Inflation Target: the Statistical Perspective*, ONS, December 2003.

[3] Housing Benefit, Council Tax Benefit and Income Support for Mortgage Interest are available to help low income households with housing costs.

Box 2.1: The Consumer Prices Index

The Consumer Prices Index (CPI) is a measure of the change in the level of prices charged for consumer goods and services. It is constructed on a common, or harmonised, basis for all EU Member States. The common European standard is known as the Harmonised Index of Consumer Prices (HICP) and the CPI is the UK's measure.

As with RPIX, the CPI is calculated by weighting prices according to the pattern of households' expenditure. Both indices are 'chain-linked', which means that the weights are adjusted annually to reflect changes in the pattern of consumers' expenditure. While the CPI is calculated from the same raw price data as the RPI and RPIX, there are a number of methodological and coverage differences between RPIX and CPI that lead to differences between the inflation rates, as described in the Office for National Statistics (ONS) paper. These methodological differences can be broadly divided into two effects, the formula effect and the coverage effect.

The formula effect relates to the way the two indices aggregate individual prices within individual expenditure categories. The CPI uses the geometric mean and RPIX uses arithmetic means. The geometric mean is the approach used in most other countries, and as stated in the ONS paper, has some advantages over arithmetic means.

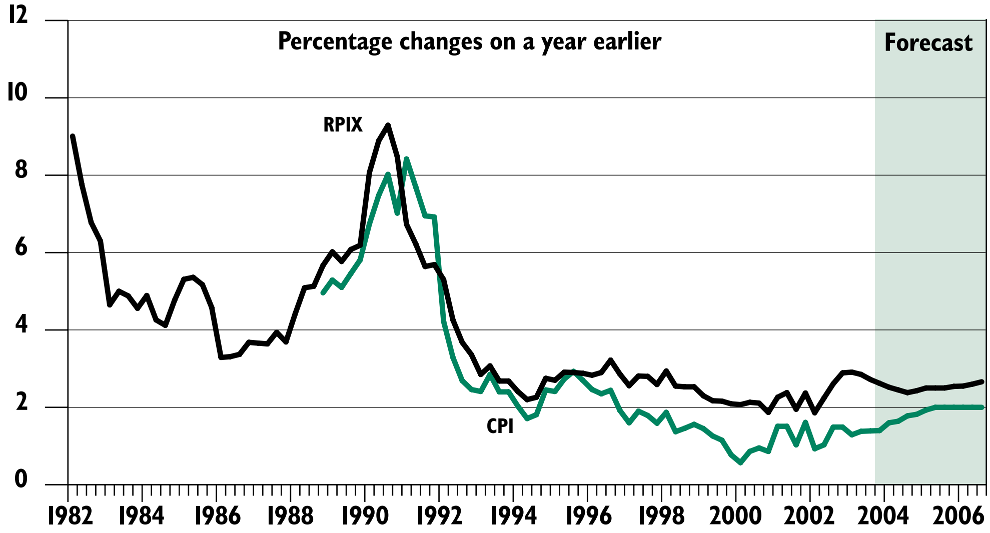
The coverage effect is due to the different coverage of the two indices and relates primarily to differences in population and expenditure coverage, and commodity measurement. The population coverage differences reflect the fact that the CPI is based on the purchasing patterns of all private households, including expenditure by foreign visitors, the richest households and the poorest pensioner households, all of which are excluded from the RPI. On expenditure coverage, the major difference is the exclusion of several components of housing costs from the CPI that are included in RPIX, including housing depreciation and council tax. The commodity measurement effect reflects different treatment of items such as insurance premiums.

Since 1997, the formula effect and the difference in coverage relating to housing costs have been the main reasons for the differences between CPI and RPIX inflation. The other coverage effects have tended to be negligible on average.

2.11 The difference between CPI and RPIX inflation is expected to narrow markedly from 1.3 percentage points in October 2003 to ½ percentage point two years ahead, the typical forecast horizon for monetary policy purposes. Thereafter, the differential is expected to remain broadly stable, rising slightly above ½ percentage point in future years. With CPI inflation expected to remain at its target level of 2 per cent, RPIX inflation is expected to rise slightly above 2½ per cent depending on a range of economic factors and rounds up to 2¾ per cent in this Pre-Budget Report forecast.

2.12 The exclusion of certain housing cost elements from the CPI does not mean that housing developments will not be an important factor in setting monetary policy or that house prices will be more volatile under a CPI-based target. Although the MPC will target CPI inflation, house prices are – and will continue to be – an important indicator in assessing macroeconomic developments for the purposes of setting monetary policy. Furthermore, as discussed in detail in the ONS paper, Eurostat is currently undertaking a pilot study (in which the UK is participating) to assess the preferred means of incorporating a measure of housing costs into the CPI. The ONS is expected to take into account any internationally agreed future changes in the measurement of inflation.

Chart 2.1: CPI and RPIX[1]



[1] *Outturns until 2003Q3; forecasts for every second quarter from 2003Q4 to 2006Q4.*

Fiscal policy framework

2.13 The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*[4] – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

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

2.14 These objectives are implemented through two fiscal rules, against which the performance of fiscal policy can be judged. The fiscal rules are:

- the golden rule: over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the sustainable investment rule: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

[4] *Code for fiscal stability*, HM Treasury, 1998.

2.15 The fiscal rules ensure sound public finances in the medium term while allowing flexibility in two key respects:

- the rules are set over the economic cycle. This allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand; and
- the rules work together to promote capital investment while ensuring sustainable public finances in the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending. The sustainable investment rule ensures that borrowing is maintained at a prudent level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

2.16 The fiscal policy framework also takes account of uncertainty that is inherent in projections of the public finances. The fiscal projections are based on cautious assumptions for key economic variables, including the trend rate of growth, oil prices and the level of unemployment. This cautious approach builds a safety margin into the public finances and minimises the need for unexpected changes in taxation or spending. The assumptions are audited by the Comptroller and Auditor General as part of a three-year rolling review to ensure that they remain reasonable and cautious.

Whole of Government Accounts

2.17 Accurate data is essential if policy makers are to make the right decisions. Publishing this data improves the transparency of decision-making. Whole of Government Accounts can help do this by including all entities within the public sector and using best-practice accounting methods, thereby increasing the transparency of Government finances, providing an additional and valuable perspective on the public finances and improving the completeness and comparability of public sector financial data. However, the development work for Whole of Government Accounts raises significant methodological issues that will take some time to address. As a result, the Government will publish full Whole of Government Accounts for the first time based on figures for 2006-07 once these methodological issues have been addressed through dry-run processes.

Economic statistics

2.18 In February 2003, the Chancellor asked Christopher Allsopp to undertake a wide-ranging review of the informational and statistical requirements for monetary and wider economic policymaking, including to support the Government's objective of promoting economic growth in all regions. Allsopp's First Report is being published today and is described in Box A5. The Government welcomes the report and looks forward to discussing the proposals with Christopher Allsopp, the National Statistician and others.

Public spending framework

2.19 The fiscal rules underpin the Government's public spending framework. The golden rule increases the efficiency of public spending by ensuring that public investment is not sacrificed to meet short-term current spending pressures. Departments are now given separate allocations for resource and capital spending to help ensure adherence to the rule. The sustainable investment rule sets the context for the Government's public investment targets and ensures that borrowing for investment is conducted in a responsible way. Full details of the public spending framework are set out in Chapter 6.

Financial stability framework

2.20 A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system, with distinct roles for the Treasury, the Bank of England and the FSA. A Memorandum of Understanding[5] in 1997 established a framework for co-operation between these three bodies on financial stability. The Bank of England is responsible for the stability of the financial system as a whole, including the payments infrastructure. The FSA is responsible for the authorisation and supervision of financial institutions including banks, for supervising financial markets and securities clearing and settlement systems, and for regulatory policy. The Treasury has responsibility for the overall institutional structure of regulation and the legislation that governs it.

2.21 A Standing Committee, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss financial stability, focusing on risks deemed to have systemic consequences. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure and co-ordinates the three authorities' contingency plans. In the event of a crisis, it would meet at short notice and co-ordinate any necessary action by the authorities.

2.22 A review of the soundness of the UK's financial sector completed in February 2003, under the Financial Sector Assessment Programme run jointly by the IMF and World Bank, commented that[6]: *"The UK's large and sophisticated financial sector features fundamentally sound and highly developed financial institutions, markets and infrastructure. It is supported by a financial stability policy framework that has been significantly strengthened in a number of ways in recent years, and that in many respects is at the forefront internationally."*

[5] Full text available at on the Treasury website www.hm-treasury.gov.uk.

[6] Full report available at www.imf.org.

Box 2.2: Promoting stability and combating criminal abuse of the financial system

The Treasury has recently consulted on possible legislative responses to major operational disruption to the UK financial system. Following the publication of a Green Paper, *The financial system and major operational disruption,* in February 2003, the Treasury asked the Bank of England's Deputy Governor for Financial Stability, Sir Andrew Large, to chair a Task Force to examine whether further legislation was needed. The final report, *Do we need new statutory powers?,* was published on 3 December 2003. It concluded that no new statutory powers were needed, as the present range of legislative tools were appropriate to manage the risks posed by a major operational disruption. This conclusion is predicated on the considerable work already ongoing to address financial sector business continuity issues. The Task Force made eight recommendations aimed at reinforcing and developing that work. The Government has accepted its conclusions and recommendations, and a progress report will be published by October 2004.

The Government is committed to ensuring the effectiveness of financial systems and international standards that combat money laundering and terrorist financing. Reducing incentives to commit crime by depriving criminals of the proceeds of drug dealing, smuggling, fraud, theft and tax evasion is a key aim in the fight against money laundering. Since 2002, the UK has recovered over £48 million in criminal assets. The new Money Laundering Regulations will impose high-level objectives that are non-prescriptive and allow businesses the flexibility to make controls that are proportionate to the risk of money laundering.

The UK works closely with international partners in the global fight against terrorism by delivering technical assistance and promoting worldwide implementation of high level counter terrorist initiatives. The UK has fully implemented all UN anti-terrorist Resolutions. Over $10 million has been frozen in the UK since the terrorist attacks in September 2001. Following the liberation of Kabul, the bulk has been unfrozen and made available to the legitimate Government of Afghanistan. Around $500,000 remains frozen.

THE PERFORMANCE OF THE FRAMEWORK

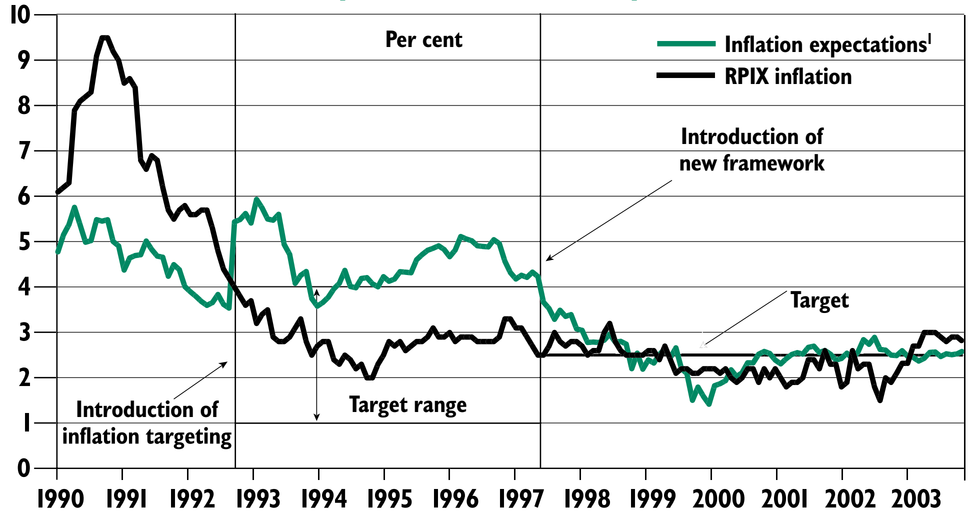
2.23 The frameworks for monetary policy, fiscal policy and public spending provide a coherent strategy for maintaining high and stable levels of growth and employment, and for minimising the adverse impact of external events.

Monetary policy

2.24 The monetary policy framework has improved the credibility of policy making and continues to deliver clear benefits. Since the framework was introduced:

- RPIX inflation has fluctuated in the narrow range of 1.5 to 3.2 per cent and has averaged 2.3 per cent, close to the Government's target; and
- long-term inflation expectations, as measured by financial markets data, show that expected inflation has remained close to the Government's target, having fallen from over 4 per cent in 1997, demonstrating the framework has a high degree of credibility.

Chart 2.2: Inflation performance and expectations



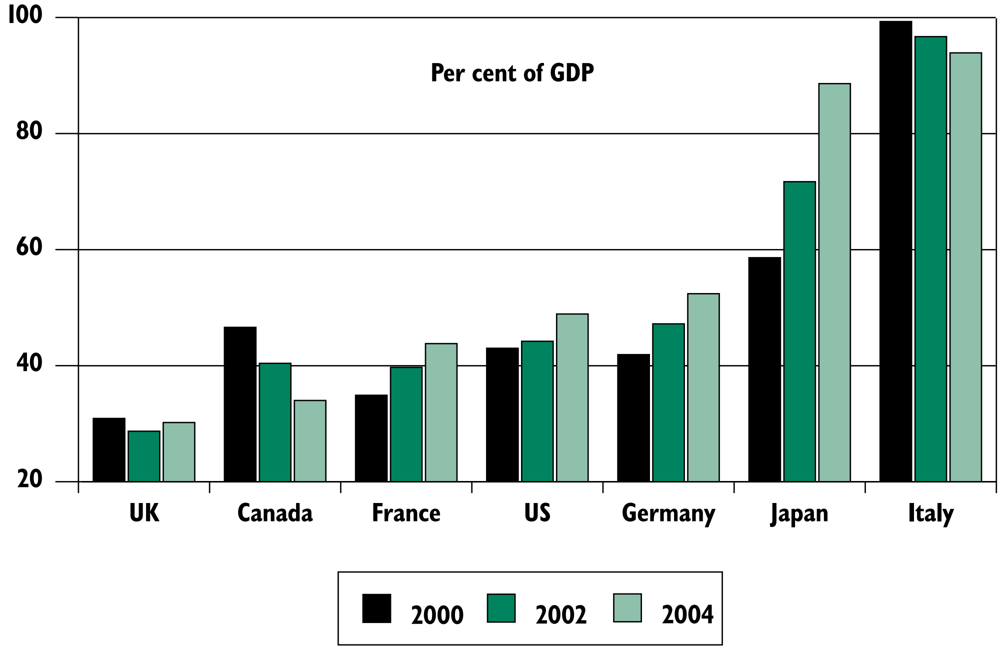
[1] Ten-year ahead market inflation expectations.

2.25 The framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3.5 per cent. This helped to keep output close to its trend level, while ensuring that inflation remained close to target. The MPC then increased interest rates in November 2003 in response to a strengthening global economy and a pick up in growth in the UK. Long-term 30 year interest rates are lower than in the US or the euro area, reducing the Government's debt interest payments and freeing up resources for investment in public services.

Fiscal policy

2.26 The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by more than 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend. Public sector net debt has also been reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03. As Chart 2.3 shows, the UK now has the lowest level of debt as a proportion of GDP in the G7.

Chart 2.3: OECD estimate of general government net financial liabilities for G7 countries



Source: OECD Economic Outlook June 2003.

2002 Spending Review

2.27 The 2002 Spending Review set spending plans for the years 2003-04 to 2005-06 for the public services other than the NHS, for which spending plans to 2007-08 were fixed in the 2002 Budget. Continuing the trend set in previous Spending Reviews, these spending plans allowed for significant increases in investment for the key public services, with resources focused on health, education, transport, criminal justice and housing. The overall spending 'envelope' set in Budget 2002 and confirmed in the 2002 Spending Review remains sustainable and fully consistent with the fiscal rules. This 'envelope' allows:

- public sector net investment to rise from its target of 1.6 per cent of GDP in 2003-04, to 2 per cent of GDP by 2005-06 and to 2¼ per cent by 2007-08, continuing to address the legacy of under-investment in public infrastructure, while meeting the sustainable investment rule;
- planned UK spending on the NHS to increase by an average of 7.1 per cent a year in real terms over the five years to 2007-08; and
- planned UK spending on education to increase by 6 per cent a year in real terms between 2002-03 and 2005-06.

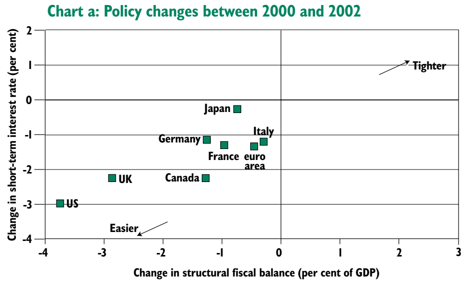
Box 2.3: Comparative performance of macroeconomic frameworks

In the first synchronised global slowdown in almost 30 years the US, Japan and parts of Europe all moved into recession in 2001. The leading role of business investment and confidence, combined with the increased globalisation of product markets, meant that volatility and uncertainty spread faster between economies than in the past. While the slowdown was synchronised, signs of recovery have so far been uneven. Since the last quarter of 2000, the UK's economy has grown at almost 5 per cent, while the euro area and Japan have witnessed growth around 2 per cent. A mixture of policy responses and structural factors can help explain this.

In the face of a series of large and destabilising shocks to the global economy, those countries with credible fiscal and monetary frameworks based on transparent, medium-term objectives have seen greater stability and stronger growth. The Bank of England cut short-term interest rates on nine occasions since 2001, from 6 per cent to 3.5 per cent, while maintaining long-term inflation expectations close to the inflation target. The combination of operational independence, a clear objective, and full accountability and transparency has allowed such flexibility while maintaining credibility.

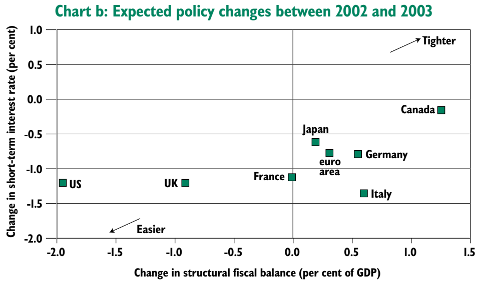
In addition, low debt combined with structural improvements in the fiscal position in the UK have allowed fiscal policy to support monetary policy in recent years without undermining the sustainability of the public finances or the credibility of the fiscal framework. If the public finances had not been consolidated and debt levels not reduced, or if the fiscal rules had not been flexible enough to allow for the economic cycle, fiscal policy would not have been able to help support economic growth.

Chart a: Policy changes between 2000 and 2002



Source: IMF World Economic Outlook, (September 2003).

Chart b: Expected policy changes between 2002 and 2003



Source: IMF World Economic Outlook, (September 2003).

The charts above, based on IMF data, show that monetary and fiscal policy helped to support growth in both the UK and the US in the recent past. In comparison high debt levels and macroeconomic inflexibilities prevented fiscal policy from fully supporting monetary policy in many euro area countries in 2003.

Structural reform can also complement flexible macroeconomic frameworks and help economies to absorb shocks. The more responsive economies are to changing economic circumstances, the more likely a sustained recovery. The recent global economic slowdown has shown that more flexible labour markets keep unemployment down and employment up. More flexible product markets have also helped to cushion the shock while financial sectors, with better risk management and more diversified sources of finance, have remained robust.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.28 At the beginning of 2003 significant global uncertainties weigh heavily on short-term prospects for the world economy. Global confidence and demand was dampened by geo-political tensions, volatility on international financial and exchange rate markets and general uncertainty regarding prospects for growth in the major economies, in particular the euro area where, during the first half of this year, output stagnated.

Table 2.1: Summary of world forecast

	Percentage changes on a year earlier unless otherwise stated				
	Outturn	Forecasts			
	2002	2003	2004	2005	2006
Major 7 countries[1]					
Real GDP	1½	2¼	3	2¾	2¾
Consumer price inflation[2]	1¾	1½	1½	1¾	1¾
Euro-area					
Real GDP	¾	½	1¾	2¾	2½
World trade in goods and services	3½	4	7¾	8	7¼
UK export markets[3]	2	3¼	6¼	7¼	6¾

[1] *G7: US, Japan, Germany, France, UK, Italy and Canada.*
[2] *Per cent, Q4.*
[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

2.29 In the first half of 2003, the UK economy was affected by these uncertainties. Faced with these challenging international conditions, UK companies further postponed decisions on new investment expenditure in the first quarter. Sluggish external demand continued to restrain underlying UK export growth in early 2003. Moreover, consumer confidence appears to have been dented by global geo-political tensions in the early months of the year.

2.30 The domestic stability delivered by the Government's macroeconomic frameworks has enabled the UK economy to cope well in a challenging global economic environment and UK demand and activity has strengthened as geo-political uncertainties have receded. Against a steadily improving global background, financial markets have more than made up the losses incurred over the first quarter of 2003. Many forward-looking survey and confidence measures have also improved considerably in recent months and manufacturing output has risen. Following growth of 0.2 per cent in the first quarter – the weakest for almost eleven years – GDP grew by 0.6 per cent in the second and by 0.7 per cent in third quarter of the year, broadly in line with the Budget forecast.

2.31 Growth in most G7 economies looks set to steadily improve during the course of 2004, though this acceleration is likely to remain uneven. While most forecasts for growth in the US and Japan have been revised up significantly since the spring, activity in the euro area, the UK's most important trading partner, has remained subdued. However, recent improvements in leading indicators, notably confidence measures and equity markets, point to a gradual recovery going forward.

Revisions to UK national accounts

2.32 Extensive revisions to the UK national accounts were introduced by the Office for National Statistics (ONS) in the Blue Book 2003. These revisions reflect both methodological changes and new information on the economy. They mainly affect real volume measures with only small changes to nominal data. The overall effect of the revisions is that GDP growth since the mid-1990s is now stronger and relatively more balanced between expenditure components than previously estimated. In particular, household consumption is now estimated to have grown more slowly over the recent past, with business investment and net trade both stronger. More detail on the revisions can be found in Box A3.

Box 2.4: Revisions to national accounts and trend growth

Data revisions since Budget 2003 provide new information, and point to a higher than previously thought trend rate of output growth over the past few years, but for the Pre-Budget Report the existing 2¾ per cent trend growth rate projection is retained, and the public finance projections are based on a lower trend growth assumption of 2½ up to 2006-07 and 2¼ for subsequent years.

Substantial upward revisions to measured UK GDP data were introduced by the Office for National Statistics (ONS) in Blue Book 2003, and are discussed in more detail in Annex A. This has the effect of boosting the estimated trend rate of growth between the adjudged on-trend points in the first half of 1997 and the third quarter of 2001. Over this period, the Blue Book 2003 data yield an annual trend rate of output growth of 2.9 per cent, revised up from the previous estimate of 2.6 per cent at the time of Budget 2003.

There have been no significant revisions over the same period to outturns for the trend growth rates of average hours worked or employment, so the increase in the trend rate of output growth is reflected in the productivity growth component. Therefore, the estimated growth rate of underlying trend output per hour between 1997 and 2001 has increased to 2.7 per cent, 0.3 percentage points higher than at Budget time.

A mechanical application of the Treasury's trend growth methodology would project forward this trend productivity increase, which, with other trend growth components unchanged, would raise the trend output growth projection well above the existing 2¾ per cent neutral assumption. This would imply a negative output gap in mid-2003 in excess of the 1½ per cent gap estimated on the basis of the 2¾ per cent trend growth assumption. However, evidence and judgement suggest that a current negative output gap substantially wider than 1½ per cent of GDP would be implausible.

After considering the data and taking a cautious approach to projecting trend growth, the existing 2¾ per cent trend output growth projection is retained as the neutral judgement. However, the data revisions increase further confidence that the 2¾ per cent assumption is consistent with the economy's potential. More detail and explanation on the decomposition of trend growth can be found in Annex A. As shown in the table below, the public finances projections will continue to be based on a lower cautious view of trend growth of 2½ per cent, as audited by the NAO, up to 2006-07 and 2¼ per cent for subsequent years, with the slowdown reflecting expected demographic trends.

Contributions to trend output growth[a]

	Estimated trend rates of growth, per cent per year					
	Trend output per hour worked		Trend average hours worked	Trend employment rate	Population of working age	Trend output
	Underlying	Actual				
Over the recent past (1997H1 to 2001Q3)						
Budget 2003	2.35	2.14	–0.47	0.43	0.50	**2.61**
PBR 2003	2.65	2.44	–0.47	0.42	0.54	**2.94**
Projection						
Budget 2003	2.35	2.25	–0.10	0.20	0.50	**2¾**
PBR 2003	2.35	2.25	–0.10	0.20	0.50	**2¾**

Economic prospects

2.33 As a result of sound fundamentals, the UK economy is forecast to build on recent positive developments and accelerating through into 2004. GDP is expected to grow by 2.1 per cent in 2003 as a whole, within the lower half of the Budget 2003 forecast range. In both 2004 and 2005, GDP is forecast to grow by 3 to 3½ per cent. Growth is expected to fall back to its trend rate by early 2006 as slack in the economy is taken up and output returns to its trend level.

Table 2.2: Summary of UK forecast

	Outturn	Forecast			
	2002	2003	2004	2005	2006
GDP growth (per cent)	1¾	2	3 to 3½	3 to 3½	2½ to 3
CPI inflation (per cent, Q4)	1½	1½	1¾	2	2

2.34 Underlying consumption growth appears to have eased since the second half of 2002 and there have been tentative signs that a gradual business investment recovery is underway. The forecast also shows a continuing rebalancing of growth going forward. Household consumption is forecast to continue growing at around recent rates, increasing by 2½ per cent this year and by between 2¼ to 2¾ per cent in 2004 and 2005.

2.35 At the same time, with corporate profitability having risen over the past year and company balance sheets far healthier than during the late 1990s ICT boom, businesses are well positioned to step up investment as the global recovery gathers pace into 2004. Business investment is forecast to rise by 3 to 3½ per cent next year and 5½ to 6¼ per cent in 2005. With government investment expected to continue growing strongly as a result of the Government's spending plans, whole economy fixed capital formation is expected to grow significantly faster than household consumption and GDP in all forecast years.

2.36 CPI inflation is forecast to remain a little below target in 2004 as existing slack in the economy continues to dampen domestically generated pricing pressures. However, inflation is expected to return to target from 2005 as the combined effects of the recovery in the world economy and this year depreciation of sterling feed through to higher import prices.

2.37 Until recently, independent forecasters had generally been revising down their projections for UK GDP growth in 2003, but they have lately upgraded their forecasts. The average of *new* growth forecasts in November was 2 per cent, consistent with the Pre-Budget Report estimate.

Forecast risks

2.38 Downside risks to the forecast have receded since the time of Budget 2003. Nonetheless, if realised, the risks to the global forecast would clearly affect the UK's prospects. There are still significant imbalances in the global economy which pose the threat of sudden, sharp movements in exchange rates. These highlight the urgent need for policy makers to push ahead with the structural reforms that will ensure a broad based and sustainable recovery over the medium term. A further downside risk comes from the potential rebuilding of balance sheets. Though significant progress has been made in rebuilding household and corporate balance sheets across several major economies since the recession of 2001, this process may not be complete. Further balance sheet adjustment might entail significantly weaker spending from households or the business sector and could undermine the recovery. Sharp movements in exchange rates or further balance sheet adjustment in certain key economies would threaten UK external demand and confidence.

2.39 Upside risks to the global outlook also raise the possibility of a sharper than expected upturn in UK economic growth going forward. The forecast for G7 GDP growth assumes a relatively modest acceleration in capital spending compared with previous recoveries, so it is possible that investment will rebound more sharply than forecast. Similarly, in the past, UK business investment has accelerated sharply and proved stronger than expected once GDP growth has picked up and again the forecast recovery in business investment could prove more robust than expected.

2.40 In the UK, a sharp weakening of the housing market and a corresponding adjustment in prices would be likely to have an adverse effect on consumption expenditure. On the upside, momentum in consumer spending and house prices in the short term could continue to exceed expectations, though this would tend to increase the medium-term downside risks. Although household borrowing has increased, households net wealth has increased by over 50 per cent since the beginning of 1997, reflecting the boost to housing wealth from the strong rise in house prices. As a result, the ratio of household debt to total wealth has remained stable, as described in Box A6.

The economic cycle

2.41 While the national accounts data revisions introduced by the ONS in the Blue Book 2003 led to changes in the path of economic growth over the recent past, it contained no new evidence to alter the Government's provisional judgement on the dating of the current and past economic cycles. On this basis, the economy completed a full, though short, cycle between the first half of 1997 and mid-1999. The current economic cycle began in mid-1999 when actual output moved above the trend level. In the second half of 2001, the economy moved below trend with actual output remaining below the trend level since then. The economy is expected to return to trend by early 2006 as forecast in Budget 2003.

Caution and the public finance projections

2.42 A number of key assumptions that underpin the public finance projections are independently audited by the Comptroller and Auditor General under a three-year rolling review to ensure that they remain reasonable and cautious. A complete list of these assumptions is set out in Annex B. This prudent approach to fiscal policy builds an important 'safety margin' into the public finance projections to guard against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in plans for taxation or spending.

2.43 For this Pre-Budget Report, the Comptroller and Auditor General has audited the assumption relating to equity prices. While the assumption was an imprecise one over the last three years, the Comptroller and Auditor General concluded that it remains a sensible and transparent rule for forecasting purposes. In addition, following the change in the measure of inflation used in the inflation target, the Government has revised the assumption on the consistency of price indicators used to project the public finances, and this has also been audited. The assumption was deemed to be reasonable. The Comptroller and Auditor General also audited the assumption for projecting VAT receipts, and found that it had been less cautious than evidence at the time of making the assumption suggested it would be. The Comptroller and Auditor General will complete the audit of the assumption at the time of Budget 2004, after considering the additional analysis being undertaken by HM Customs and Excise, following the recent data revisions to UK national accounts. In the meantime, the existing assumption has been used for the projections in this Pre-Budget Report, an approach that the Comptroller and Auditor General considers a cautious response.[7]

[7] *Audit of Assumptions for the 2003 Pre-Budget Report*, National Audit Office, December 2003 (HC 35).

2.44 The Government launched a comprehensive strategy for tackling VAT fraud, avoidance and non-compliance in the 2002 Pre-Budget Report. This strategy is being extended further, as described in Chapter 5, and consistent with previous practice the VAT ratio assumption takes account of the direct and preventive effects, but not the deterrent effects, and has been audited by the Comptroller and Auditor General who concluded that a reasonable and cautious approach had been adopted in the assumptions underlying the projected extra yield. In line with the cautious approach to the public finances, the Government has included an additional £185 million in 2004-05, rising to £315 million in 2006-07 in the public finance projections from the extension of the strategy.

Box 2.5: Government policy on EMU

The Government's policy on membership of the single currency was set out by the Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor is the national economic interest and whether, on the basis of an assessment of the five economic tests, the economic case for joining is clear and unambiguous.

An assessment of the five tests was made in June 2003.[a] This concluded that: *"since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area."* The assessment set out a reform agenda of concrete and practical steps, including:

- **reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets in the UK. The Government announced it would publish six monthly flexibility reports, the first of which is published as Annex C to this Pre-Budget Report;**
- **independent reviews, with interim reports published alongside this Pre-Budget Report, of mortgage finance and the supply of UK housing to examine their impact on economic stability;**
- **the publication of a draft referendum bill, published on 10 December 2003. The draft bill will allow for consultation over the details of a referendum if one were to be held; and**
- **the publication of the *Seventh report on euro preparations* on 18 November 2003, setting out the progress that has been made across the economy since June 2003. A further report will be published in spring 2004.**

Work is also proceeding on a number of issues identified in the discussion paper *Fiscal stabilisation and EMU*.[b] This includes clarifying how a new fiscal stabilisation rule might work, the case for modernising the tax regulator powers, improving the understanding of the fiscal transmission mechanism, examining the case for strengthening automatic stabilisers and giving further consideration to the effectiveness of different fiscal instruments in stabilising the economy.

Budget 2004 will include a report on progress on the issues identified in the June 2003 assessment of the five tests, and will determine whether a further assessment of the five tests should be undertaken next year. If a further assessment were to conclude that the five tests had been met, the Government would put the issue before the British people in a referendum.

[a] *UK membership of the single currency: An assessment of the five economic tests*, HM Treasury, June 2003 (Cm 5776).
[b] HM Treasury, June 2003.

RECENT FISCAL TRENDS AND OUTLOOK

2.45 The public finance projections in the Pre-Budget Report have a different status from those produced at the time of the Budget. They represent an interim forecast update and not necessarily the outcome that the Government is seeking. The projections for the public finances presented below include the effects of firm decisions announced since Budget 2003 and in this Pre-Budget Report, in accordance with the *Code for fiscal stability*.

2.46 The forward-looking fiscal projections described in this section are complemented by the 2003 *End of year fiscal report,* published alongside this Pre-Budget Report, which provides detailed retrospective information on the public finances in 2001-02 and 2002-03.

2.47 The economy is expected to grow by 2.1 per cent this year and by 3 to 3½ per cent in both 2004 and 2005, consistent with the Budget 2003 forecast. The composition of growth, however, is forecast to be different from that projected at the time of the Budget. In particular, growth in wages and salaries this year is forecast to be lower than projected.

2.48 The Government has always remained vigilant to the uncertainties inherent in forecasting the public finances and it has created a margin against unexpected events through the use of cautious, audited assumptions and the cautious case. This caution combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, means the Government can now draw on this margin to safeguard the increase in investment in priority public services, fully meet the UK's international commitments and allow the automatic stabilisers to work in full following a period of global economic uncertainty, while remaining on track to meet the fiscal rules.

Table 2.3: Fiscal balances compared with Budget 2003

	Outturn[1]	Estimate			Projections		
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Surplus on current budget (£ billion)							
Budget 2003	**–11.7**	**–8.4**	**–1**	**2**	**6**	**9**	
Effect of changes to current receipts since Budget 2003	–0.5	–5.5	–4	–4	–2	0	
Effect of changes to current expenditure since Budget 2003	0.4	–5.4	–3	–3	–3	–4	
PBR 2003	**–11.8**	**–19.3**	**–8**	**–5**	**0**	**4**	**8**
Net borrowing (£ billion)							
Budget 2003	**24.0**	**27.3**	**24**	**23**	**22**	**22**	
Effects of changes in current surplus	0.1	10.9	7	7	6	4	
Effect of changes in net investment	–1.5	–0.9	0	0	0	0	
PBR 2003	**22.5**	**37.4**	**31**	**30**	**27**	**27**	**24**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2003[1]	–0.5	0.2	0.5	0.4	0.4	0.6	
PBR 2003	**–0.6**	**–0.8**	**–0.1**	**–0.1**	**0.0**	**0.3**	**0.6**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2003[1]	1.7	1.5	1.5	1.7	1.7	1.6	
PBR 2003	**1.6**	**2.4**	**2.0**	**2.2**	**2.0**	**1.9**	**1.7**
Net debt (per cent of GDP)							
Budget 2003[1]	30.9	32.2	32.7	33.2	33.5	33.8	
PBR 2003	**30.9**	**32.8**	**33.8**	**34.6**	**35.1**	**35.4**	**35.5**

Note: Figures may not sum due to rounding.
[1] *The 2002–03 figures were estimates in Budget 2003.*

2.49 Table 2.3 shows the changes to the main fiscal aggregates since Budget 2003. The outturn for the current budget for 2002-03 is only marginally different from the Budget 2003 estimate, while net borrowing is now around £1.5 billion lower than estimated in Budget 2003. Projections for the current budget and net borrowing are now weaker, reflecting the changed pattern of growth compared with Budget 2003. The effect of the changed composition of growth has also affected estimates of the underlying structural position of the public finances, shown by the cyclically-adjusted current budget and net borrowing shown in Table 2.3.

2.50 Table 2.4 explains the reasons for the change in public sector net borrowing and Table 2.5 shows how specific receipts and spending items have changed since Budget 2003. The proportion of the overall change in net borrowing explained by changes in GDP components is just under half in 2003-04, rising over the projection period.

Table 2.4: Public sector net borrowing compared with Budget 2003

£ billion	Estimate[1]	Projections			
	2003-04	2004-05	2005-06	2006-07	2007-08
Budget 2003	**27.3**	**24**	**23**	**22**	**22**
Economic assumptions audited by the NAO[2]	**–0.7**	**–1½**	**–1½**	**–2**	**–2**
of which: equity prices	–0.4	–1	–1½	–1½	–1½
GDP components	**4.0**	**5½**	**5½**	**5**	**4**
of which: wages and salaries	3.4	4	4	3½	3
household consumption	0.3	½	1	1	½
Other forecasting effects	**4.2**	**2**	**2½**	**2**	**2**
of which: receipts	2.1	½	1	0	-1
expenditure	2.1	1	1½	2½	3
Total before discretionary measures	**34.9**	**30**	**29**	**27**	**26**
Discretionary measures[2]	2.5	1	½	½	½
PBR 2003	**37.4**	**31**	**30**	**27**	**27**

Note: Figures may not sum due to rounding.

[1] The 2003-04 figures were projections in Budget 2003.

[2] The effects of the extension of the VAT strategy are included in discretionary measures.

Changes in receipts

2.51 The change in GDP components has had a significant impact on receipts. In particular, the lower growth in wages and salaries this year has reduced income tax and national insurance contributions receipts by around £4 billion. In addition, lower growth in consumers expenditure has reduced receipts from VAT.

2.52 ONS revisions to GDP have increased the level of wages and salaries in 2002, which means that the effective tax rate of income tax and national insurance contributions was lower than expected, as described in the 2003 *End of year fiscal report*. In addition, the flexibility of the UK's labour market in the face of global and wider economic uncertainty has been reflected in lower than expected average earnings growth since the Budget. With broadly similar levels of wages and salaries compared to Budget 2003 over the medium term, receipts from income tax and national insurance contributions are lower.

2.53 Changes in the economic determinants audited by the NAO have increased public sector receipts by around £2 billion per year from 2004-05 onwards. This is principally a result of higher equity prices, which have risen by around 20 per cent since the Budget. This higher level increases receipts from stamp duty, capital taxes and corporation tax from life assurance companies. In addition, despite lower than expected growth in household consumption, VAT revenues in the first half of 2003-04 have been substantially above the levels projected in Budget 2003. This is included under other forecasting effects and reflects, in part, the caution in the NAO audited assumption used to forecast VAT revenues. In addition, lower forecasts for companies' profits have reduced projected receipts from non-North Sea corporation tax by around £2 billion a year, as shown in Table 2.5.

Table 2.5: Changes in projections of public sector net borrowing since Budget 2003

£ billion	Estimate[1]	Projections			
	2003-04	2004-05	2005-06	2006-07	2007-08
Budget 2003	**27.3**	**24**	**23**	**22**	**22**
Changes before discretionary measures	**7.5**	**6**	**6**	**5**	**4**
of which:					
Income tax and NICs	5.9	4½	5	4	3½
Non-north sea corporation tax	1.6	2	2	2	2
Stamp duty and capital taxes	0.5	–½	–½	–1	–1
VAT	–2.5	–2	–2	–2	–2½
AME[1]	2.0	1½	1½	2	2½
Other	0.1	½	½	–½	–½
Discretionary measures[2]	2.5	1	½	½	½
PBR 2003	**37.4**	**31**	**30**	**27**	**27**

[1] *Resource AME.*

[2] *Including the impact of the extension of the VAT strategy.*

Changes in spending

2.54 Projections for DEL up to 2005-06 are based on the 2002 Spending Review allocations, adjusted to take account of classification changes between DEL and AME that have no effect on overall public spending. Projections for AME programmes are higher than projected in Budget 2002. This is due to higher than projected take up of the Child and Working Tax Credits in the short term, greater than forecast spending on the Supporting People programme and higher debt interest payments.

Discretionary policy changes

2.55 In considering the impact of additional discretionary policy changes on the fiscal position, the Government has taken into account the following factors:

- the importance of ensuring the fiscal rules are met over the cycle;
- its broader, medium-term objectives for fiscal policy, including the need to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and
- the need to ensure that fiscal policy supports monetary policy.

2.56 Consistent with the requirements of the *Code for fiscal stability,* the updated projections take into account the fiscal effects of all firm decisions announced in this Pre-Budget Report or since Budget 2003. This includes:

- increases in the child element of the Child Tax Credit, which will contribute to reducing the number of children in low income households;
- a package of measures designed to protect tax revenues for the benefit of all taxpayers, including an extension to the VAT strategy to tackle VAT fraud, avoidance and non-compliance; and
- the next steps in the Government's strategy to promote productivity growth through a more enterprising and highly skilled economy, including improvements to the VAT flat rate scheme and a new, clear and more accessible R&D tax credit definition.

2.57 Since September 2001, the Government has spent nearly £2 billion on the war in Afghanistan and to combat terrorism both domestically and abroad. In Budget 2003, the Government made a special contingency provision of £3 billion to meet the costs of the military conflict in Iraq and its other international obligations. Of that special reserve, £1 billion was allocated to the Ministry of Defence DEL in 2002-03 with the rest remaining unallocated. A further £1.3 billion of current spending has been charged against the special reserve in 2003-04. **In this Pre-Budget Report, the Government carries forward the £2 billion unallocated special reserve into 2003-04 and adds a further £500 million taking provision in the special reserve for the year to £2.5 billion. A further £300 million will be added in 2004-05** as a prudent allowance against continuing commitments. This will ensure that the Government is able to meet all its internatonal commitments in Iraq and elsewhere in the war against terrorism.

2.58 The fiscal impact of these and other measures is set out in Table B4. The projections do not take account of measures proposed in this Pre-Budget Report for consultation or other proposals where final decisions have yet to be taken.

FISCAL POSITION AND MEDIUM-TERM PROSPECTS

2.60 Table 2.5 presents a summary of the key fiscal aggregates under the five headings of fairness and prudence, sustainability, economic impact, financing and European commitments. It illustrates the Government's performance against its fiscal rules, and shows that the Government remains on track to meet its strict fiscal rules over the economic cycle.

Table 2.6: Summary of public sector finances

	Per cent of GDP						
	Outturn		Estimate		Projections		
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Fairness and prudence							
Surplus on current budget	–1.1	–1.7	–0.7	–0.4	0.0	0.3	0.6
Average surplus since 1999-2000	1.0	0.4	0.3	0.2	0.1	0.2	0.2
Cyclically-adjusted surplus on current budget	–0.6	–0.8	–0.1	–0.1	0.0	0.3	0.6
Long-term sustainability							
Public sector net debt[1]	30.9	32.8	33.8	34.6	35.1	35.4	35.5
Core debt[1]	31.2	32.2	32.6	33.2	33.7	34.1	34.3
Net worth[2]	24.3	21.5	19.4	16.2	16.0	14.8	14.4
Primary balance	–0.5	–1.7	–0.9	–0.7	–0.4	–0.3	–0.1
Economic impact							
Net investment	1.0	1.6	1.9	2.0	2.1	2.2	2.2
Public sector net borrowing (PSNB)	2.1	3.4	2.6	2.4	2.1	1.9	1.7
Cyclically-adjusted PSNB	1.6	2.4	2.0	2.2	2.0	1.9	1.7
Financing							
Central government net cash requirement	2.1	3.6	2.8	2.6	2.5	2.1	1.8
Public sector net cash requirement	2.1	3.6	2.6	2.3	2.2	1.8	1.6
European commitments							
Treaty deficit[3]	2.1	3.3	2.6	2.4	2.1	2.0	1.8
Cyclically-adjusted Treaty deficit	1.5	2.4	2.0	2.2	2.1	2.0	1.8
Treaty debt ratio[1,4]	37.9	39.3	40.2	40.8	41.1	41.4	41.5
Memo: Output gap	–1.1	–1.4	–0.7	–0.2	0.0	0.0	0.0

[1] *At end March; GDP centred on end March.*

[2] *At end December; GDP centred on end December.*

[3] *General government net borrowing on a Maastricht basis.*

[4] *General government gross debt measures on a Maastricht basis.*

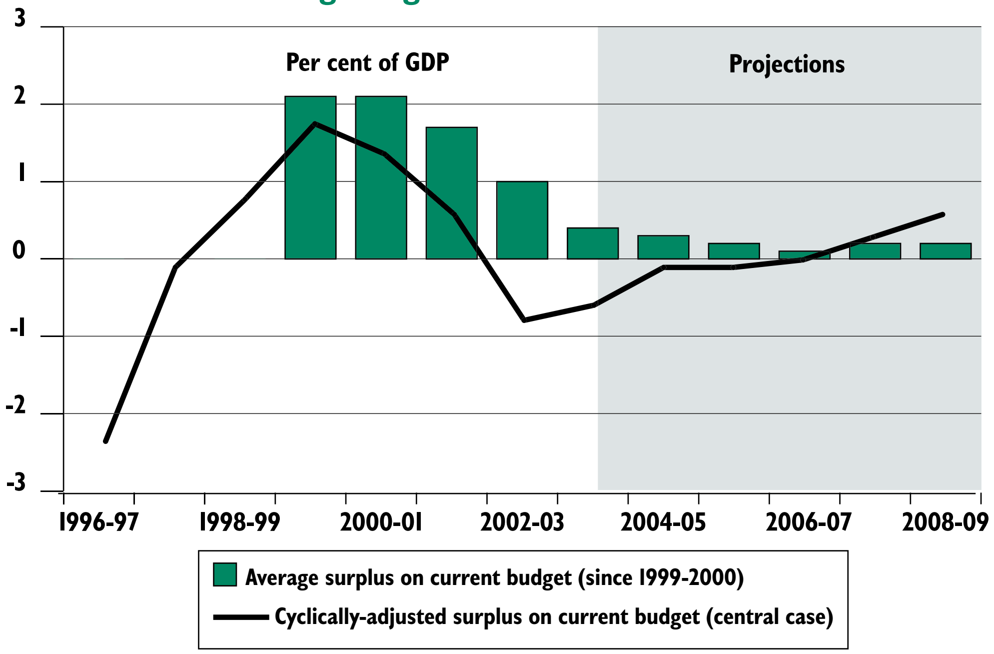
Golden rule

2.61 The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and is therefore an important indicator of inter-generational fairness. Lower receipts and additional spending in the short term means that the deficit on the current budget is forecast to be 1.7 per cent of GDP this year, falling to 0.7 per cent next year and moving back to balance in 2006-07, and showing a surplus of 0.6 per cent of GDP by the end of the projection period.

2.62 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the impact of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began.[8] The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is positive in every year. The economy is projected to return to trend during 2005-06, meaning that over the whole cycle the average annual surplus on the current budget would be around an annual 0.2 per cent of GDP, equivalent to a margin or surplus in this cycle of £14 billion. On this basis, and based on cautious assumptions, the Government is on track to meet the golden rule. If the economic cycle were to have started in 1997-98, the average surplus on the current budget up to 2005-06 would be over 0.2 per cent of GDP.

2.63 The economy is projected to return to trend by early 2006. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2008-09 is 0.1 per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on track to continue to meet the golden rule after the end of this economic cycle.

Chart 2.4: Meeting the golden rule



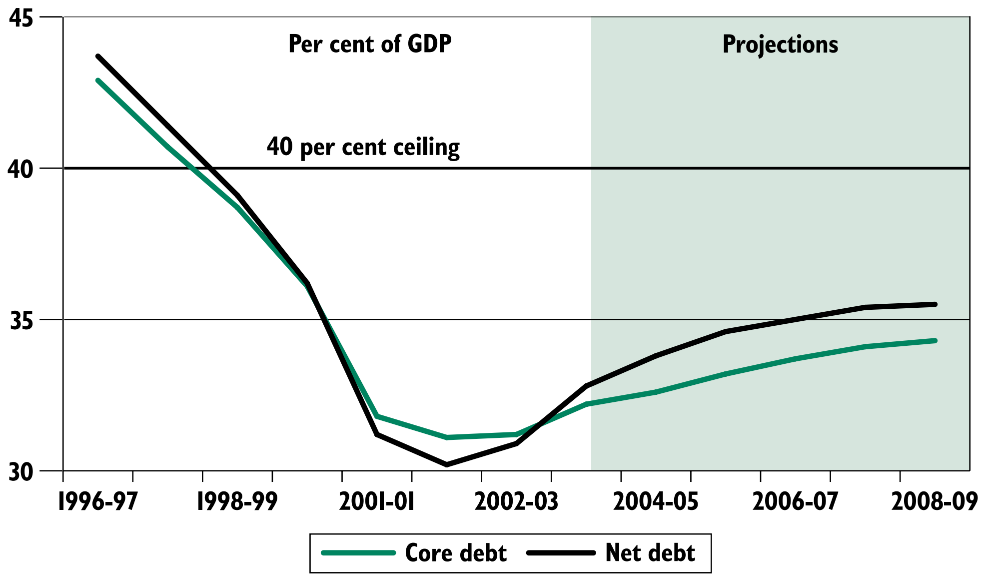
2.64 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

[8] Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002 and performance over past cycles is described in Budget 2000.

Sustainable investment rule

2.65 Chart 2.5 shows that, despite sustained weakness in the world economy, net debt is expected to remain low and stable, rising slightly from 31 per cent to stabilise at 35½ per cent at the end of the projection period – £64 billion below the 40 per cent level. Therefore, the Government comfortably meets its sustainable investment rule. Chart 2.5 also illustrates the Pre-Budget Report projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt is projected to rise to just over 34 per cent of GDP as the Government borrows modestly to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the key objective of inter-generational fairness which underpins the fiscal framework.

Chart 2.5: Meeting the sustainable investment rule



Box 2.6: Public finances in the G7

The table below compares the projections presented in this Pre-Budget Report with those for other G7 countries, as forecast by the European Commission or the OECD. While care needs to be taken when comparing numbers internationally, the UK performs well: gross debt is the lowest in the G7 and the deficit is below the average for the G7 as a whole.

Public finances in the G7

Per cent of GDP	Estimate[a]	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
United Kingdom						
Treaty deficit	3.3	2.6	2.4	2.1	2.0	1.8
Cyclically-adjusted Treaty deficit	2.4	2.0	2.2	2.1	2.0	1.8
Treaty debt	39.3	40.2	40.8	41.1	41.4	41.5
Public sector net investment	1.6	1.9	2.0	2.1	2.2	2.2
	2003	**2004**	**2005**			
France						
Treaty deficit	4.2	3.8	3.6			
Cyclically-adjusted Treaty deficit	3.9	3.3	3.2			
Treaty debt ratio	62.6	64.3	65.6			
Germany						
Treaty deficit	4.2	3.9	3.4			
Cyclically-adjusted Treaty deficit	3.5	3.3	3.0			
Treaty debt ratio	63.8	65.0	65.8			
Italy						
Treaty deficit	2.6	2.8	3.5			
Cyclically-adjusted Treaty deficit	2.1	2.3	3.2			
Treaty debt ratio	106.4	106.1	106.1			
Canada						
Deficit	1.0	0.7	0.8			
Cyclically-adjusted deficit	1.1	0.6	0.7			
Gross debt ratio	77.3	74.8				
Japan						
Deficit	7.4	6.8	6.9			
Cyclically-adjusted deficit	6.9	6.5	6.6			
Gross debt ratio	155.7	164.1				
USA						
Deficit	4.9	5.1	4.9			
Cyclically-adjusted deficit	4.5	5.1	5.0			
Gross debt ratio	63.8	65.7				
G7 average[b]						
Deficit	3.9	3.7	3.6			
Cyclically-adjusted deficit	3.5	3.3	3.4			
Gross debt ratio	81.2	82.8	69.4			

Source: data for EU countries excluding UK from European Commission autumn forecasts; non-EU countries from OECD: borrowing figures from OECD Economic Outlook 74 (preliminary version, November 2003), debt figures from OECD Economic Outlook 73 (June 2003). The fiscal aggregates forecast by the OECD are slightly different from those forecast by the European Commission, deficit refers to deficit on general government financial balance, gross debt to general government gross financial liabilities.

[a] The 2003-04 figures were projections in Budget 2003.

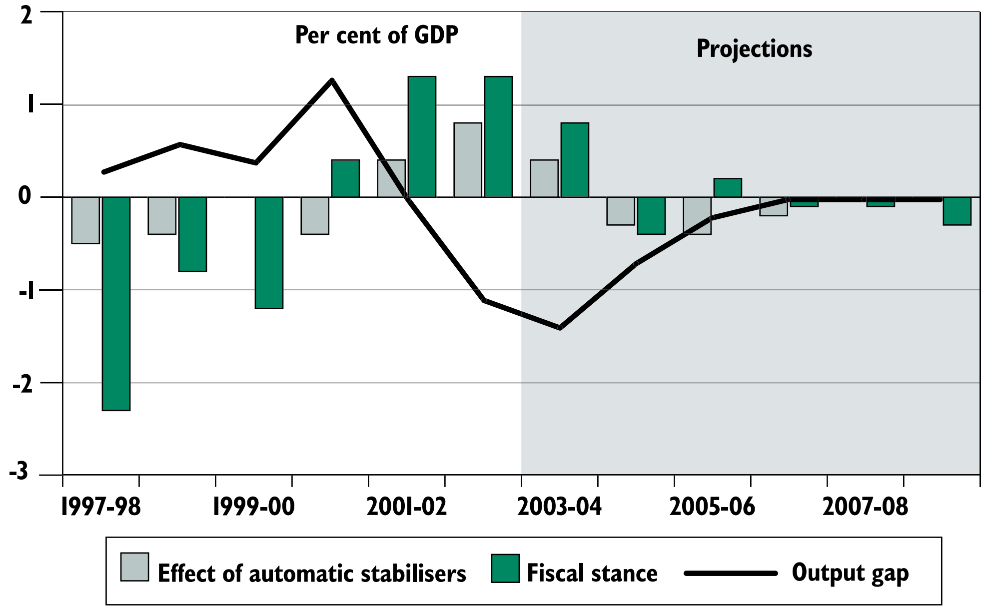
[b] Unweighted average (financial year figures used for UK).

Economic impact

2.66 While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.6 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy.

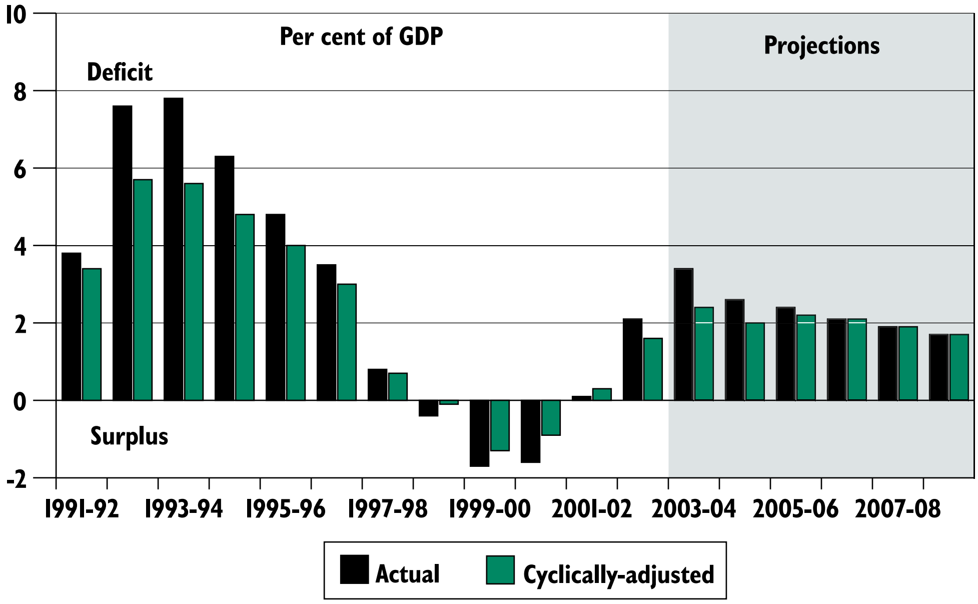
2.67 During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. As the economy has moved below trend so the fiscal stance has eased, helping to maintain economic stability. Over the next few years, as the economy returns to trend, fiscal policy moves towards a more neutral stance.

Chart 2.6: Fiscal policy supporting monetary policy



2.68 Modest levels of borrowing over the forecast period reflect sustained capital investment in public services, and is fully consistent with meeting the Government's firm fiscal rules.

Chart 2.7: Public sector net borrowing



Financing

2.69 As a result of the new projections for the fiscal balances, the forecast for the central government net cash requirement for 2003-04 has been revised from £35.3 billion to £40.5 billion. Accordingly, it has been decided to meet the increased financing requirement by increasing gross gilt sales by £2.3 billion to £49.7 billion. Full details and a revised financing table can be found in Annex B.

European commitments

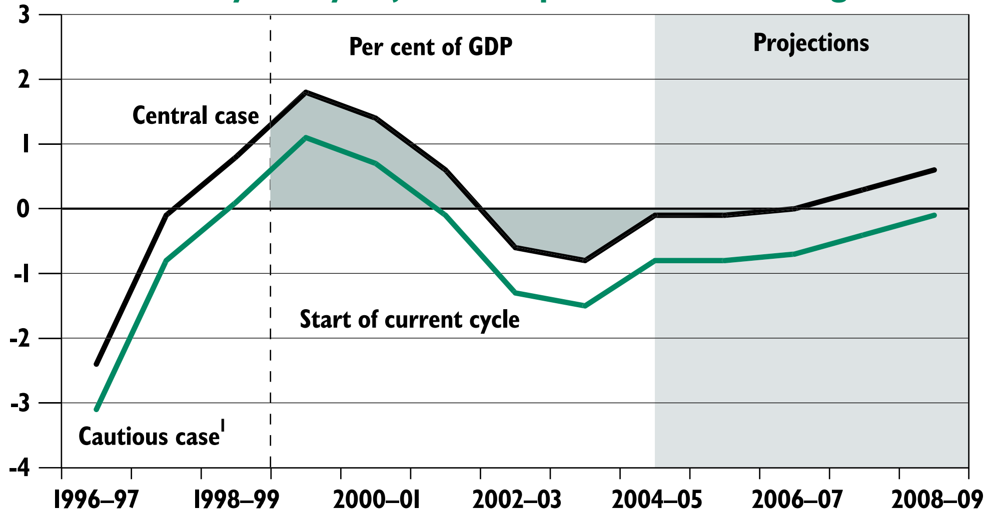
2.70 The Government supports a prudent interpretation of the Stability and Growth Pact as described in Box 2.7. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in this Pre-Budget Report, which show the Government on track to meet its fiscal rules over the cycle, low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with the prudent interpretation of the Pact. Box 2.6 also shows that the UK's public finances compare favourably to other G7 countries. As usual, the Treasury is sending a copy of an updated Convergence Programme to the European Commission. The updated annual Programme is subject to the usual UK parliamentary scrutiny and approval.

Dealing with uncertainty

2.71 Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. The use of cautious assumptions audited by the NAO builds a margin into the public finance projections to guard against unexpected events. To accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term, the Government bases its public finance projections on a trend growth assumption that is ¼ percentage point lower than its neutral view.

2.72 A second important source of potential error results from misjudging the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart 2.8 illustrates the Pre-Budget Report projection for this cautious case.

Chart 2.8: Cyclically-adjusted surplus on current budget



[1] *Cautious case assumes trend output one percentage point lower in relation to actual output than in the central case.*

2.73 The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. Combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, the Government can now draw on this margin to safeguard the increase in investment in priority public services, fully meet the UK's international commitments and allow the automatic stabilisers to work in full following a period of global economic uncertainty, while remaining on track to meet the fiscal rules.

2.74 Drawing on this margin means the average surplus on the current budget in the cautious case is no longer positive, though the Government is on track to meet the golden rule. The projections show that this margin is being rebuilt at the end of the projection period as the current budget moves into surplus and the cyclically-adjusted surplus in the cautious case moves back to balance. In the meantime, the Government will remain vigilant to the risks and continue to base projections of the public finances on cautious assumptions.

Box 2.7: The Stability and Growth Pact

The Stability and Growth Pact is intended to ensure that EU Member States maintain sound public finances. Fiscal sustainability is a prerequisite for macroeconomic stability, and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy co-ordination.

The Government supports a prudent interpretation of the Pact that builds on the Code of Conduct, agreed by Member States in June 2001 and the report agreed by EU Finance Ministers on strengthening budgetary co-ordination in June 2003. A prudent interpretation would lock in long-term fiscal discipline and sustainability, enhancing credibility across the economic cycle, while allowing the automatic stabilisers to smooth fluctuations in output, and allow appropriate increases in investment in public services. Specifically, it would take into account all the following factors in applying a country by country approach to assessments of compliance with the medium-term fiscal objective of 'close to balance or in surplus':

- **the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy. It is therefore welcome that the Council and Commission now focus more on cyclically-adjusted fiscal balances when assessing the public finances, and hence recognise the importance of avoiding pro-cyclical fiscal policy;**
- **sustainability – low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of the sustainability of the public finances should also take into account the long-term budgetary impact of ageing populations, such as that set out in the *Long-term public finance report*, published alongside the 2003 Pre-Budget Report; and**
- **public investment – against a background of sound public finances and economic stability and subject to the sustainable investment rule, public investment contributes to the provision of high-quality public services and can help to**

Long-term fiscal sustainability

2.75 While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects on long-term growth. It would also be inconsistent with the principles of fiscal management as set out in the *Code for fiscal stability.* Many developed countries face significant challenges over the long term as a result of ageing populations. For example, the demand for health care is likely to rise as a result of the increased number of older people.

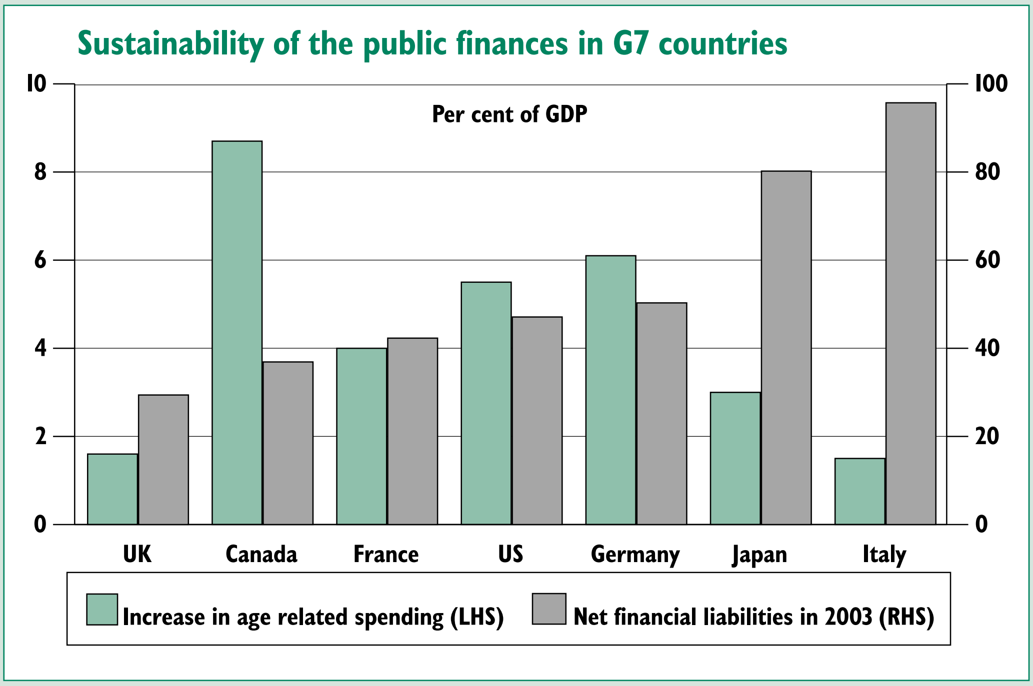
2.76 An improved and updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2003 *Long-term public finance report.* The report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances, updating the illustrative long-term projections set out in Budget 2003. To provide a comprehensive and robust analysis, the report:

- shows performance against a wide range of indicators;
- includes analysis based on different population projections to test the robustness of the conclusions; and
- provides spending projections for education, health and pensions.

2.77 The report shows that, based on reasonable assumptions, the public finances are sustainable in the longer term, and that the UK is well placed relative to other countries to meet the challenges of an ageing population. Current consumption can grow slightly faster than GDP growth in the long term while still meeting the golden rule. Public sector net investment can grow close to the economy's growth rate over the next 30-years without jeopardising the sustainable investment rule, and the net debt to GDP ratio is projected to remain below 40 per cent.

Box 2.8: Comparisons of long-term fiscal sustainability within the G7

The challenges posed by an ageing population on the public finances vary considerably between countries. The chart below shows the ratio of net financial liabilities (net debt) to GDP of the G7 countries in 2003 and the projected increase in age-related spending.[a]



Source: Net financial liabilities from OECD Economic Outlook 73 (June 2003), Increase in age-related spending for UK from 2003 Long-term public finance report, other EU countries from European Union's Economic Policy Committee's working group on ageing 2003 and for non-EU countries from OECD Economic Outlook 69 (June 2001).

A number of countries face large projected increases in age-related spending over the next 50 years, mainly resulting from greater pension payments and higher spending on health and long-term care. Of those countries with relatively small projected increases in age-related spending, some have high starting levels of debt. In contrast, the UK has the lowest debt to GDP ratio in the G7 and faces only a relatively small increase in age-related spending, illustrating that the UK is well placed to meet the long-term challenges to the public finances.

A more detailed analysis of long-term trends and sustainability in different countries is presented in Chapter 6 of the 2003 *Long-term public finance report*.

[a] *Defined primarily as the change in spending on pensions, health, long-term care and education between 2008-09 and 2052-53 for the UK and between 2000 and 2050 for others.*

MACROECONOMIC STABILITY AND THE HOUSING MARKET

2.78 The housing market in the UK has often been associated with instability in the economy as a whole. Pronounced cycles in the housing market have been a notable feature of the UK economy over the past three decades and have affected the wider economy through private consumption. Housing is a key asset for households and household spending is closely associated with changes in housing wealth. Reducing volatility in the housing market will therefore help promote macroeconomic stability.

2.79 A number of structural features may contribute to the high levels of housing market volatility in the UK compared to other European countries, and could explain the strong link to consumption:

- the low responsiveness of housing supply to demand in the UK, which has contributed to the strong rise in real house prices in the UK and tends to increase house price volatility;
- the dominance of variable rate mortgages and high level of mortgage debt combine to explain both households' sensitivity to interest rate changes and the strong link between the housing market and consumption in the UK; and
- high levels of owner occupation, as compared to renting, and the ability of households to withdraw equity from housing adds to the impact of changes in housing wealth on consumption.

2.80 A reduction in housing market volatility could help enhance macroeconomic stability if the UK were to remain outside EMU. Should the UK join EMU, it would become more important as the housing market forms an significant part of the monetary transmission mechanism – the means by which interest rates affect the wider economy.[9]

2.81 The Government has recognised that reforms in the housing market are needed to reduce volatility and promote stability in the wider economy, and particularly importantly to increase the supply of affordable housing. Budget 2003 announced reforms in this area, and a step change in the planning system. The Chancellor asked Kate Barker to analyse the issues surrounding housing supply in the UK. Details of the interim report by Kate Barker are presented in Chapter 3.

2.82 At the time of Budget 2003, the Chancellor also asked David Miles to review the mortgage market in the UK, to consider why, unlike in many other developed economies, very little mortgage debt in the UK is at longer-term fixed interest rates. Attention was to be paid to both supply and demand factors, and the examination of whether any market failure held back the development of this market, and the associated opportunities, risks and potential costs. An interim report was published on 9 December 2003. The Government will consider the interim report carefully and looks forward to the final report, which is due by Budget 2004.

[9] *Housing, consumption and EMU*, HM Treasury 2003.

Box 2.9: The Miles Review interim report

The dominance of variable rate mortgages has been associated with higher levels of housing market volatility in the UK. In Budget 2003, the Chancellor asked David Miles to review the mortgage market to consider why, unlike in many other developed countries, very little mortgage debt is at longer-term fixed interest rates. The Miles Review interim report analyses this and considers whether there are obstacles to the development of a larger market where interest rates are fixed for longer periods than is currently common.

The Report states that the following demand side factors are preventing the emergence of a larger market in longer-term fixed-rate mortgages:

- when choosing between mortgages, many borrowers attach too great a weight to the level of initial monthly repayments and too little to the likely overall cost of borrowing over the life of the loan;
- many borrowers' understanding of risk is poor. On average, longer-term fixed-rate mortgages are likely to have interest rates slightly above variable-rate mortgages but the added certainty over future payments is worth something – it can give homeowners insurance against unexpected changes in interest rates. If risk is not well understood by households this will not be appreciated; and
- the way in which many mortgage lenders compete for new business results in cross-subsidisation from existing borrowers paying Standard Variable Rates to new borrowers taking out discounted variable and short-term fixed-rate mortgages. This practice makes longer-term fixed-rate mortgages appear expensive when judged against the initial cost of discounted variable-rate mortgages.

The Report also considers a number of potential constraints to a larger market in longer-term fixed rate mortgages on the supply side. Some of these factors would probably prove temporary if greater demand emerged. For example, constraints due to insufficient liquidity or the inability of lenders to assess the pre-payment risk associated with fixed-rate products would ease as the market developed and lenders experience of pre-payments grew. Other constraints, such as capital requirements, accounting rules and legislative constraints on building societies might require a policy response to enable the market to develop properly.

The macroeconomic implications of the way in which households choose mortgages and the way in which mortgages are funded and priced are also analysed in the Report. Here the current functioning of the mortgage market is found to have adverse macroeconomic consequences for the wider economy. Borrowers tendency to focus excessively on the initial cost of a mortgage makes the housing market and wider economy more sensitive to short-term interest rate changes than it would otherwise be. This can make monetary policy more difficult to operate.

The Report does not see the UK mortgage market as fundamentally flawed and finds no evidence of classical anti-competitive behaviour. However, there are concerns that some features of the market are not working as well as they should and in the interests of all borrowers. In addition to his continuing consultation with market practitioners and others, David Miles now intends to have detailed discussion with the FSA and OFT. The report states that, in the light of these discussions, he will consider whether in his final report he should include, among his wider recommendations, a recommendation for action from the FSA or the OFT under their respective powers. The final report will be published at the time of Budget 2004.

3 MEETING THE PRODUCTIVITY CHALLENGE

Productivity growth underpins strong economic performance and sustained increases in living standards. The Government's long-term goal is for Britain to achieve a faster rate of productivity growth than its main competitors. Productivity growth requires flexible markets and an economy which can promote enterprise and fairness together. Building on the reforms and initiatives already introduced, the Pre-Budget Report sets out the next steps the Government is taking to strengthen the drivers of productivity growth:

- **reforms to reduce the regulatory burden on enterprise,** including improvements to the VAT flat-rate scheme to ensure more businesses can benefit fully from compliance savings;
- **measures to overcome barriers to raising finance for small business**, including a pathfinder round of Enterprise Capital Funds and proposed enhancements to Venture Capital Trusts and the Enterprise Investment Scheme;
- **launching an independent review of the Small Firms Loan Guarantee**, to ensure its effectiveness;
- measures to support regional growth, including **details of the Local Authority Business Growth Incentives scheme**, which will boost the role of local authorities in promoting growth, and, in Enterprise Areas, **a Business Premises Renovation Allowance**;
- measures to promote **a step change in the UK's enterprise culture, including supporting a national campaign by Enterprise Insight**;
- **a new, clearer and more accessible R&D tax credit definition**, which will promote the development of science and innovation;
- **an extension of Employer Training Pilots** to encourage skills training for a third year and to cover over a third of England;
- **publication of the interim report of the Barker Review on the factors affecting housing supply in the UK**; and
- **consulting on the most appropriate structure for a tax transparent property investment trust**, as recommended in the interim report of the Barker Review.

MEETING THE PRODUCTIVITY CHALLENGE

3.1 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. The UK has historically experienced low rates of productivity growth by international standards, as a result of macroeconomic instability and market failures. The Government's long-term goal is for Britain to achieve a faster rate of productivity growth than its main competitors.

3.2 Productivity growth requires a flexible economy that can promote enterprise and fairness together. Product market flexibility represents the ease with which firms are able to adapt to changing market conditions. Increased flexibility enables individual enterprises or industries to respond rapidly to change, allowing them to exploit new opportunities and to deal with potential challenges effectively. Flexibility provides firms with the scope to succeed in a competitive market environment. Capital markets contribute to the flexibility of the economy by ensuring that capital is employed effectively and providing the finance needed to allow firms to cope with economic shocks. Annex C of this Pre-Budget Report describes progress in raising flexibility across the UK's labour, product and capital markets.

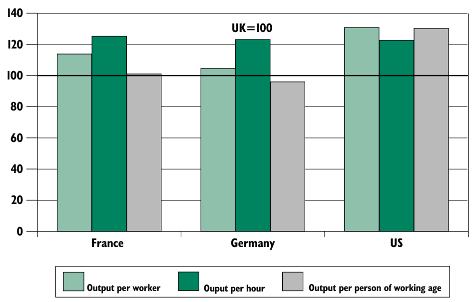
3.3 Chapter 4 describes how employment is currently at record highs, having risen by 1.7 million since spring 1997. Sustained employment growth has made the aim of raising overall productivity more challenging. New workers tend to have lower than average productivity as they take time to learn job-specific skills, an issue discussed in Box 3.1. This effect is likely to have resulted in lower productivity growth than would otherwise be the case in a growing economy. However, the Government is determined to achieve higher productivity growth alongside employment opportunity for all.

Box 3.1: Assessing UK productivity and employment performance

Productivity and employment are both important determinants of welfare. Chart (a) shows that UK productivity remains relatively low. US workers produce on average 31 per cent more than UK workers, French workers produce 14 per cent more and German workers 5 per cent more.[a] The productivity gap, on an output per hour basis, is 23 per cent with Germany and the US, and 25 per cent with France.

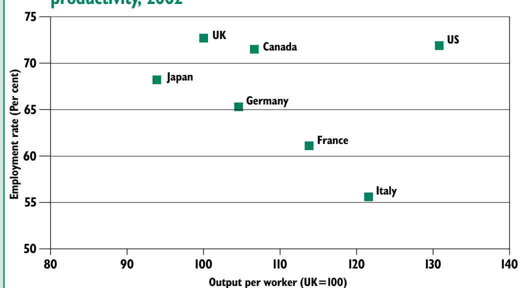
However, Chart (b) shows that the UK has a higher rate of employment than any other G7 country. The UK's relative economic performance is therefore better under measures that take into account both employment and productivity. Chart (a) indicates that comparisons of output per person of working age significantly narrow the gap between the UK and its European counterparts. This measure indicates how effectively an economy includes all of its potential workers in productive employment.

Chart a: International comparisons of productivity, 2002



Sources: Output per worker and output per hour (experimental) measures based on OECD/ONS data.
Output per person of working age: HMT estimate based on OECD data.

Chart b: International comparisons of employment and productivity, 2002



Source: OECD.

Strong employment performance may dampen productivity growth. This is because new workers entering employment take time to learn the job-specific skills that are necessary to raise their productivity to the average level. However, increasing the labour supply reduces the amount of labour wasted and makes the economy as a whole more efficient. Performance on this basis is reflected in output per person of working age data.

The position of the US in Chart (b) shows that it is possible to combine both high employment and productivity. The challenge for the UK is to increase productivity while maintaining high employment, by continuing to promote competition, enterprise, innovation and investment in the economy.

[a] Based on most recent OECD and ONS data. Estimates by the Treasury suggest that recent revisions to ONS population estimates would change productivity gaps to 31.6 per cent for the US, 14.5 per cent for France and 5.2 per cent for Germany.

3.4 This chapter describes the steps the Government is taking to raise productivity and promote enterprise in the UK. It focuses on five key drivers of productivity performance:

- improving **competition**, which promotes flexible markets and increases business efficiency and consumer choice;
- promoting **enterprise**, through measures aimed at removing barriers to entrepreneurship and developing an enterprise culture;
- supporting **science and innovation,** to promote the development of new technologies and more efficient ways of working;
- raising **skills levels,** to create a more flexible and productive workforce; and
- encouraging **investment,** to increase the stock of physical capital through stronger, more efficient capital markets.

Monitoring progress on the five drivers

3.5 The Government is considering options for further developing the monitoring of progress on the drivers of productivity. In the new year, the Treasury and the Department of Trade and Industry will publish a consultation document proposing a short set of indicators for monitoring the UK's performance against the drivers. These indicators will build on the *UK productivity and competitiveness indicators 2003*[1] and wherever possible will include indicators that are annually updated and benchmarked internationally. International comparisons of productivity figures are based on OECD purchasing power parity data. While this provides a useful measure of the productivity gap, it is not ideal for comparisons over time – the consultation document will examine other methods.

Productivity in the regions

3.6 The Government is committed to ensuring that the benefits of improved productivity are spread throughout the country. Its goal is to make sustainable improvements in the economic performance of all UK regions and, over the long run, reduce the persistent gap in growth rates between the regions. The Regional Development Agencies (RDAs) are an important part of the Government's strategy for delivery of this goal. They are the strategic leaders of economic development and regeneration in the regions, and work in partnership with key national, regional, sub-regional and local bodies, such as the local Learning and Skills Councils and the Small Business Service (SBS). Building on these partnerships, the Government launched pilot schemes in April 2003, giving RDAs in selected regions a wider role in driving forward economic development.

[1] *UK productivity and competitiveness indicators 2003*, DTI Economics Paper No.6, November 2003.

3.7 Recognising the pivotal role that they have in promoting economic development, the RDAs have been asked to contribute to the development of Budget 2004 in five areas:

- barriers to business start-ups;
- provision of government services to small businesses;
- access to finance for small and medium-sized firms;
- barriers to skills provision; and
- knowledge transfer between businesses and universities.

3.8 The RDAs have also been asked, in advance of Budget 2004 and the 2004 Spending Review, to identify the top ten institutional and administrative barriers that are hindering effective coordination of policy decisions and service delivery in the regions.

European economic reform

3.9 The Government is continuing to press for changes that will improve the flexibility of the European economy and so enhance its productivity performance. In the past, Europe has sometimes adopted economic strategies that were insufficiently responsive to changing economic circumstances, overly uniform, or too insular. The Government believes that the EU needs to be flexible, reforming, open and globally orientated. In the context of globalisation, it needs to capitalise on the diversity of its economies and the Government will work for further progress at next spring's European Council on economic reform.

International trade and productivity

3.10 Alongside regional, national and European reforms, the Government is determined to promote productivity by increasing international trade. Openness to trade helps to drive economic growth and productivity by encouraging a more efficient allocation of resources, heightening competitive pressures and encouraging firms to adopt new technologies and better management practices. Chapter 5 describes the action the Government is taking to revive the Doha Development Agenda talks to reduce trade barriers. It is also pressing for enhanced economic cooperation between the EU and US, to address unnecessary non-tariff barriers hindering transatlantic trade.

COMPETITION

3.11 Competition is a key driver of productivity and promotes more flexible product and capital markets. Competition provides opportunities for entrepreneurs to start and develop new businesses and creates incentives to innovate and invest for the future. Competitive markets and empowered consumers put downward pressure on prices and give consumers greater choice.

The competition framework

3.12 The Government has worked to ensure that the UK consumer and competition regime ranks among the best in the world. The 2003 Global Competition Review[2] ranked the UK competition regime joint second in the world behind the US, as shown in Table 3.1. With implementation of the Enterprise Act in June 2003, this regime has been strengthened further and the focus is now on ensuring that the benefits of the new regime are realised quickly.

Table 3.1: Global Competition Review rankings of competition regimes

	G7 comparison			
Rank	**2000**	**2001**	**2002**	**2003**
1st	Germany	US (DoJ)	US (DoJ) US (FTC)	US
2nd	US (DoJ)[1] Italy	Germany Italy	**UK** France[5] Germany	**UK** Germany
3rd	US (FTC)[2] **UK** (CC)[3] EU	**UK** (CC) **UK** (OFT) US (FTC)	EU Italy	EU
4th	**UK** (OFT)[4] France	Canada EU France	Canada Japan	Canada France Italy Japan
5th	Japan			

[1] US (DoJ) – Department of Justice, Antitrust division.
[2] US (FTC) – Federal Trade Commission.
[3] UK (CC) – Competition Commission.
[4] UK (OFT) – Office of Fair Trading.
[5] France's rating for 2002 covered agencies working without the burden of compulsory merger notification.

Source: Global Competition Review annual survey.

Note: This survey ranks the performance, transparency and accountability of international competition enforcement agencies, based on the views of businesses that have had dealings with them. This table shows the rankings for G7 members. US competition institutions were assessed separately until this year, and UK institutions were assessed separately until 2002.

[2] Global Competition Review, The International Journal of Competition Policy and Regulation, 2003.

Competition in specific markets

3.13 The Enterprise Act has significantly strengthened Britain's competition regime. In particular, it has given the competition authorities a flexible tool to investigate markets where there may have been no explicit breach of competition law but where the market may not be working well for consumers. The Office of Fair Trading (OFT) can also carry out market studies on Government regulation. The Government is committed to addressing their findings.

Professions

3.14 Following the OFT's report on competition in the professions,[3] the Department for Constitutional Affairs (DCA) announced in July 2003 that David Clementi would lead an independent review into regulation of the legal services market. The review, which will report in December 2004, aims to promote competition and innovation, and improve services for the customer. In July 2003, the DCA also published a consultation paper on the future role of Queen's Counsel, a system identified by the OFT as potentially distorting competition. The consultation closed in November 2003 and **the Government will announce its policy decisions in February 2004.**

Taxis

3.15 The Government welcomes the OFT study into the Taxi and Private Hire Vehicle market.[4] Taxi services are an important provider of local transport, particularly for those on lower incomes and in rural areas. Work is already under way in the Department for Transport to implement the recommendation on quality and safety rules. The OFT also concluded that quantity restrictions on taxi licenses, which 45 per cent of local authorities apply, act as a barrier to entry, increase waiting times and have a negative impact on personal safety. Stakeholders are being consulted so that a rapid decision can be made about the way forward. **An announcement will be made in early 2004.**

Payment systems

3.16 The Government welcomes moves made by payment system participants to address some of the competition issues identified by the Cruickshank report on competition in UK banking.[5] However, the Government considers that problems remain and that an increased focus on competition in the industry would deliver significant benefits. It believes that the OFT could provide this focus and address the remaining concerns, in advance of any legislation. **The OFT will shortly take on an enhanced role in relation to payment systems for a period of four years.** The Government will then review competition in the industry and will legislate unless there has been a significant improvement. Further details on these proposals will be announced by the OFT in due course.

Employers' liability compulsory insurance

3.17 The Department for Work and Pensions published a review of the operation of employers' liability compulsory insurance this month. It concludes that the market has not failed, but recognises the difficulties many businesses face due to rapid increases in premiums and sets out an agenda for action by the Government and stakeholders to improve the working of the market. The OFT will keep the liability insurance market under review.

[3] *Competition in professions*, A report by the Director General of Fair Trading, March 2001.

[4] *The regulation of licensed taxi and private hire vehicle services in the UK*, Office of Fair Trading, November 2003.

[5] *Competition in UK banking: a report to the Chancellor of the Exchequer*, Don Cruickshank, March 2000.

Competition in regulated industries

Energy **3.18** Liberalisation in energy markets has boosted competition, delivered lower gas and electricity prices, and reduced the need for regulation. The Energy Bill, currently before Parliament, will extend New Electricity Trading Arrangements to the Scottish electricity market by April 2005, giving Scottish consumers the competitive benefits enjoyed by those in England and Wales, while allowing generators fair and open access to the market.

Water **3.19** The provisions of the Water Act, which received Royal Assent in November 2003, will extend opportunities for competition to non-household consumers who use large quantities of water. The Office of Water Services (Ofwat) will invite applications from prospective new licensees from summer 2005, with the new regime fully in place from autumn 2005. A review of the competition framework, including the 50 megalitre threshold above which competition applies, will be undertaken within three years of the commencement of the regime.

Communications **3.20** From December 2003, Ofcom will have powers to investigate abuses of competition within broadcast markets in addition to exercising the powers in telecommunications markets previously held by the Office of Telecommunications. The Communications Act aligns the merger regime for newspapers and media ownership with general merger processes, while ensuring that the principles of media plurality and freedom of speech are maintained.

Financial services **3.21** The market environment in financial services is rapidly evolving. Small businesses represent just under 90 per cent of the firms regulated by the Financial Services Authority (FSA). The Government has announced a review of the Financial Services and Markets Act two years after it came into force. The review will consider three key issues: the impact of the Act on competition; changes to the FSA and possible changes to the operation of the Financial Ombudsman Service; and simplifying the boundary of FSA regulation.

Empowering consumers

3.22 Empowered consumers are able to make effective market choices, promoting competition and driving business and economic performance. To fulfill this role effectively, consumers need the right tools, including the right to take action, access to redress for damage and good quality information.

3.23 The DTI is currently reviewing the UK consumer framework and in October 2003 published a comparative report on approaches in different countries. The report found that the UK had some important strengths, including strong consumer rights, good advice to consumers, and consumer representation at a national level. The regime has also been strengthened by the recent Enterprise Act, which introduced Stop Now Orders, and allowed the competition authorities to investigate markets that are not working in the interest of consumers. However, the report did identify areas for improvement, including the absence of a general duty to trade fairly underlying all transactions, poor mechanisms for redress and the fragmented nature of the UK enforcement regime. **The Government will publish the conclusions of this review in 2004.**

3.24 The Government is committed to excellent consumer representation in regulated industries and has made reforms to put consumer interests at the heart of sectoral regulation. To test the effectiveness of these reforms, the DTI and the National Audit Office (NAO) have jointly commissioned a benchmarking study of Energywatch and Postwatch, as part of a wider review of the operation of these bodies, with a view to maximising the benefits they bring to consumers. **It will be completed in spring 2004.**

Competition in the supply of goods and services to Government

3.25 The Government is committed to achieving value for money through improving procurement (as set out in Chapter 6). The Office of Government Commerce (OGC) has today published a report, *Increasing competition and improving long-term capacity planning in the Government market place* and an associated Action Plan. These identify measures to improve the way the public sector engages with potential suppliers, including:

- increased consultation with business so that supplier lead times and information requirements are better understood. For example, **a 'suppliers/buyers' forum led by OGC will maintain regular dialogue with industry representatives,** who will help to develop the Action Plan;
- professional relationship management, such as the **implementation by September 2004 of public sector plans to improve the information given to suppliers about future requirements.** This will involve the use of a broader range of tools such as bid conferences, websites and trade fairs; and
- **the Government will also take action to strengthen public sector procurement infrastructure,** to deliver stronger leadership and enhance commercial skills.

3.26 The joint Cabinet Office and OGC report, *Making a difference: reducing bureaucracy in central civil Government procurement*, to be published on 15 December 2003, will make other improvements to the Government market place, for example by setting targets for reducing bureaucracy and supplier costs.

3.27 The Government is committed to encouraging small businesses to compete for contracts to supply the public sector. It has accepted the recommendations made by the Better Regulation Task Force and the Small Business Council in their report, *Government: supporter and customer?* The OGC and SBS have now begun to pilot measures to help small- and medium-sized enterprises (SMEs) overcome barriers to doing business with government. Results will be reported in the summer and, taking into account lessons learnt, **measures for small businesses will be rolled out nationally.**

3.28 The Government is working for strong markets and competition in overseas markets as well as in the UK. **It has therefore asked Alan Wood, Chair of the Economic Policy Committee of the Engineering Employers' Federation and Chief Executive of Siemens in the UK, to review UK businesses' experiences of accessing public contracts in Europe** and to report back in summer 2004 on how to improve the ability of UK firms to compete effectively for public procurement contracts in other EU countries.

Competition in the EU

3.29 Revised European competition laws will come into effect over the next few months. These revisions modernise the European regime for dealing with anti-competitive agreements and abuses of dominant positions. They include a number of improvements to strengthen the involvement and responsibilities of national competition authorities, with the European Commission able to adopt a more proactive and strategic role. This provides an opportunity for the Commission to develop its capacity to investigate markets, as well as respond to cases. It has already taken some steps in this direction, announcing a study of European competition issues in the market for professional services. The Government welcomes this and would like to see this approach taken further in future.

3.30 New EU merger rules have recently been agreed which should improve handling of merger cases. In particular, the test that mergers are considered against will change to prohibit all mergers which would significantly impede effective competition. This will make the test simpler, more economically grounded and closer to practice in other jurisdictions such as the US and UK. Alongside improvements to competition policy, the Government continues to press for reform of the state aid regime to underpin strong competition across the EU, described further in Box 3.2.

Box 3.2: EU state aid reform

Strong and effective regulation of state aid is central to a competitive and prosperous European economy. The Government has three key objectives for state aid reform within the EU, aimed at achieving less and better state aid:

- **to reduce state aid that undermines competition, focusing especially on the most distorting aids;**
- **to target state aid on promoting structural reform, by addressing clearly identified market failures; and**
- **to ensure the state aid system operates efficiently and effectively.**

Good progress has been made at the EU level, both in bringing aid levels down and in shifting the balance of state aid away from specific firms toward 'horizontal objectives' which target specific problems or market failures.

In the UK, this shift has been reflected in schemes such as the Regional Venture Capital Funds, approved under recently introduced horizontal risk capital guidelines, which were an important step in allowing capital market failures to be tackled. The European Commission has also approved a number of important UK state aid schemes to support regeneration. These now enable the UK to address market failures that prevent the regeneration of brownfield sites.

While the EU rules on state aid have been improved over recent years, more needs to be done. In particular, the Government has actively promoted proposals for a significant impact test to allow aid which does not significantly distort trade and competition to be approved quickly. It will use the forthcoming review of regional aid to press for a regime which allows the economic causes of under-performance to be tackled at the local level wherever they occur.

ENTERPRISE

3.31 A strong entrepreneurial base is an essential driver of growth and prosperity in a modern economy. The Government's vision is that anybody with the talent, potential and drive to succeed in business should have the opportunity and support to do so, regardless of their background, in a culture which values and supports entrepreneurship. A thriving and dynamic small business sector is also key to economic flexibility, as new businesses bring new or improved products and services to consumers, increasing competition and challenging existing businesses to improve their own performance.

Services to small businesses

3.32 The SBS is responsible for working across government to deliver this vision, ensuring that the UK is the best place in the world to start and grow a business. The SBS is the Government's centre of expertise on small business issues, developing innovative new approaches to meeting the needs of small business at the national, regional and local levels. The SBS will shortly publish a Government Action Plan, developing its strategy and setting out the measures that government as a whole will take to make this aim a reality.

3.33 To succeed in business, current and potential entrepreneurs need to know where to find the right advice, information, training or funding. Business Link, the publically funded service providing help, information and advice to businesses across England, has achieved a substantial increase in take-up of its services and an improvement in customer satisfaction during 2003, with 43 per cent more enquiries from people seeking advice on starting up new businesses. Improvements in Business Link will be reinforced in 2004 with a new service to advise and support anyone setting up in business.

businesslink.gov.uk

3.34 **In April 2004, the Government will launch the new businesslink.gov.uk website,** which will provide an online service for business advice, helping users to understand the regulatory requirements on their business together with the support that is available.

3.35 The website, businesslink.gov.uk will include a new online training directory for SMEs. As announced in Budget 2003, a steering group chaired by Sue Brownson has been advising the Government on the establishment of this service. It will be available to all firms, offering a choice of online courses provided by *learndirect* and a directory of other courses across the UK. It will be promoted to business customers by banks and the Business Link network working together.

Encouraging SMEs to export

3.36 Even though they make up 99 per cent of UK firms, less than three quarters of exporters are small businesses. The Government wants more small businesses to take advantage of export opportunities. The internet is opening up new markets and making cross-border trade easier, but SMEs can face particular barriers when exporting. Access to advice and information is particularly important, as is the availability of external sources of finance to ensure smooth cash flow. The Government is taking steps to help small businesses expand into export markets, including:

- the businesslink.gov.uk website, which will provide a new gateway for firms seeking a one-stop source of advice on how to expand into export markets;
- the range of training, information and advisory services provided by UK Trade and Investment, which supports UK companies trading internationally, is particularly relevant to the needs of SMEs. Its Passport programme, delivering training, planning and ongoing support on a regional basis for new and inexperienced exporters, has recently been expanded; and
- helping small businesses overcome barriers to accessing finance, the measures outlined below will help firms access financial support that many firms need to grow, including into overseas markets.

Improving access to finance

3.37 For enterprise to thrive, innovative businesses need access to finance. The joint SBS and Treasury consultation paper, *Bridging the finance gap*, published alongside Budget 2003, presented evidence that a small but important minority of innovative growth-oriented businesses continue to face difficulties in attracting funding.

3.38 The Government is already working to stimulate private sector provision of risk capital. Over £3 billion of investment has been made through the Enterprise Investment Scheme (EIS) in the past five years, and Venture Capital Trusts (VCTs) have raised over £1 billion in the same period. The Regional Venture Capital Funds, the UK High Technology Fund and the Early Growth Funding programme will collectively invest around £400 million in businesses otherwise affected by the equity gap at the sub-£500,000 level. The Government has also introduced specific measures to improve access to finance in the UK's least prosperous communities, including the Phoenix Fund and Community Investment Tax Relief, and has supported the Bridges community development venture fund. Nevertheless, responses to the consultation *Bridging the finance gap* broadly agreed that an equity gap continues to exist. It appears to be most acute for investment between £250,000 and £1 million, but also affects businesses seeking up to £2 million.

Enterprise Capital Funds

3.39 The Government's response to the consultation is published alongside this Pre-Budget Report in Bridging the finance gap: next steps in improving access to growth capital for small businesses. To address the equity gap, **the Government intends to launch a competitive bidding process for a 'pathfinder' round of Enterprise Capital Funds** (ECFs), subject to state aid approval. ECFs will be private sector, commercially-managed entities that adapt the US Small Business Investment Company model for the UK by investing a mix of public and private sector capital in businesses with growth potential affected by the equity gap.

3.40 Details of the bidding process for this first round of pathfinder ECFs will be published in spring 2004, subject to receiving EU state aid clearance. Pathfinder ECFs will be allowed to invest in SMEs in funding rounds of up to £2 million and will put the private sector on the same risk basis as public sector capital. The design of any future round of ECFs will take into account market developments and lessons from the pathfinder bidding process.

Venture Capital Trusts

3.41 Following this consultation, the Government is also bringing forward proposals to target structural factors that contribute to volatility in fundraising for VCTs. In particular, the balance of respondents supported a move towards enhanced income tax relief under the scheme. The Government is in favour of a less cyclically sensitive set of incentives for investors. Subject to discussion with industry, it **will consider withdrawing, from 6 April 2004, the current capital gains tax relief for investments in VCTs, and replacing it with an enhancement, of equivalent value, to the incentives to invest through income tax relief.**

3.42 The Government is also mindful of the recent relative weakness of the VCT market and intends, subject to discussion with the industry, to provide a temporary stimulus to VCT fundraising for two years. **The Government's favoured option is a temporary increase in the effective rate of income tax relief from 20 per cent to 40 per cent, with the value of the additional 20 per cent relief paid directly to the VCT rather than the investor.** The expected cost of such a temporary measure would be in the region of £50 million per year, with further details to be provided in Budget 2004.

Enterprise Investment Scheme

3.43 Subject to discussion with the industry, the Government intends to raise to £200,000 the annual investment limit for VCTs from 6 April 2004. It also plans to raise to £200,000 the threshold for income tax benefits under the EIS, which has not experienced weakness in fundraising to the same extent as VCTs.

Debt finance for small firms

3.44 Enhancements to the Small Firms Loan Guarantee (SFLG) announced in the 2002 Pre-Budget Report have proved popular, and take-up has increased by more than 40 per cent since their introduction in April 2003. The Government is nevertheless aware that the market in which businesses raise debt finance is more sophisticated now than when the SFLG was first introduced in 1981. The Government believes that the SFLG continues to play a valuable role, and wishes to build upon the recent success of the scheme by examining its effectiveness in this changing market environment. **It has asked Teresa Graham, a member of the Small Business Council, to conduct a review of the SFLG** to ensure that it is working effectively, and that through the SFLG and other interventions, start-ups and small firms have all the help that they need to overcome the obstacles that they face when raising debt finance.

Awareness and access to finance

3.45 Respondents to *Bridging the finance gap* identified a number of barriers deterring SMEs with high growth potential from seeking the finance that best suits their needs, including small amounts of equity finance. *Bridging the finance gap: next steps in improving access to growth capital for small businesses* identifies the need to match improved supply of risk capital with measures to ensure that firms understand the finance options available to them and how to access them. The Government therefore intends to:

- **publish a no-nonsense guide to finance for start-ups and small and growing firms,** to raise businesses' awareness of their financing options;
- work with the RDAs to **build on the findings of six 'investment readiness' demonstration projects** at the local level;
- work with the accountancy profession and other business bodies to **develop the proposals of the the Accountancy Working Group,** chaired by Michael Snyder, which is considering how best to enhance the role of business advisers in providing financial advice to firms; and
- work with the Small Business Investment Taskforce to **examine barriers to the growth of affordable financial intermediation focused on small-scale risk capital.**

Modernising and simplifying the business tax system

VAT flat-rate scheme

3.46 The Government has introduced a series of measures to reduce the compliance costs which small businesses face as a result of the VAT system, while improving their cash flow. Building on these measures, from 1 January 2004 the Government will introduce improvements to the VAT flat-rate scheme, helping more small businesses to take advantage of the scheme. **These include new, lower flat rates, simplified administration to make it easier to join the scheme, and a new discounted rate, 1 percentage point below the normal flat rates, for newly-registered small businesses.** Following detailed consultation since Budget 2003, the Government now confirms that all businesses approved for simplified import VAT accounting can benefit from 100 per cent reduction in deferred payment guarantees, and that third party agents are eligible to apply, allowing the smallest and occasional importers to benefit.

Corporation tax

3.47 In Budget 2003, the Government announced further consultation on reform of the corporation tax system aimed at removing tax distortions, assisting business decision-making and ensuring that the UK remains an attractive place for business to locate. Two proposals considered in the consultation are being taken forward today, with the publication alongside this Pre-Budget Report of draft legislation for further consultation with businesses:

- in its August 2003 consultation document the Government set out proposals to amend the transfer pricing and thin capitalisation rules, to remove uncertainty about the application of European law. The Government now announces measures to ensure that **the extension of the transfer pricing rules to transactions between related entities in the UK will not result in a disproportionate administrative burden for smaller businesses;** and
- **the Government proposes to extend corporation tax relief for expenses of managing investments by lifting the requirement to qualify as an investment company**. This will further facilitate businesses' compliance with the extended transfer pricing regime.

Review of construction industry

3.48 **The Government will introduce a revised Construction Industry Scheme from April 2006.** This will reduce the regulatory burden on the industry, improve compliance, help to get the status of workers right, and replace the present cards, certificates and vouchers with an Inland Revenue verification service and monthly returns. The Government has delayed implementation from April 2005 to April 2006 to ensure a smooth and orderly introduction for the new scheme.

International Accounting Standards

3.49 From January 2005, all companies with securities traded on a regulated market will be required to use International Accounting Standards (IAS) to draw up their consolidated accounts, and will be permitted to prepare their individual company accounts using IAS. Other companies will be permitted to use IAS for their consolidated and annual accounts. **The Government intends that such accounts should be acceptable for tax purposes.**

SME qualification threshold

3.50 The Government announced in the last Budget that the company law thresholds for small and medium-sized companies would be increased to the maximum possible under EU regulations[6]. The new EU maxima have now come into force so the Government can today announce that legislation will be introduced shortly. The new thresholds are expected to apply from January 2004.

3.51 The increase in the qualification thresholds will double the amount of investment eligible for 40 per cent plant and machinery first year capital allowances, providing a cash flow benefit for smaller firms investing in plant and machinery of nearly £400 million over the next three years. Businesses falling under the revised small company threshold will also be eligible for the 100 per cent information and communication technology allowance, until it expires on 31 March 2004. The increased thresholds will also allow more companies to take advantage of less onerous accounting and filing requirements.

Regulatory reform

Reducing the regulatory burden

3.52 Effective and well-focused regulation can play a vital role in correcting market failures, promoting fairness and driving up standards. However, unnecessary or poorly implemented regulation can be an obstacle to flexibility, restricting employment growth and competitiveness, particularly for smaller firms. Where appropriate, the Government is reducing the regulatory burden and considering well-targeted exemptions, including:

- **improving the VAT flat-rate scheme**, as set out above;
- increasing the statutory audit turnover threshold to £5.6 million – the maximum allowed under EU law - providing a further 69,000 companies with the flexibility to opt out of an independent audit;
- **publication today by the Cabinet Office of a revised Regulatory Reform Action Plan,** taking to over 650 the total number of deregulatory measures identified, with one third already implemented;
- **accepting in full the recommendations of September's Better Regulation Task Force report, *Imaginative thinking for better regulation,*** and encouraging policy makers to consider alternatives to prescriptive regulation. Departments will report on their regulatory performance this year, to feed into the 2004 Spending Review;
- targeted reviews, led by private sector secondees, of regulation in transport, construction and environmental services;
- publishing a draft Bill to remove unnecessary restrictions on gambling, while ensuring a greater emphasis on the protection of the vulnerable particularly children; and
- introducing, in November 2003, the National Insurance Contributions and Statutory Payments Bill to streamline the administration of tax and NICs.

[6] The new EU maximum thresholds for small businesses are 50 employees, £5.6 million turnover and £2.8 million balance sheet total. For medium-sized companies, the EU maximum figures are 250 employees, £22.8 million turnover and £11.4 million balance sheet total.

Simplifying regulation

3.53 Where regulations are necessary, the Government is committed to making them comprehensible and easy to implement, and to communicating effectively with business. **It will produce 'see at a glance' guidance on all new regulations** to reduce the time that entrepreneurs spend establishing whether a regulation applies to them. To provide businesses with a single, accessible source of advice and guidance on equality legislation, the new Commission for Equality and Human Rights will replace the existing equality commissions. A White Paper setting out detailed proposals will be published in spring 2004. Furthermore, last week the Government launched a consultation on proposals for streamlining employment tribunal procedures.

Stability and certainty

3.54 The Government will continue to pursue deregulatory measures and simplify the regulatory framework for businesses. However, it also recognises that businesses want stability and certainty in the regulatory environment. To aid regulatory certainty, the Government announced in Budget 2003 its intention to introduce changes to employment regulation only on two fixed commencement dates each year. The DTI is now piloting this approach, with the intention that it will be rolled out for employment regulation across all Departments. **Once the pilot has been evaluated, the Government will consider widening this approach to other areas of regulation.** The Government will also publish details of forthcoming changes to EU environmental policies and employment regulations to assist firms in contributing to, preparing for and managing those changes.

3.55 The Government welcomes the recommendations made in the Better Regulation Task Force report, *Independent regulators*, published in October 2003, and will respond in full next month. The report encourages good practice, including adoption of the Enforcement Concordat and the completion of Regulatory Impact Assessments for all major new policies and initiatives.

European regulation

3.56 Many EU Member States are increasingly aware of the dangers of disproportionate or burdensome regulation. At the level of European law, the EU is introducing a new system of impact assessments to test the effect of new legislation on the economy, and its social and environmental effect. The Government will work closely with the European Commission and other Member States to ensure that this action plan has real bite. In particular, the Government believes it is important that impact assessments and consultations are of a high standard and subject to a proper process of scrutiny.

3.57 The principles that apply to new legislation should also extend to that which is already in force, and the European Commission is now looking to simplify existing laws. The Government believes that it is essential that this process of simplification makes a real difference to the regulatory framework in Europe. It looks forward to working with other Member States to ensure that added momentum is given to the review and that substantial progress is made during 2004 and 2005. There must be adequate external input – including from business – in this process of simplification. To help provide that input, the Better Regulation Task Force will select an area of EU legislation for investigation.

Creating an enterprise society

3.58 There is strong evidence that cultural and social constraints inhibit enterprise activity in the UK. The Government believes that efforts to build a deeper enterprise culture must start with young people. More people between the age of 16 and 25 years consider starting up their own business than in any other age group, although few young people actually go on to do so. New measures to support the implementation of the Davies Review[7] include:

- **supporting a national campaign by Enterprise Insight to create a step change in enterprise culture,** building up to Enterprise Week in November 2004;
- **providing opportunities for selected participants in the New Entrepreneur Scholarship scheme to attend a US business school;** and
- **setting up a forum for US and UK experts to share best practice on enterprise education, work-related learning and professional development for teachers.**

National Council for Graduate Entrepreneurship

3.59 In Budget 2003, the Government announced that it was considering establishing a National Council for Graduate Entrepreneurship. **The SBS and the Department for Education and Skills are collaborating to establish the Council, which will be backed by a budget of £700,000. A Chief Executive will be appointed in the new year**. The Council will act as a central information source for students and graduates. Its principal aim will be to engage career advisers, academics, institutions and organisations to raise the profile of entrepreneurship within universities and Higher Education Institutions. The Council will promote the idea of starting up in business as a viable career option with the objective of increasing the number of students and graduates who give serious thought to starting their own business.

Social enterprise

3.60 Social enterprises are businesses with primarily social objectives, whose surpluses are principally reinvested for that purpose. The Government believes that they have a distinct and valuable role to play in helping to create a strong, sustainable and socially inclusive economy. Measures to support the social enterprise sector include introducing legislation to create Community Interest Companies as part of a Companies Bill, and opening the way for legislation enabling Industrial and Provident Societies to commit their assets in perpetuity for the public good.

Promoting enterprise in the regions and in disadvantaged areas

Enterprise and economic development

3.61 Sustainable economic growth cannot be achieved in all regions and localities of the country through top-down policy making by central government. The Government has consulted extensively with the RDAs and the Local Government Association (LGA) on how they can drive progress together towards regionally balanced growth. At the LGA conference in July, the Chancellor and the Deputy Prime Minister launched a consultation on the Local Authority Business Growth Incentives scheme, which will give local authorities a direct financial incentive to maximise economic growth in their areas. Analysis based on historical growth rates shows that the scheme could be worth up to £1 billion to local authorities over a three-year period, by allowing them to retain a proportion of increases in local business rate revenues. The extra resources will be entirely additional to local authorities, with no ring-fencing by central government. Furthermore, no business will pay more under the scheme.

[7] *A review of enterprise and the economy in education*, Howard Davies, February 2002.

3.62 The Government set out three key principles for the scheme in the consultation document. These were that the incentive must be applicable to all authorities, that the distribution of benefits must be fair, and that the scheme should be as intelligible as possible. Following the consultation, two thirds of those who expressed clear preferences favoured basing the scheme on either the national historic growth model or the sub-regional model. **The Government has decided to take the scheme forward based on the national historic growth model as this is fairer on local authorities in different regions with similar growth rates.**

3.63 However, the Government intends to adapt the model by dividing authorities into seven rather than five groups, based on historical rates of growth. This takes on board the strengths of the sub regional model and improves the incentive for most authorities, particularly those with higher rates of growth, while retaining the advantage of relative simplicity. Baselines, floors and ceilings will be announced in Budget 2004 and authorities will be able to benefit from the incentive from April 2005. The Welsh Assembly Government has also finished consultation on a similar scheme.

3.64 The Government is continuing to work closely with the LGA, local authorities, the Core Cities and the RDAs to develop the local economic growth agenda, including through:

- continuing to improve the strategic direction of the planning system, and helping local authorities to speed up and simplify the planning process;
- considering how further to develop the advantages of collaborative working and local flexibility by building on the regional business support pilots of RDA-led Business Links announced in 2002; and
- boosting enterprise in the most disadvantaged areas of the country through a focus on the Enterprise Areas and the proposed Business Premises Renovation Allowance, outlined below.

Enterprise Areas

3.65 The Government believes that raising levels of enterprise and economic activity is essential to sustainable neighbourhood renewal in the UK's most disadvantaged communities. The 2002 Pre-Budget Report designated 2,000 Enterprise Areas in which measures to boost enterprise are being focused to reinforce local economic development. Further measures may be introduced as more information becomes available about the scale of market failures in these areas. In Budget 2003, the Government announced the removal of the cap on stamp duty relief for non-residential property purchases where transactions were completed on or after 10 April 2003. Since the announcement, over 5,000 transactions have benefited from the relief.

3.66 In Budget 2003, the Government announced that it was considering how enhanced capital allowances might be used to tackle specific market failures in Enterprise Areas. **The proposed Business Premises Renovation Allowance scheme would provide 100 per cent first-year capital allowances for the capital costs of renovating business premises vacant for a year or more in Enterprise Areas.** The Government is discussing the state aid aspects of the scheme with the European Commission.

3.67 The Phoenix Development Fund is providing resources for several measures focused on Enterprise Areas. In November 2003, the SBS invited bids of up to £30,000 for feasibility studies for business incubators in the 88 neighbourhood renewal areas that are also Enterprise Areas. The SBS is undertaking a pilot with the Housing Corporation and the National Housing Federation to provide advice and support to existing or potential businesses within their tenant groups. In addition, following the success of the first round of City Growth Strategy pilots, towns and cities with Enterprise Areas were invited to participate in the second round in early December.

Land Remediation Tax Credit

3.68 The Contaminated Land Tax Credit provides business with a stronger incentive to clean up land made unusable and compensates them for the wider environmental and social benefits that the remediation could bring. **The Government will therefore examine the possibility of extending the relief to include remediation of land that is long-term derelict, which could have similar positive spillover effects.**

SCIENCE AND INNOVATION

3.69 Innovation is an important source of productivity growth. The UK has an excellent science base but has been less effective at realising the commercial potential of its research. The Government is determined to address this, and last year commissioned two complementary reviews to shape future innovation policy – the Lambert Review[8] and the DTI Innovation Report.

3.70 The findings of the Lambert Review are set out in Box 3.3. The Government will consider the Review, consult interested parties, and make a full response to the recommendations by summer 2004.

Box 3.3: The findings of the Lambert Review

In the 2002 Pre-Budget Report, the Government asked Richard Lambert to undertake a review to examine whether the links between universities and business in the UK could be improved. The Review gives an overview of current collaborations - including case studies of successful collaboration - and identifies opportunities for greater interaction. It concludes that there are significant benefits to be gained from collaboration for the university sector, businesses and the economy as a whole. Key recommendations include:

- **a greater role for the Regional Development Agencies in facilitating knowledge transfer in their regions;**
- **a new funding stream for business-relevant research, along with increased and improved 'third stream' funding for knowledge transfer;**
- **that universities should develop a code of governance, and demonstrate good management and strong performance in return for a lighter regulatory touch from the Government and the Funding Councils;**
- **the development of model contracts and a protocol for intellectual property (IP) to speed-up IP negotiations;**
- **the encouragement of new forms of formal and informal networks between business people and academics, including the establishment of a business-led R&D employers' forum; and**
- **that universities should provide more information on student employability, and businesses take a greater role in influencing university courses and curricula.**

[8] *Lambert review of business-university collaboration: final report*, Richard Lambert, December 2003.

DTI Innovation Report

3.71 In November 2002, the Chancellor and the Secretary of State for Trade and Industry launched a wide-ranging review of business innovation and its contribution to productivity growth. After consultation with key stakeholders, the forthcoming Innovation Report will set out the need for a coordinated approach by Government across a range of policy areas, including procurement and regulation, to improve the UK's innovation performance. A key issue will be to raise the level of R&D in business, which will involve a longer-term and more strategic approach to focus Government support on key technologies and markets. The economic analysis underlying the report was published by the DTI in November 2003.[9]

Investing in innovation

3.72 The implementation of the Government's science strategy, published in July 2002, is now well advanced, with measures in place to ensure the sustainability of university science research. Systems are being put in place to ensure that universities recover the full economic costs of the research they conduct.[10] Furthermore, allocations to universities were made in August 2003 for the latest round of the Science Research Infrastructure Fund, a dedicated capital stream for infrastructure that will build to £500 million by 2005-06. The Government is also promoting knowledge transfer through the Higher Education Innovation Fund, comprising £187 million for investment between 2004 and 2006, and the Public Sector Research Establishments Fund, a £15 million knowledge-transfer fund for other research establishments.

Supply of scientists

3.73 The Government is taking forward the key recommendations of the Roberts Review[11] and published an update on progress in implementing the Review's recommendations in October 2003.[12] Measures underway include a £51 million partnership with the Wellcome Trust for a national network of Science Learning Centres to train science teachers and technicians. In order to improve the recruitment and training of researchers, the Government has allocated funds to increase the minimum Research Council PhD stipend to £12,000 by 2005-06, and to increase the Research Council postdoctoral salaries by an average of £4,000 by 2005-06.

R&D tax credits

3.74 To promote commercial R&D in the UK, the Government introduced R&D tax credits for SMEs in 2000 and extended this to large companies in 2002. Though it is too early for data on the large company scheme, the take up of the SME scheme has been significant, with over 8,000 claims since its inception, giving around £500 million of support for innovative companies.

3.75 A consultation document, *Defining innovation*,[13] published in July 2003, sought views on how the current definition of R&D could be improved. The responses showed strong support for R&D tax credits as a spur to promote greater levels of innovation and provided valuable recommendations on how the definitions could be made more effective. The Government is committed to ensuring that the tax credits are soundly based, internationally competitive and will deliver a real incentive for new R&D. It has today published a summary of the responses to the consultation, together with:

- **a new draft definition of R&D,** giving greater clarity and certainty about what activities constitute R&D for tax credit purposes;
- **details of an extension of qualifying costs** from the current 'consumable stores' to include materials, software, water and fuel directly used in the R&D, and discussion will continue with business on the appropriate boundaries for 'direct costs'; and
- confirmation that there will be **a new generic definition for qualifying bodies,** including Public Sector Research Establishments.

[9] *Competing in the global economy: the innovation challenge*, DTI Economics Paper No. 7, November 2003.

[10] *The Sustainability of University Research: a consultation on reforming parts of the Dual Support System*, Office of Science and Technology, May 2003.

[11] *SET for success: the supply of people with science, technology, engineering and mathematics skills*, The Report of Sir Gareth Roberts' Review, April 2002.

[12] *Update on UK science skills post-Roberts Review*, DfES information note, October 2003.

[13] *Defining innovation: a consultation on the definition of R&D for tax purposes*, HM Treasury, DTI, and Inland Revenue, July 2003.

3.76 These changes represent significant further investment in R&D tax credits. Provisions to implement the measures will be in the forthcoming Finance Bill.

Scientific Research Organisations

3.77 The Government, jointly with the Economic and Social Research Council, has commissioned independent research into the contribution Scientific Research Organisations make to innovation and knowledge transfer and their distinctive role in stimulating collaborative research. The Government will bring forward proposals at Budget 2004 aimed at refining the tax treatment of Scientific Research Organisations, to foster the wider economic benefits that such organisations can provide to UK businesses.

Box 3.4: The changing shape of the global economy

Increasing globalisation brings opportunities in the form of new export markets for firms and better value goods and services for consumers. It also brings new challenges, including increased competition, in particular from emerging economies such as China and India, an issue discussed further in Box A1 in Annex A.

UK businesses must adapt to prosper in this new environment and can no longer rely on relatively low labour costs to compete. The challenge they face is to compete on high value-added products which are driven by innovation and design. The key to success in this respect will be the quality and skills of the UK's labour force and the willingness of managers to invest in innovation. These issues are among those analysed in detail in the recent DTI economics paper, *Competing in the global economy: the innovation challenge*.[a]

The UK economy has already experienced significant change. Alongside modern manufacturing strength, high quality services will be essential for the future. In the same way that an innovative process adds value to a manufactured product, a creative idea or new branding concept can also increase value and profit. Producing services that are valued by consumers abroad is essential to the UK's future prospects.

Creative industries will therefore become an increasingly important component of the economy, not just as a sector that exports in an increasingly integrated world economy, but by adding value to products and services in the wider UK economy.

[a] *Competing in the global economy: the innovation challenge*, DTI Economics Paper No. 7, November 2003.

Science and innovation in the regions

3.78 The Government recognises the value that regional bodies can add in promoting R&D and innovation, and in facilitating knowledge transfer. All RDAs are now investing in science and innovation, with an estimated £240 million invested in 2002-03.[14] Sir Tom McKillop, Chair of the first Regional Science and Industry Council, has been working with the RDAs at the request of the Secretary of State for Trade and Industry to ensure that best practice is spread rapidly between the regions, and has reported that most RDAs have now established, or are in the process of establishing, their own versions of Science and Industry Councils.

Science and innovation in Europe

3.79 Action is also needed at European level to boost R&D. In March 2002, the Barcelona European Council declared an aspiration that the EU's R&D and innovation spending should approach 3 per cent of GDP by 2010, with two-thirds of this new investment coming from business, an aspiration that has been taken forward in the R&D Action Plan of April 2003. The measures outlined above constitute the UK's own contribution.

[14] 'Memorandum by the Regional Development Agencies', in *Science and the RDAs: SETting the regional agenda - Evidence*, 5th Report of the House of Lords Science and Technology Select Committee, Volume II, July 2003.

SKILLS

3.80 Skills underpin a productive economy. International evidence suggests that the UK suffers from significant skills shortages, especially at lower skills levels. Skilled workers are more able to adapt and respond to change, making the economy more flexible. The Government is seeking to improve both the skills of young people entering the workforce and the opportunities available to those already in the workforce to acquire new skills.

Developing the skills of young people

Primary and secondary education

3.81 The Government is determined to raise pupil attainment across the education system. Between 1997 and 2003, the proportion of 11 year-olds reaching expected levels in reading and maths rose by 12 per cent and 11 per cent respectively. The proportion of 16 year-olds achieving five A*-C grades at GCSE also rose, from 45 per cent in 1997 to 52 per cent in 2003.

Post-16 learning

3.82 The Government is working to increase the number of young people continuing in post-16 education and training, and has set an ambitious target that by 2010, 90 per cent of young people will have participated in a full-time programme preparing them for entry to higher education or skilled employment by the age of 22. The Government has established a working group, led by Mike Tomlinson, to investigate the reform of education for 14 to 19 year olds. Its initial proposals, published in July 2003, include the creation of a diploma that will prepare young people for different types of further education, training or employment. Chapter 5 describes the measures the Government is taking to support young people in post-16 education, and its wider review of the financial support system for 16 to 19 year olds.

Improving workforce learning

3.83 Improving education will lay the foundations for a better UK skills base in the future, two-thirds of today's workforce will still be in the labour market in 2020 and more than one-third have no skills. The Government is therefore also taking steps to improve training opportunities for those already in the workforce.

3.84 The UK's investment in workforce training has historically been low, and has been inhibited by a range of market failures. Businesses, particularly small businesses, are unwilling to release valuable staff for training, and may be unable to gain the full returns of training. Individuals may face financial barriers or be poorly informed about the value of training. Although voluntary approaches have increased participation in workplace training, they have not been sufficient given the scale of the problem.

3.85 Addressing these problems is a priority and will require a step change on the part of employers, individuals and the Government. The Government is therefore introducing a range of policies to help individuals and employers to meet their responsibilities in this area.

New Deal for skills

3.86 The National Skills Strategy recognises the need to support and encourage individuals to start learning and then continue to improve their skills. This can often be challenging, for example, some may have had negative learning experiences at school, which they need to overcome. To lift these barriers, the Government has committed to a package of measures that gives adults in the labour force a free entitlement to train in order to obtain a good foundation of skills. The entitlement reflects the different needs of potential learners and subsidises learning towards:

- basic skills in literacy, numeracy and information and communications technology;
- a first level 2 National Vocational Qualification (NVQ) or equivalent; and
- increased support for higher level skills in areas of sectoral or regional skill priority.

Modern Apprenticeships

3.87 The number of young people participating in Modern Apprenticeships (MAs) has more than doubled since 1997 and now stands at around 235,000. The Government's aim is that 320,000 young people will be participating by 2006. A National Modern Apprenticeship Taskforce was established in February 2003 under the chairmanship of Sir Roy Gardner, CEO of Centrica. This employer-led taskforce seeks to increase the number of apprenticeship opportunities available and ensure that the MA framework is fit for purpose. The Task Force is working closely with the national Learning and Skills Council (LSC) on how to improve the marketing, delivery and design of MAs. It will present formal recommendations on promoting greater employer engagement in MAs in a report in Spring 2004, focusing on a number of specific sectors such as retail, construction and health.

Further Education

3.88 In November 2002, the Government launched the Success for All reform strategy to promote further improvements in quality and performance in the Further Education sector. This year the national Learning and Skills Council has introduced a tougher accountability framework setting out minimum standards for the sector. Each local LSC must agree three-year development plans with its providers based on stretching targets to improve learner success rates and professionalise the Further Education workforce.

Employer Training Pilots

3.89 Employer Training Pilots (ETPs) were introduced in September 2002 to test new measures to improve access to training. ETPs offer a package of support to help low-skilled people in work gain basic skills or their first level 2 qualification. Employers that offer their low-skilled staff paid time off to train are being provided with compensation for wage costs (varying according to pilot area and size of firm). Training is free or heavily subsidized, and is delivered in the way that most suits the employers' business. Both employees and employers are offered free information, advice and guidance.

Box 3.5: Employer Training Pilots

An independent evaluation of the first year of Employer Training Pilots (ETPs) was published on 4 December 2003. The evaluation showed that over 3,000 employers and 14,000 learners had registered to take part by the end of first year, August 2003. Three months later, over 5,000 employers and 20,000 learners are involved.

The scheme is reaching workplaces where training has not been a high priority in the past. Over 70 per cent of the employers taking part had fewer than 50 employees, and 40 per cent of employers had no previous involvement with a government agency. Elements of the scheme that employers found particularly valuable were the free and flexibly provided training. Overall almost 90 per cent of employers were either very or fairly satisfied with the scheme.

A variety of sectors are participating in the scheme. In particular, take-up has been high in the health and social work, distribution (which in the evaluation includes, retail, hotels and catering and transport) and manufacturing sectors.

Of the participants, 55 percent of learners were female, 59 per cent were aged between 26 and 45, and 75 per cent worked full time. 75 per cent of learners had left school at or before the age of 16, and almost 50 per cent reported that they had not been given the opportunity to train by their employer before. Through their employers, these pilots are giving learners an important second chance to gain vital skills. Over 80 per cent of learners said they were satisfied with the training.

3.90 The 2001 Pre-Budget Report announced the launch of the first ETPs in six local LSC areas (Greater Manchester, Derbyshire, Essex, Tyne and Wear, Wiltshire and Swindon, and Birmingham and Solihull). They were extended for a further year and doubled to cover six new areas (Shropshire, Leicestershire, Kent, East London, Berkshire and South Yorkshire) in the 2002 Pre-Budget Report.

3.91 ETPs demonstrate the Government's commitment to a new relationship with employers and individuals. The Government is accepting its responsibility to provide the finance for courses and to compensate employers who provide training opportunities for their low-skilled staff. Providers are taking on board their responsibility to deliver flexible training at the workplace tailored to employers' needs. Local colleges are being encouraged to adopt new methods of delivering training to fit the needs of individual businesses, while brokers offer a wide choice of providers to employers. Employers are delivering new training opportunities for their staff without either basic or level 2 skills. With the support of their employers, employees are taking up new training choices and opportunities with greater success rates than in the past.

3.92 The pilots are involving all local partners in delivering skills and training and are demonstrating the Government's commitment to the devolution of control over skills training to meet regional and sub-regional priorities and the needs of local business and employees.

3.93 ETPs are also encouraging local colleges and providers to adopt new methods in response to employers' needs. Demand-driven funding is already encouraging providers within ETP areas to work on employers' premises, fitting in with the patterns of their business, and tailoring training to fit the skills needs of individual employees – as well as exposing the need for more qualified instructors in key areas.

3.94 Building on the success of this programme, **the Government is now extending ETPs for a third year.** ETPs will launch in six further local LSC areas, bringing the total to 18, which covers over a third of England. This measure is funded through the Windfall Tax (as set out in Table 4.3). This will enable the Government to explore further the impact of the existing pilots on the demand for training.

Raising skills through professional bodies

3.95 Budget 2003 announced the Government's intention to review the tax treatment of fees and subscriptions to professional and other approved bodies, to establish whether the current system makes a sufficient contribution to the wider training and skills agenda. As part of the review the Government will consider whether there are alternative models that might achieve these objectives more effectively. **The Government is publishing a discussion paper on these issues, *Delivering an incentive for membership bodies to provide workforce development,* alongside this Pre-Budget Report.**

Migration

3.96 Migration helps to raise productivity and boost economic growth by increasing labour supply and reducing domestic skills shortages. The Government is taking further steps to maximise the contribution of migration to a skilled and flexible workforce and to help employers facing recruitment difficulties.

3.97 Since January 2002, the Highly Skilled Migrant Programme has enabled approximately 5,000 talented individuals to seek and take up work in the UK, using their skills in areas as diverse as medicine, academia and music. Budget 2003 announced that the Programme would be strengthened to attract a wider range of skilled applicants. The new criteria came into effect in October 2003.

3.98 Budget 2003 also announced a new entitlement for foreign students, the Science and Engineering Graduates' Scheme. From summer 2004, students in shortage science, maths and engineering subjects will be able to work for a year after graduating from UK institutions without the need for a work permit. Students will be able to access detailed information on their eligibility for the scheme by March 2004, and to apply following confirmation of their results.

3.99 Migration may have a role to play in helping employers to overcome recruitment difficulties at lower skills levels. New schemes for migration below NVQ level 3 began in May 2003 to alleviate labour shortages in the hospitality and food processing sectors. Full evaluation of these pilots will contribute to wider research on the economic impact of low-skilled migration and its role in tackling illegal working. The Government is also considering the potential role of migration in addressing skills shortages at NVQ level 2, as announced in Budget 2003, and will issue a public consultation document early in 2004.

3.100 In a speech in November 2003, the Home Secretary set out the Government's approach to migration, and underlined the need to harness the innovation, skills and productivity that new migrants can bring. Earlier this month, the Home Office launched a new website dedicated to legal migration,[15] which will ensure that both individuals and employers can access information on recruiting, working and settling in the UK.

[15] www.workingintheuk.gov.uk

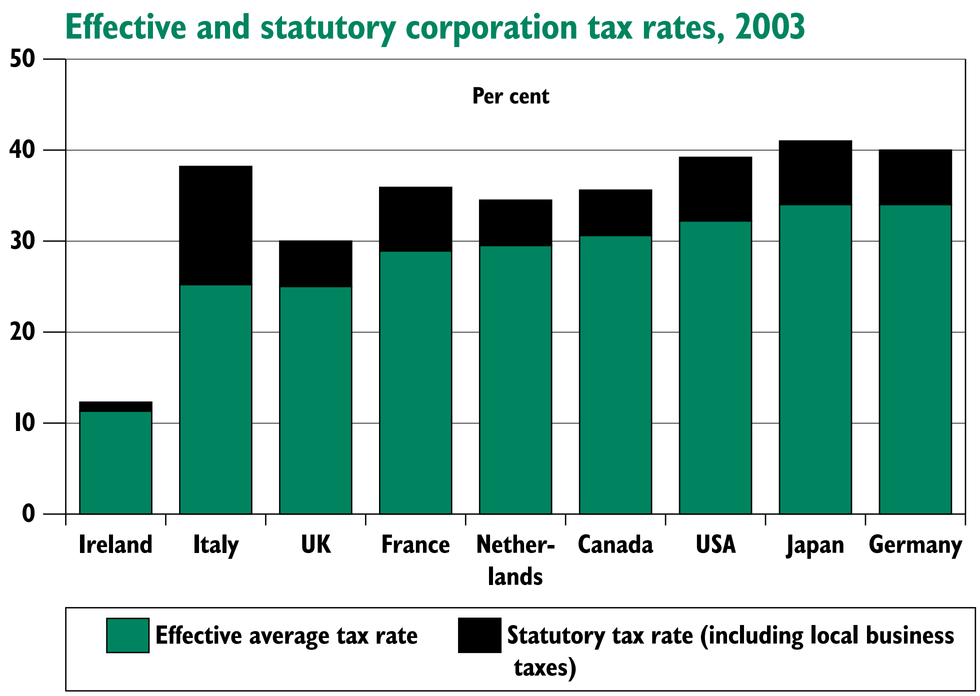
INVESTMENT

3.101 Alongside a skilled labour force, investment in physical capital is vital to support a productive, enterprising economy. The UK has relatively low levels of physical capital. Research suggests that US and German workers have access to over 45 per cent more capital than UK workers, and French workers over 75 per cent more.[16] The Government is taking steps to reverse this long-term trend, improving the environment for private investment and investment decision-making through macroeconomic stability, promoting flexibility in capital markets, and addressing specific failures in transport, planning and the property market.

Box 3.6: Taxation and international investment

A competitive corporate tax regime can help boost foreign direct investment (FDI) and encourage domestic investment. A number of factors influence decisions about the location of FDI in a particular country: macroeconomic stability, labour market flexibility, quality of infrastructure, the nature of regulation and relations between government and business. As economic activity becomes increasingly globalised, corporation tax is also considered in an international context by multinational enterprises.

A feature of company taxation over the past twenty years has been a trend towards lower statutory corporation tax rates in most OECD countries. The UK's *statutory corporation tax rate* (a measure which includes any local as well as central government corporate income taxes) compares well internationally, as does its *effective average tax rate* - a more accurate measure of the extent to which multinational enterprises' profits are taxed, including the effect on companies of both capital allowances and the statutory corporation tax rate. The chart compares the statutory tax rate and the effective average corporation tax rate in selected OECD countries.



Source: The Institute for Fiscal Studies, December 2003.
Note: the effective average tax rate measures the share of the pre-tax value of a profitable investment project (domestic plant and machinery, financed by retained earnings, and earning 10 per cent economic rent) to shareholders that is reduced by corporate income taxes.

[16] *Britain's relative productivity performance: updates to 1999 NIESR*, O'Mahony and de Boer, March 2002.

Retail and planning

3.102 The Government is committed to promoting investment in town centres, to support its objectives of achieving sustainable communities, productivity growth and improved accessibility for all. In recent years, there has been increased investment in town centres, which has helped to revitalise towns and cities. **The Government intends to build on that success when the Office of the Deputy Prime Minister releases a revised planning policy statement on town centres in England for consultation next week.** It will encourage local planning authorities to:

- plan for growth in town centres;
- expand the boundaries of town centres where this will facilitate further development;
- promote consumer choice through the planning system; and
- promote social inclusion and, where appropriate, regenerate deprived areas with new and additional employment.

Housing

3.103 A stable and flexible housing market is essential to a healthy and productive economy. Housing market imbalances are a potential brake on economic development. The cost and availability of housing influences the geographical distribution and mobility of the labour force and may affect capacity levels in local labour markets. Housing is a key asset for households and consumer spending is closely associated with changes in housing wealth. Reducing volatility in the housing market will therefore help promote macroeconomic stability. The Government is committed to a comprehensive programme to improve the functioning of the UK housing market and to ensure a better match between supply and demand.

Sustainable communities

3.104 In February 2003, the Deputy Prime Minister set out the Government's new approach to creating and maintaining sustainable communities in a growing and changing economy, with £22 billion being invested over the next three years. The Government's strategy places key housing, planning and regeneration policies in the context of wider requirements for sustainable communities including jobs, quality public services, transport, a safe and healthy local environment, and sound local government. Development in the Thames Gateway and three other growth areas is expected to deliver 200,000 more homes over and above existing plans.

3.105 Greater public investment is being complemented by fundamental reforms to the planning system to unlock land and private development. The centrepiece of this is the Planning Bill, now before Parliament, which contains a wide range of measures designed to improve the speed, predictability and certainty of the planning system.

Urban coding

3.106 The Government is promoting new urban design principles to speed the planning process and deliver better quality design. It aims to achieve consistent, high quality design in larger developments by developing urban codes in discussion with the community before development takes place that, once approved by the local authority, allows buildings constructed in compliance with the code to be fast-tracked through the planning system.

Planning obligations

3.107 The Government is currently consulting on proposals for reforming and improving planning obligations. This aims to provide greater transparency and certainty to help enable developers and local planning authorities to avoid the delays that sometimes occur under the current system by establishing a new optional planning charge as an alternative to negotiated planning obligations.

Barker Review of housing supply

3.108 Building on reforms to housing and the planning system, which are already underway, the Chancellor and Deputy Prime Minister jointly commissioned Kate Barker to lead a review of the factors affecting housing supply in the UK. The Government welcomes the interim report of the Barker Review, *Securing our future housing needs*, published alongside this Pre-Budget Report, and looks forward to the final report in spring 2004. The Chancellor also asked Professor David Miles to undertake a review of the supply and demand factors limiting the development of fixed rate mortgages in the UK, as described in Chapter 2.

Box 3.7: The Barker Review of housing supply

The interim report of the Barker Review was published today. The Review finds that the UK housing market is not working as well as it should. In particular there is a problem of weak supply with major implications for the UK's economic well-being:

- **over the past ten years the number of new dwellings built has been 12.5 per cent lower than in the previous decade;**
- **the current rate at which the housing stock is replaced implies that houses built now need to last 1,200 years;**
- **only 37 per cent of new households could afford to buy in 2002 compared to 46 per cent in the late 1980s; and**
- **undersupply of housing constrains economic growth. Had housebuilding rates been higher and UK house prices risen in line with the European average since 1975, the UK would have been £8 billion better off.**

The Review identifies a range of factors which reduce UK housing supply:

- **the housebuilding industry is characterised by low levels of responsiveness to demand, low levels of investment in brownfield, and low levels of innovation;**
- **competition tends to focus on land, once land is acquired housebuilders have little incentive to compete for consumers or innovate;**
- **local authorities have few positive incentives to build and few sanctions if they fail to meet targets;**
- **infrastructure barriers hold up construction of over 40,000 dwellings in the South East alone; and**
- **institutional investment in property is limited, the Review suggests Government should consider a tax transparent vehicle to encourage investment.**

The Review will take forward this analysis and produce a final report with recommendations in spring 2004.

Private rented sector

3.109 The private rented sector (PRS) provides a flexible form of housing that contributes to labour market mobility and an efficient housing market. However, its 10 per cent share of the UK housing market is low in comparison to the US and many European countries. Institutional investment in the sector is low and over 70 per cent of the PRS stock is run by landlords managing only a few properties. The reputation of the PRS is often undermined by the actions of a minority of rogue landlords, the mishandling of some tenant deposits, and the poor condition of almost half of the stock.

3.110 There is scope for the PRS to make a bigger contribution to meeting individuals' housing needs. However, making the sector a desirable tenure of choice in the UK will require greater investment and reforms in a number of areas. **The Government is therefore considering the role of specific fiscal and other measures in encouraging a stronger and better PRS and will be reporting back on fiscal measures at Budget 2004.** This Pre-Budget Report announces consultations on a tax transparent property investment trust, described below, that could lead to greater investment in the PRS. The Government is also considering a Domestic Business Tax Allowance, described in Chapter 7, and the case for a Tenancy Deposit Scheme. It is also introducing licensing for PRS landlords in certain situations.

An efficient property investment market

3.111 Following Budget 2003, and in line with the interim conclusions of the Barker Review, the Government has also concluded that a tax transparent property investment trust would improve liquidity, transparency and scrutiny, provide access to property for long-term savings, and could expand the private rented sector. Evidence from other countries suggests that these vehicles have worked particularly well where they are publicly listed, internally managed, closed-end companies, with a requirement for high distributions. In order to protect the Exchequer against loss of revenue, the Government also intends to apply a charge on conversion of property into a new vehicle. **A consultation document, which will consider the most appropriate structure, alongside related property investment products, will be issued at Budget 2004.**

3.112 The Government has also considered how tax reform might help the development of a market in property derivatives, which would also improve the overall efficiency and liquidity of the property investment market. As a result of informal discussion with industry **the Government has today published draft legislation** showing how a model for the taxation of property derivatives might operate, which also addresses certain tax problems in relation to equity derivatives.

Commercial lease flexibility

3.113 The Government has been working with the commercial property industry to promote a voluntary code of conduct on commercial leases to improve the flexibility of lease terms for businesses. The code is intended to tackle inflexible lease terms, which can restrain business growth and expose businesses to undue risk. As noted in Budget 2003, the impact of the code on flexibility in the commercial lease market is being independently evaluated. The Government expects to receive the interim findings of the evaluation by the end of 2003 and remains committed to consulting in 2004 on possible legislative options, if those findings show that the code is having little impact on flexibility in the commercial lease market.

Investing in transport

3.114 Investing in a modern, effective transport system is crucial to UK economic performance. The Government's 10-year plan for transport set out a programme of substantially increased investment, amounting to over £180 billion of public and private spending over the current decade. As described in Chapter 6, the Department for Transport is currently reviewing the plan in the light of progress so far and in conjunction with the 2004 Spending Review.

3.115 Air transport contributes significantly to the national economy. It is not only a high value sector in its own right, but also helps to boost productivity and growth across many other sectors, and supports a large number of jobs. Later this month, the Government will set out its thirty-year vision for UK aviation in an Air Transport White Paper.

Investing in British films

3.116 Building on the tax measures introduced by the Government in 1997, and extended in 2001, to promote investment in British films, **Budget 2004 will announce the results of discussions with the industry and others to extend support through the tax system beyond 2005**. In doing so, the Government will consider the scope for further simplification, and ensure that the extended support is targeted effectively.

Encouraging North Sea investment

3.117 The Government is committed to maximising recovery of UK oil and gas reserves by encouraging new investment and making full use of existing infrastructure to ensure all economically viable reserves are developed. Budget 2003 announced the removal of Petroleum Revenue Tax from 1 January 2004 on all new third-party tariffing business under contracts completed on, or after, 9 April 2003.

3.118 Budget 2003 also launched a consultation on the current low levels of oil and gas exploration. The consultation is now complete and **the Government will introduce a new Exploration Expenditure Supplement to reduce barriers to entry for new North Sea companies that do not receive the full benefit of current 100 per cent exploration and appraisal capital allowances.** Full details will be announced in Budget 2004. The consultation has also resulted in significant progress on non-tax issues such as terms and conditions for third party access to infrastructure. The Government will continue to monitor levels of exploration and work with industry to tackle barriers to investment that hinder maximum economic recovery of UK hydrocarbon reserves.

Flexibility in capital markets

The Myners Review of institutional investment

3.119 The Myners Review of institutional investment in the UK was published in March 2001.[17] The Government promised to review progress against the recommendations after two years. Qualitative research into the progress made by pension scheme trustees, commissioned as part of that review, was published in November 2003. It showed that, while some progress has been made, particularly by larger schemes, further progress is necessary against many of the Myners' principles:

- enhancing the expertise trustees are able to bring to bear on investment issues;
- clarifying the respective roles of trustees and investment consultants;
- increasing the proportion of resources devoted by pension funds to asset allocation decisions;
- securing greater clarity in the investment time horizons which trustees set; and
- promoting greater shareholder activism.

3.120 Measures to strengthen trustees' competence in relation to investment matters, and to replace the Minimum Funding Requirement with scheme-specific funding standards, will be included in the forthcoming Pensions Bill. In addition, **the Government will, in the coming months, undertake discussions with the industry on the potential for further progress in these areas,** before it concludes the current follow-up review.

3.121 In addition, following the Myners Review, the Institutional Shareholders Committee (ISC) and its members have committed to incorporating the ISC's best practice principles into fund management mandates. The Government has said that it will review the extent to which this has delivered behavioural change towards the end of 2004.

Higgs Review

3.122 The Higgs Review,[18] which reported in January 2003, examined the role and effectiveness of non-executive directors. Its recommendations have been substantially incorporated into a revised Combined Code, which applies to listed companies with reporting years starting on or after 1 November 2003. The Government will examine how the new Combined Code has affected behaviour and outcomes. It remains committed to a review of progress after two years.

Accountancy and audit

3.123 The Companies (Audit, Investigation and Community Enterprise) Bill was introduced earlier this month. It takes forward recommendations of the Swift Review[19] into the reform of regulation in the auditing profession and the Co-ordinating Group for Accounting and Audit. These improvements enhance auditor independence and strengthen financial reporting.

[17] *Institutional investment in the United Kingdom: a review*, Paul Myners, March 2001.

[18] *Review of the role and effectiveness of non-executive directors*, Derek Higgs, Jan 2003.

[19] *Review of the regulatory regime of the accountancy profession*, Jane Swift, October 2003.

4 INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. Worklessness, particularly on a long-term basis, is a constraint on the economy's growth potential and a major cause of poverty and deprivation, entailing costs for individuals, households and society as a whole. Delivering full employment requires that everyone should be able to take advantage of the opportunities offered in a stable and enterprising economy. To achieve this, people must be able to exercise real labour market choice and be able to choose between alternatives that work, while policy delivery should be responsive to both individual and local circumstances. To move further towards its aim of full employment in every region, the Government proposes:

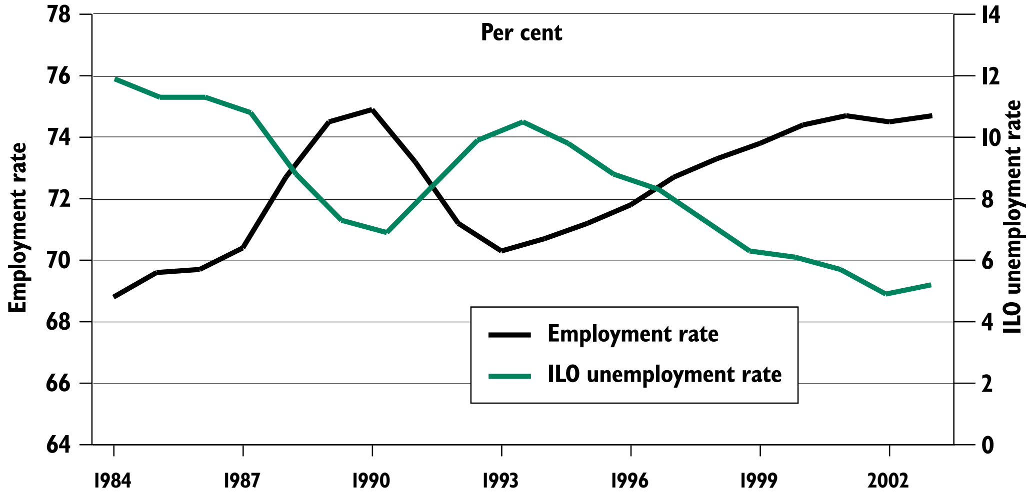
- **extra support to help the unemployed,** by piloting mandatory short intensive work-focused courses at the six-month stage;
- **an extension of eligibility for the enhanced New Deal for partners;**
- **enhanced help for lone parents,** increasing the number of work-focused interviews lone parents with children aged 14 or over are required to attend, and providing help with childcare costs in the week before starting work;
- **improving work incentives in London** by extending pilots of the £40 per week in-work credit to parents, including lone parents, who have been on certain benefits for a year or more;
- **continued reform of Housing Benefit,** beginning flat-rate Pathfinders in the social sector as soon as it is practical and aligning some of the rules of Housing Benefit and tax credits;
- **additional help for those on benefits to enter self-employment;**
- **an extension of back to work help for those aged 60 and over and on the Pension Credit by October 2004;** and
- **extra help for sick and disabled people** by enabling Jobcentre Plus personal advisers to provide additional voluntary support to Incapacity Benefit customers who want to return to work.

INTRODUCTION

4.1 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. For both economic and social reasons, everyone who is able to work should have the opportunity to do so. Worklessness, especially when long-term, is a constraint on Britain's growth potential and entails major costs for individuals, households and society. Employment is the best means of avoiding poverty during working life and provides the best platform from which to save for security in retirement.

4.2 The performance of the UK labour market over recent years has been strong by both international and historical standards. At 5.0 per cent, UK unemployment on the International Labour Organisation (ILO) definition is the lowest among the G7 economies. Claimant count unemployment has fallen by more than 700,000 since 1997. Since the start of 2001, unemployment has remained consistently below one million – the first time this has happened since 1975. Falls in unemployment have been particularly marked among certain groups. Long-term unemployment has fallen by over 332,000 since spring 1997 to its lowest level for a generation, including a fall in long-term youth unemployment of over 138,000. Employment is currently at record highs, having risen by 1.7 million since spring 1997.

Chart 4.1: UK employment and ILO unemployment rates



4.3 The Government is committed to building on this strong performance to deliver employment opportunity for all. To achieve this requires a productive, enterprising economy with a flexible labour market. In today's global market place, flexible economies are also those with higher employment.

4.4 Flexibility must be matched with fairness. The Government has provided increased financial support for those who need it most, when they need it most, through reform of the tax and benefit system. The introduction of the National Minimum Wage and new tax credits have been key reforms. In addition, the Government has made reforms to employment services, such as Jobcentre Plus, which provides the advice and support that enable people to enter the labour market rapidly. Annex C of this Pre-Budget Report describes progress in raising flexibility and fairness across UK labour, product and capital markets. Labour market flexibility remains central to achieving the challenges facing the EU's labour markets, as discussed in Box 4.1.

Box 4.1: Delivering full employment in the European Union

In July 2003 the Government published *A full employment strategy for Europe*, which set out the key challenges facing EU labour markets. The paper highlighted the importance of flexibility and employment in promoting social inclusion.

The EU contains 15 diverse labour markets, with different cultures, traditions, frameworks and institutions, but common goals. The EU has three employment targets for 2010. While the UK already meets all of these targets, the labour market performance of many other Member States has been less strong and the EU as a whole falls short of all three targets. A step-change in the pace of reform is essential if these targets are to be met. From May 2004, the EU will welcome ten new members, making labour market reform even more important. After enlargement and for the EU25:[a]

- **to reach the 70 per cent overall employment target by 2010 will require the creation of at least a further 21.5 million jobs, given the current employment rate of 62.9 per cent;**
- **meeting the 60 per cent goal for female employment requires at least 8 million jobs, given a current female employment rate of 54.7 per cent; and**
- **meeting the 50 per cent employment target for older workers requires at least 6 million more jobs given a current employment rate for older workers of 38.7 per cent.**

Member States must act now to achieve these goals, a message reinforced by the report of the European Employment Taskforce in November 2003.[b] The UK Government welcomes the report of the Taskforce, and in particular its focus on job creation and its specific recommendations to Member States. The Government believes that the report represents a vital opportunity to reinvigorate labour market reform in the EU, and calls on all Member States to demonstrate the political will to drive through necessary change.

Reform must not come at the expense of those on the margins of the labour market. The challenge facing EU Member States is to raise employment and increase social cohesion by making labour markets respond more efficiently to changes in economic conditions. Flexible working patterns and working hours are an important first step back into the labour market for vulnerable groups, such as lone parents and older workers, and enable firms to respond to difficult economic conditions. Badly targeted legislation can, by contrast, reduce labour market flexibility and damage the EU's prospects of achieving its objectives.

[a] *Employment in Europe 2003. Recent Trends and Prospects*, Eurostat, 2003.

[b] *Jobs, Jobs, Jobs, creating more employment in Europe*, Report of the Employment Taskforce, November 2003.

Choice in the labour market

4.5 Delivering full employment requires that everyone should be in a position to take advantage of the opportunities offered by a stable, enterprising economy. Choice in the labour market is essential to achieving full employment. To have genuine choices over entering, remaining and progressing in employment, individuals must have the necessary financial incentives, skills, mobility and support. Two key elements of the Government's full employment strategy ensure that individuals are able to do this by:

- removing the barriers to entering, remaining in and progressing within work; and
- ensuring policy delivery is effective, efficient and responsive to individual and local circumstances.

This chapter describes the steps the Government is taking to deliver both of these elements.

EXTENDING CHOICE – ENSURING REAL OPPORTUNITY FOR ALL

4.6 The ability of individuals to make genuine choices in the labour market must not be constrained or distorted by barriers to employment or to progression within work. Neither should it be eroded by detachment from the labour market or by an inability to adapt to new technologies, changing consumer preferences or evolving demands for skills.

Effective job search

4.7 Effective support for job search is central to taking advantage of employment opportunity. The Government is committed to providing the support needed for everyone to fulfil their potential in a dynamic, enterprising economy. Active labour market policies (ALMPs) are tailored to meet the particular needs and circumstances of each individual. They are also based on evidence of what works, and confined to options that are effective, a choice of inadequate support measures being of little value. Participation in job search activity for the long-term unemployed is, for example, mandatory, as its absence would risk long-term detachment from the labour market and the consequent erosion of labour market choice. This Pre-Budget Report sets out measures that build on the success of ALMPs and further extend opportunity for all.

Helping the unemployed

4.8 The Government's Welfare to Work strategy ensures that those who are unemployed remain attached to the labour market. It seeks to tackle and prevent long-term unemployment by equipping people with the skills and opportunities they need to compete successfully for job vacancies. The New Deal for young people (NDYP) and the New Deal for those aged 25 and over (ND25+) have helped to deliver significant reductions in long-term and youth long-term unemployment. Over 460,000 long-term unemployed 18 to 24 year olds have found jobs through the NDYP, while ND25+ has helped almost 165,000 older people back into work. New Deal programmes have helped to reduce long-term youth and adult unemployment by over three-quarters. In 2000, the National Institute of Economic and Social Research (NIESR) concluded that, without the NDYP, the level of long-term youth unemployment would have been twice as high.[1]

[1] *The New Deal for young people: implications for employment and the public finances*, NIESR, December 2000.

4.9 Budget 2003 announced a series of reforms to build on the success of the Jobseeker's Allowance (JSA) regime and improve its effectiveness in maintaining low unemployment and promoting effective and informed labour market choice. **From April 2004, the minimum number of steps that JSA claimants are required to take to search for jobs will increase, as will the number of interventions in the first six months.** These earlier interventions will help to reduce the risk of long-term detachment from the labour market. Budget 2003 also announced an **increase in the area over which JSA claimants are expected to travel to find work, from one hour to one and a half hours travelling time, after 13 weeks on JSA.**

4.10 The Government is committed to ensuring people have the support they require to return to the labour market. **From June 2005, the Government will build on existing measures by piloting in ten areas a mandatory short intensive work-focused course for all JSA claimants, aged 25 or over, at the six-month stage, in order to support them back into the labour market. This course will be followed by three mandatory personal adviser interviews.**

Lone parents

4.11 The Government is giving the 1.7 million lone parents in the UK the ability to exercise informed choice to overcome the difficulties they would otherwise face, particularly when seeking to balance work and family life. The lone parent employment rate in the UK has lagged behind the employment rate of mothers in couples, as well as that of lone parents in other countries. Lone parents are also more likely to live in poverty. Most want to work, and helping them to do so is key to reducing child poverty. The Government's target is for 70 per cent of lone parents to be in work by 2010.

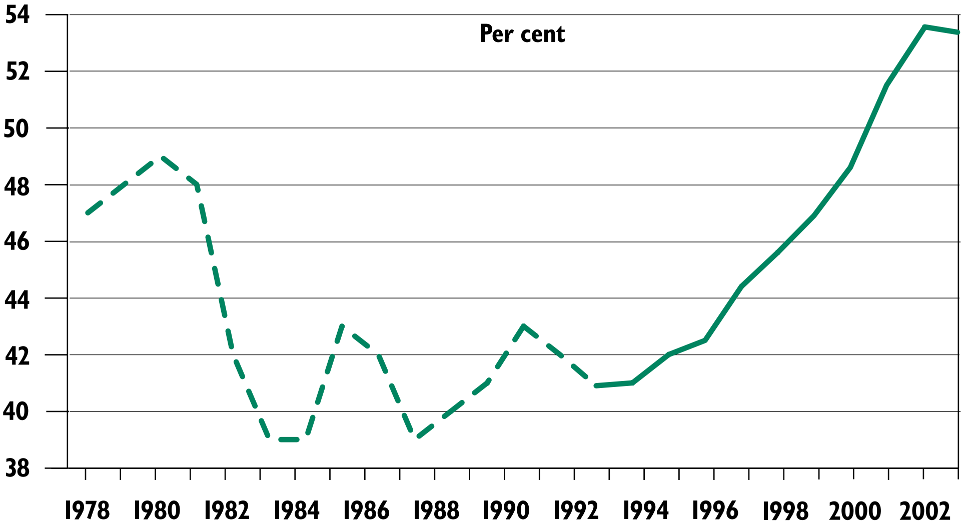
4.12 The New Deal for lone parents (NDLP) gives lone parents the help and support they need if they choose to look for work. It offers a comprehensive package of support, including access to a personal adviser, to all lone parents who are either not working or who are working fewer than 16 hours a week.

4.13 In the five years since the NDLP was launched nationally it has helped more than 225,000 lone parents into work. Evaluation evidence[2] suggests that the NDLP more than doubles the employment chances of participants. By cutting the benefit bill and increasing employment, analysis[3] suggests that the NDLP programme saved the Government £40 million in 2000-01. In part as a result of the NDLP and other Government measures, employment among lone parents has risen substantially, from just over 40 per cent in the early 1990s to 53.4 per cent in spring 2003.

[2] *New Deal for lone parents: findings from the quantitative survey*, Department for Work and Pensions, March 2003.

[3] *New Deal for lone parents: second synthesis report of the national evaluation*, Department for Work and Pensions, June 2003.

Chart 4.2: Lone parent employment rate



Note: Data from 1978 to 1992 refer to lone mothers and are derived from the General Household Survey. Data from 1992 onwards are from the Labour Force Survey and refer to all lone parents. All data are for Great Britain.

4.14 While significant progress has been made, the Government recognises that more help must be offered if the 2010 target is to be met. The implementation of many policies, such as the roll-out of work-focused interviews to all lone parents, is still underway. As well as completing these, the Government also intends to take further steps to enhance the level of work-focused support provided through Jobcentre Plus and the NDLP, and to further facilitate access to good quality and affordable childcare.

4.15 Work-focused interviews help to ensure that lone parents are aware of the help and support available, and are able to exercise an informed choice. More than 600,000 of these interviews have taken place and independent evaluation shows[4] they have significantly increased participation in the NDLP, while maintaining the rate at which participants find jobs. As announced in Budget 2002, **from April 2004 the requirement to attend a work-focused interview will be extended to lone parents on Income Support with children under the age of five,** completing the extension of mandatory work-focused interviews to all lone parents. **From October 2005, lone parents will be required to attend an interview once every three months when their youngest child is aged 14 or over, to help them prepare for the transition to JSA once their child reaches 16. In addition, from October 2004 a compulsory action plan will be completed for all lone parents when attending their regular work-focused interview.**

4.16 **In April 2004 the Government will be introducing extended school pilots in three areas.** As a result of the availability of quality childcare, **from September 2004 parents in workless households whose children could benefit from these pilots, and who have been on certain benefits for more than a year and whose youngest child is aged 12 or over will be required to attend quarterly work-focused interviews.**

[4] *New Deal for lone parents: second synthesis report of the national evaluation*, Department for Work and Pensions, June 2003.

4.17 Employers have a key role to play in helping lone parents into work. Budget 2003 announced a series of measures in six cities with high lone parent populations, based on the recommendations of leading employers consulted by the National Employment Panel. These included 'Discovery Weeks' designed to boost soft skills such as the confidence of lone parents. The first successfully took place in London in November 2003 and the rest will be rolled out to the other five cities from April 2004. A new communications and outreach strategy, again working closely with employers, is also being rolled out. **In addition, Budget 2003 announced that childcare tasters would be piloted in the six cities from April 2004.** These will allow lone parents to access formal childcare for up to one week, to test whether it suits their needs.

4.18 Starting a job can be a stressful time, particularly for those lone parents who have to help their child settle into formal childcare. This Pre-Budget Report therefore announces that, in line with the recommendations of the National Employment Panel, **the Government will cover the costs of a formal childcare place for a lone parent who has found a job through the NDLP for up to one week before they start work, from April 2005.**

Families in London

4.19 Making work pay is key to the Government's strategy to help workless people back into work. Work incentives can be particularly affected by the higher cost of living in London, especially for families with children. **Budget 2003 announced that in twelve locations across the country, including four in London, the Government would pilot a £40 per week in-work credit for lone parents who have been on Income Support for one year or more from October 2004.**

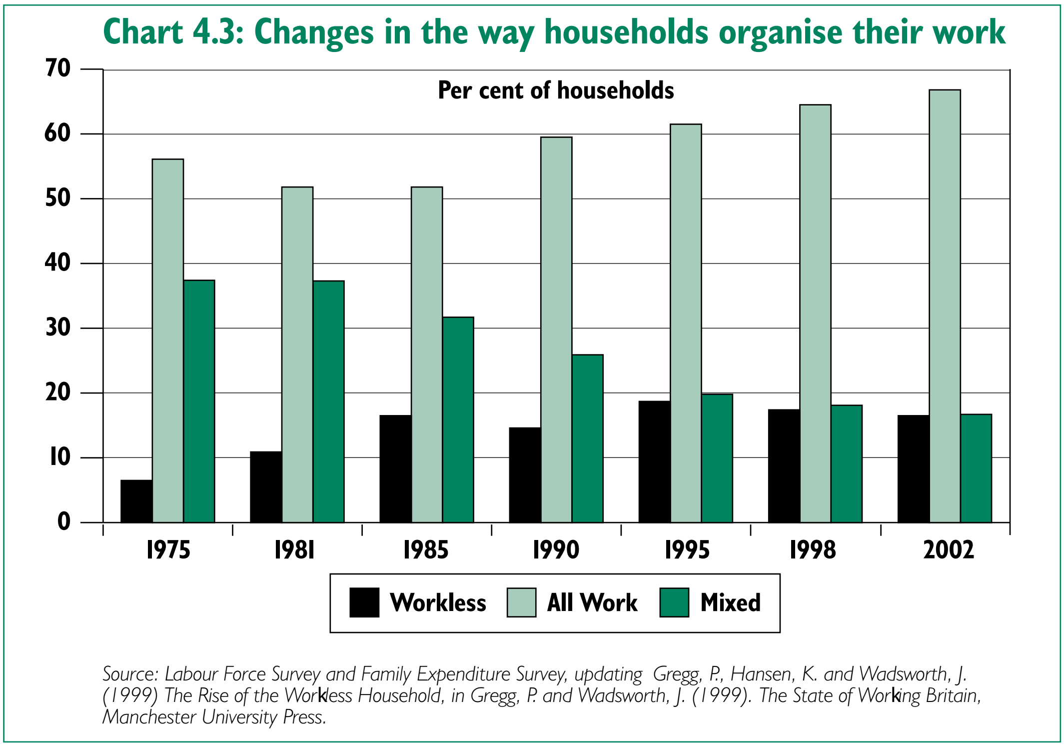
4.20 **This Pre-Budget Report announces that, to tackle the particular problem of work incentives in London, all parents in London who have been out of work and on certain benefits for more than one year will be eligible for the in-work credit from April 2005.** The pilot will not cover the North-East London Jobcentre Plus district, where the Employment Retention and Advancement Project is already testing similar incentives.

4.21 For many lone parents the costs involved in looking for work act as a disincentive to such activity. Budget 2003 therefore announced that **from October 2004 a new worksearch premium of £20 per week, paid on top of normal benefit entitlements, will be available in eight of the in-work credit pilot areas to lone parents who have been on Income Support for more than one year, and who voluntarily choose to search actively for a job.**

4.22 **The Government now announces that lone parents taking part in the pilots will be entitled to free formal childcare while undertaking worksearch activities.** This is in line with help already available for lone parents receiving the Training Allowance.

Partners

4.23 The employment rate among women has risen from 59 per cent in 1984 to almost 70 per cent today, reducing the gender employment rate gap to 10 percentage points – the lowest on record. However, the increase in female participation has been concentrated in households in which the male partner was already in work. Chart 4.3 shows how economic activity has accordingly become increasingly polarised into 'work-rich' and 'work-poor' households. The number of workless households rose from fewer than one in ten in 1975 to almost one in five in the mid 1990s.



4.24 Despite reductions in the numbers of workless people, there are still 4.3 million people of working age and almost 1.8 million children living in workless households. Extending support to every adult in a household who is without work, and not just to the main claimant, is necessary to meet the Government's goals of extending employment opportunity to all and tackling child poverty.

4.25 In the past, the tax and benefit system failed to provide the financial incentives or work-focused support needed to enable either partner in a couple to return to work. Even in the 1990s, the benefit system treated partners (usually female) of unemployed (usually male) claimants, as 'adult dependants' denying them help to make informed choices about opportunities in the labour market.

4.26 Adult dependence is an outdated concept which has denied effective employment choice to a large number of people, primarily women, and constrained effective labour supply. Given appropriate help and support, the partner of a benefit claimant may be just as likely to find work as the main claimant.

4.27 Everyone who is workless should have access to the work-focused support provided by Jobcentre Plus. The Government has already taken steps to extend the rights and responsibilities of JSA claimants on an equal basis. Since October 2002, childless partners of the unemployed, where at least one partner was born after 1957, have also become joint JSA claimants. As announced in the 2002 Pre-Budget Report, the Government also intends to introduce **compulsory work-focused interviews for partners of all new benefit claimants and existing claimants from April 2004,** over and above those having joint claim status for JSA.

4.28 Targeted support for households in which both partners are workless is provided through the New Deal for partners, a personal adviser service for partners of benefit claimants. As announced in Budget 2003, and coinciding with the introduction of compulsory work-focused interviews, **the New Deal for partners will be enhanced from April 2004** to provide the same package of support as is currently available to lone parents. **Partners will also be eligible for the enhanced Job Grant from October 2004.**

4.29 Around 750,000 children live in single-earner families with low incomes. Helping the non-working partner in a single-earner couple to find work can make a significant contribution to cutting child poverty. **The Government will therefore extend eligibility for the New Deal for partners to those in a family in receipt of the Working Tax Credit (WTC) who are either not working or are working less than 16 hours a week from October 2004.** This will help to ensure that those who are workless can benefit from work-focused help, regardless of the status of their partner.

4.30 The Government recognises that there is further to go in modernising the benefit system to reflect today's society. Its long-term aim is to extend rights and responsibilities in the benefit system, building on the success of joint claims for JSA, so that everyone has access to appropriate help and support. At present, couples can nominate the partner to whom benefit should be paid. There is a strong case in principle for extending an individual's right to payment, as and when this is practical.

Older workers

4.31 Older workers often face additional barriers to obtaining work. In 2000, the Government introduced the New Deal for the over 50s on a national basis. This has helped raise the employment rate of those aged between 50 and the state retirement age to 70 per cent. The Government is committed to building on this progress and ensuring that older workers are given the choice and opportunity to extend their working lives. **The Government now announces that, by October 2004, it will extend back to work help for those aged 60 and over and on the Pension Credit through improved access to the help available through existing employment programmes.**

Sick and disabled people

4.32 The Government recognises that there is more to be done to extend effective and informed labour market choice to sick and disabled people. Over 2.7 million working age adults claim an incapacity-related benefit and almost all of the 700,000 people moving onto these benefits each year want and expect to return to work.

4.33 The Government has already taken steps to empower disabled people and give them the ability to make the choice to return to work through the New Deal for disabled people (NDDP). By engaging those on incapacity-related benefits, this helped over 20,000 people into employment between July 2001 and September 2003. The NDDP has been extended for a further two years to March 2006, and its efficacy enhanced by improvements such as ensuring that clients have an appropriate back to work plan.

4.34 Some disabled people, while wanting to move into work, may not be ready to move immediately towards the provisions provided by the NDDP. **The Government is now introducing extra support, from April 2004, to enable Jobcentre Plus personal advisers to support those on Incapacity Benefit who want to move into work.**

4.35 Following a consultation period, the Government confirmed in June 2003 its intention to pilot a series of measures to provide new recipients of incapacity-related benefits with greater support earlier in their claim. The Pathways to Work pilots, which started in October 2003 and run to 2006, will test the effectiveness of more skilled adviser support, a series of additional work-focused interviews, rehabilitation programmes, improved financial incentives and engagement of key stakeholders including employers and General Practitioners.[5]

4.36 Disabled people often face additional costs in participating in the labour market, constraining their choice and opportunity. The WTC has addressed this by increasing the guaranteed minimum income for a single disabled person working 35 hours a week from £173 a week in April 2002 to £201 a week in April 2004. By October 2003, 64,000 families were benefiting from the disabled worker element of the WTC; 68 per cent more than was the case under the Disabled Person's Tax Credit (DPTC).

Ethnic minorities

4.37 The position of ethnic minorities in the labour market is worse than that of the rest of the population on a broad range of measures including employment rates, earnings levels and progression in the workplace, though there is significant variation between ethnic groups. In addition, people from ethnic minorities are more likely to live in the most disadvantaged areas of the UK.

4.38 The Government is taking steps to improve the employment choices and prospects of people from ethnic minority groups. The newly created Ethnic Minority Taskforce is taking forward the recommendations of the recent Prime Minister's Strategy Unit report[6] on the position of ethnic minorities in the labour market. In addition, an outreach service that helps connect people to mainstream services is operating in the five urban areas that are home to three quarters of Britain's ethnic minority population. Budget 2003 announced:

- **from April 2004, the introduction of specialist advisers in Jobcentre Plus districts with high ethnic minority populations;** and
- **a new policy fund of £8 million over two years** to help Jobcentre Plus managers provide local innovative solutions to helping people from ethnic minorities back into work.

Labour market information

4.39 To be able to make effective and informed employment choices, both with respect to occupation and location, individuals should be able to access relevant labour market information (LMI). Following an announcement in Budget 2003, a steering group has been established to improve collation of the various sources of LMI that exist, and to make these accessible to a wide range of users. The group is already looking at how LMI can be brought together and streamlined to improve both the quality of information and its usefulness in helping develop evidence-based local and regional labour market strategies. Progress is underway to make sources of LMI more easily accessible to the public and advisers through the Worktrain website and other means. The progress of the LMI project will form a part of the overall reporting procedure on the Skills Strategy White Paper, which was published earlier this year.

[5] More detail is available in *Pathways to Work: helping people into employment*, Department for Work and Pensions, November 2002 and *The Government Response and Action Plan*, Department for Work and Pensions, June 2003.
[6] *Ethnic Minorities in the Labour Market*, Prime Minister's Strategy Unit, March 2003.

Diverse patterns of employment

4.40 A flexible and fair labour market provides both employers and employees with the ability to choose from a range of alternative working patterns. Different types of employment and flexible working arrangements empower people to balance work with other responsibilities, thereby increasing employment opportunities. The UK labour market displays a significant degree of employment flexibility, being characterised by a high incidence of part-time work, a wide distribution of hours worked and widespread adoption of flexible working practices.

Self-employment

4.41 The Government is committed to providing the support necessary to allow the workless to choose their own form of future employment, including self-employment. To ensure that all workless people are able to take full advantage of the support available to them, **the Small Business Service will carry out a review of the routes off benefits into self-employment. The review will report in spring 2004** and will examine:

- the effectiveness of Government-sponsored information services in supporting the transition from unemployment, or employment, to self-employment;
- ways of encouraging moves into self-employment by promoting awareness of the financial and other support available, including the WTC; and
- client and business adviser perceptions of how Government offices and agencies, particularly Jobcentre Plus and Business Link operators, can assist potential entrepreneurs.

4.42 The Government is working hard to bridge the information gap and lack of support that can hinder those on benefits from moving into self-employment. **Jobcentre Plus, in conjunction with Business Links, will produce a leaflet, signposting the support available for those on benefits who wish to set up their own business. Business Links operators will also agree access to Jobcentre Plus offices, enabling them to market their services directly to Jobcentre Plus clients and ensure effective signposting of specialist support services.** Chapter 3 describes in detail the wider action the Government is taking to promote enterprise in the UK.

Skills

4.43 A skilled workforce is essential to the performance of the economy. Skilled workers are able to adapt faster and more effectively to change, to the benefit of the individual, society and the economy. Such flexibility ensures that those who become unemployed can return to employment more rapidly. It also enhances people's employment choices throughout their working life, enabling them to remain in productive and fulfilling employment for longer. Chapter 3 describes the steps the Government is taking to raise levels of skills in the workforce.

Labour mobility

4.44 The ease with which people are able to move location or commute is one determinant of their ability to take advantage of a broad range of employment opportunities. In the UK, as elsewhere in Europe, geographic mobility tends to be low relative to the US. Labour mobility helps ensure that the labour market remains flexible such that the right workers are matched to the right jobs, thereby helping business become more productive and enhancing the country's ability to cope with economic shocks. The way in which assistance with housing costs is delivered can be an important influence on the mobility and the employment choices available to those in receipt of such support.

Reform of Housing Benefit

4.45 Housing Benefit provides help with rental costs for low-income tenants in and out of work. Around 3.8 million tenants rely on it to help cover their rent. The current system of Housing Benefit is complex and difficult to administer, and performance in delivering it is highly variable. The requirement that claimants submit new claims each time they find a job leads many to worry that benefit payments will be interrupted if they move into work. Claimants in the private rented sector often do not know their level of entitlement until they have signed a tenancy agreement, with 70 per cent subsequently finding that their rental costs are not fully covered by their benefit payment. This constrains their ability to choose where to live and to trade off quality and price as they see fit.

4.46 The Government is determined to alleviate these problems and ensure that, regardless of where claims are made, an efficient and reliable service is given. This will help to ensure that Housing Benefit does not constrain people's employment choices. The Government's reform of Housing Benefit is well underway. Budget 2003 announced a series of changes to simplify the design and administration of Housing Benefit, and reduce variations in service and errors in processing:

- **from April 2004, returning to work will be treated as a change of circumstance and so will not require a new full claim to be submitted, and claimants will no longer be required to reclaim Housing Benefit periodically;** and

- **incentives to work for tenants will be improved by disregarding £12.32[7] of earnings in the calculation of Housing Benefit and Council Tax Benefit for all who are entitled to claim the WTC**, and not just those working 30 hours or more.

4.47 The Government is taking steps to improve the Housing Benefit system further and **from April 2004, the maximum childcare disregards in Housing Benefit will be increased by over 40 per cent to the levels in the WTC. The Government is also examining other ways of aligning Housing Benefit and tax credits.**

4.48 Budget 2003 also announced that **the Government would introduce a new local housing allowance (LHA) in nine Pathfinder areas for tenants in the private sector.** This is a major structural reform of Housing Benefit. Pathfinders have now begun in Blackpool and Lewisham, and the others are in the process of being rolled out. By ensuring that individuals know their entitlement before they sign a tenancy agreement, the LHA gives tenants the opportunity to choose where they want to live, keeping the difference if rent is below the LHA, or finding the extra money if it is above. The Government intends to introduce the flat rate system in the private sector throughout the country as soon as it is practical.

[7] This figure has been up-rated in line with inflation since this policy was announced in Budget 2003.

4.49 Tenants in the social sector should have the same fair and transparent help as those in the private sector, and benefit from the same opportunities to exercise choice. The process of restructuring rents in the social sector of England is well underway and will be substantially completed by 2011. This restructuring will ensure that the pattern of social housing rents represents more closely the relative attractiveness of properties to tenants. **The Government intends to begin LHA Pathfinders in the social sector as soon as is practical. These pilots will inform extension of a flat rate system to the social sector when rent restructuring and increased choice create a better market**.

4.50 The Government is committed to further structural reform of Housing Benefit to ease the transition to work for all working age tenants and ensure that they see appropriate gains to work as they progress within employment. This will address the problem of steep benefit withdrawal rates in order to ensure a more effective system of support for housing costs.

Making work pay

4.51 A flexible and dynamic labour market requires work incentives that make it worthwhile for people to participate in the labour market. Through the National Minimum Wage and new tax credits, the Government has made the transition from a benefit system that generated barriers to work, to a system of financial support which opens up employment choices to individuals by providing greater rewards from work. The Government's strategy to make work pay tackles two problems:

- the unemployment trap, when those without work find the difference between in-work and out-of-work income too small to provide an incentive to enter the labour market; and
- the poverty trap, when those in work have limited incentives to increase their hours or to move up the earnings ladder because it may leave them little better off.

The National Minimum Wage

4.52 The National Minimum Wage, introduced in April 1999, guarantees a fair minimum income from work. The Fourth Report from the Low Pay Commission (LPC), published in March 2003, reported that the National Minimum Wage has had no discernible negative impact on overall employment, inflation or the wider economy; indeed since its introduction the UK economy has created 1.1 million jobs.

4.53 In the light of these findings, as announced in Budget 2003, the rate for adult workers aged 22 or over was increased to £4.50 an hour in October 2003 and, **subject to consideration of the LPC's review early next year, will increase to £4.85 from October 2004.** The youth and development rate, for workers aged between 18 and 21 or in approved training, rose to £3.80 in October 2003 and **will be increased to £4.10 from October 2004, also subject to consideration of the LPC's review.** The latest Office for National Statistics (ONS) estimates indicate that between 1.0 and 1.2 million low paid workers benefited from the new rates of the National Minimum Wage in October 2003, and between 1.6 and 1.9 million will benefit in October 2004.

4.54 The Government has agreed that the LPC should consider the case for a minimum wage for 16 and 17 year olds and the Treasury is leading a wider, cross-government, review of financial support for 16 to 19 year olds as described further in Chapter 5. The Government believes that, in principle, the youngest workers should have the same protection from exploitatively low wages, as long as this does not harm their opportunities and incentives to remain in education or take up a training course, nor affect their future employment prospects.

The Working Tax Credit

4.55 The WTC is designed to tackle poor work incentives and persistent poverty among working people, providing support on top of the earnings guarantee through the National Minimum Wage. It builds on the success of the Working Families' Tax Credit (WFTC) and the DPTC by improving labour market choices for working families in several ways. The WTC is responsive to changes in income and circumstances and can provide increased support if household income falls. The WTC mainstreams support for disabled working people within the financial support system for working households and extends the scope of this support for the first time to households without children or a disabled worker.

4.56 By October 2003, just six months after the new tax credits were introduced, 1.54 million families were receiving the WTC. In addition, many more families were benefiting from extra help through the childcare and disabled worker elements of the WTC than benefited from equivalent tax credits last year. **This Pre-Budget Report announces that elements of the WTC will be uprated in line with the Retail Prices Index in 2004-05,** consistent with the Government's commitment. Chapter 5 discusses the extra help for childcare costs that the WTC provides.

4.57 Table 4.1 shows that, since the introduction of the National Minimum Wage in April 1999 and the WFTC in October 1999, the Government has increased the minimum income that people can expect when moving into work, so reducing the unemployment trap.

Table 4.1: Weekly minimum income guarantees

	April 1999	October 1999	April 2004
Family[1] 1 child, full-time work (35 hours)	£182	£200	£248
Family[1] 1 child, part-time work (16 hours)	£136	£144	£190
Single person, no children, 25 or over, full-time work (35 hours)	£113	£113	£160
Couple, no children, 25 or over, full-time work (35 hours)	£117	£117	£190
Disabled person (single), working full-time (35 hours)	£139	£155	£201
Disabled person (single), working part-time (16 hours)	£109	£112	£142

Note: assumes a single earner household, the prevailing rate of the National Minimum Wage and that the family is eligible for the Working Families' Tax Credit or Disabled Person's Tax Credit and the Working Tax Credit/Child Tax Credit.

[1] applies to one parent families and couples with children alike.

4.58 The Government's reforms are also tackling the poverty trap. Marginal deduction rates (MDRs) measure the extent of the poverty trap by showing how much of each additional pound of gross earnings is lost through higher taxes and withdrawn benefit or tax credits. Excessive MDRs reduce working families' labour market choices because they distort incentives to work longer hours or move up the earnings ladder and thereby weaken the link between increased gross earnings and improved living standards.

4.59 Table 4.2 shows that, as a result of the Government's reforms, nearly half a million fewer low-income households now face MDRs in excess of 70 per cent than in April 1997. The increase in the number of households facing MDRs of between 60 and 70 per cent is primarily due to the introduction of tax credits, which have extended financial support so that far more families benefit. The estimated number of households in this band has increased since Budget 2003, reflecting both the greater number of working families on low and moderate incomes benefiting from the new tax credits than was expected prior to their introduction, and the increase in the child element of the Child Tax Credit announced in this Pre-Budget Report.

4.60 This analysis overestimates the impact of MDRs under the new tax credits, as it does not take into account the effect of the disregard of income rises of £2,500 compared with income in the previous year. The disregard ensures that families will not see their tax credit awards reduced as soon as their income increases, with the result that the effective MDR in any one year is reduced. However, the system responds in full to falls in income as soon as they are identified, ensuring that extra support is provided to families when they need it most.

Table 4.2: The effect of the Government's reforms on high marginal deduction rates

Marginal deduction rate [1]	Before Budget 1998	2004-05 system of tax and benefits
Over 100 per cent	5,000	0
Over 90 per cent	130,000	50,000
Over 80 per cent	300,000	200,000
Over 70 per cent	740,000	270,000
Over 60 per cent	760,000	1,745,000

[1] Marginal deduction rates are shown for working households in receipt of income-related benefits or tax credits where at least one person works 16 hours or more a week and the head of the household is not disabled.

Note: Figures are cumulative. Before Budget 1998 based on 1997-98 estimated caseload and take-up rates; the 2004-05 system of tax and benefits is based on 2001-02 caseload and take-up rates, and projected caseload estimates of Working Tax Credit and Child Tax Credit in 2004-05 are based on October 2003 administrative data.

DELIVERING CHOICE – RESPONSIVENESS AND FLEXIBILITY

4.61 The Government wants to extend labour market choice to every individual by removing barriers to employment, and also by ensuring that policies are delivered in a manner that is flexible and responsive. Policies must be tailored to meet the needs of individuals in an effective and efficient way. It is important that the local autonomy and discretion this entails is anchored in clear long-term goals and strong accountability and transparency. These principles underpin the Government's wider public sector reform agenda, described in detail in Chapter 6.

Building on success

4.62 The Government intends to build upon the success of the New Deal by learning from the best of current provision and strengthening the New Deal's ability to help people who face particular difficulties in moving into employment. The Government will examine the range and availability of provision and the support needs of both unemployed and economically inactive people, integrating services within the New Deal to ensure that the full range of effective help is in place.

4.63 The Government will consider the case for extending further flexibility to respond to the needs of individual clients and local areas, subject of course to the maintenance of high national standards, and in the context of the overall framework of rights and responsibilities of the national benefit system. The Government will also consider the scope for simplifying current processes to make systems easier for employers, clients, advisers and providers.

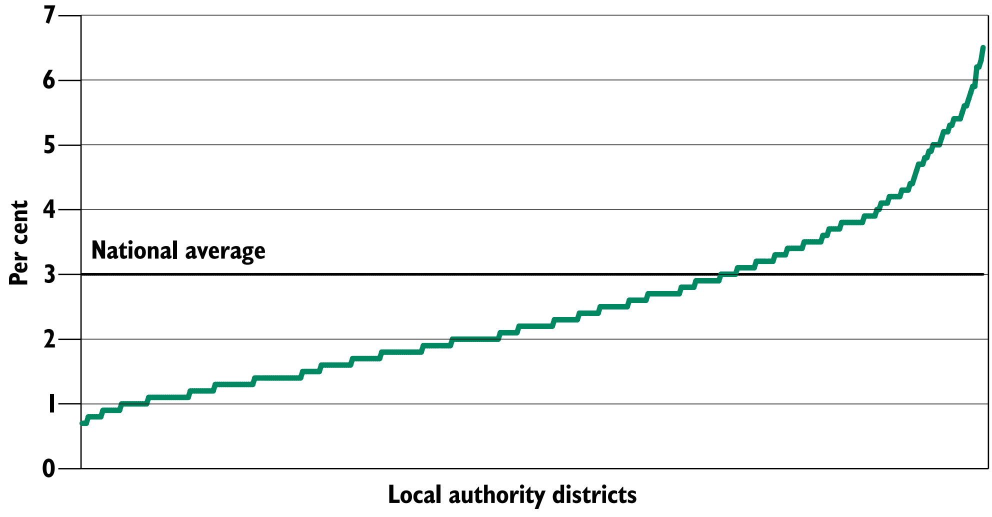
Variety of ways to access services

4.64 The creation of Jobcentre Plus brings together the Employment Service and those parts of the Benefits Agency dealing with working age people to provide inactive benefit claimants with the same level of work-focused support available to other benefit claimants. Jobcentre Plus offices have the facilities to ensure that employers and all those seeking work – the inactive as well as the unemployed – are matched more effectively, ensuring people are able to move back into work quickly. Since its launch in April 2002, almost 300 new Jobcentre Plus offices have opened and **the Government aims to complete the nationwide roll-out of more than 1000 offices in 2006.** Best practice will be adopted nationally as Jobcentre Plus is rolled out, and as resources are freed up, local discretion and autonomy will ensure that Jobcentre Plus customers are empowered to make effective and informed labour market choices.

Local responsiveness and flexibility

4.65 Chart 4.4 shows that, despite the success of Government policy in raising the overall employment rate, local concentrations of worklessness still persist. It is important that policy is delivered in such a way as to address effectively the problems of these areas, and help local and regional economies adjust to change. Further analysis is presented in *Full employment in every region* published alongside this Pre-Budget Report.

Chart 4.4: Local authority districts ranked by claimant unemployment rate



Source: ONS

Concentrations of worklessness

4.66 Recognising the importance of flexible regional and local employment programmes, the Government announced in the 2002 Pre-Budget Report **the introduction from April 2004 of the Working Neighbourhood pilots, which will provide a programme of intensive support in 12 neighbourhoods with very high concentrations of worklessness, to help local residents access jobs that are often within travelling distance of where they live.** In each Working Neighbourhood pilot area, residents claiming JSA will benefit from accelerated access onto the New Deal after just three months of unemployment. More frequent work-focused interviews will also be introduced for partners and lone parents, and new Incapacity Benefit claimants will be given more help to ensure that employment opportunities and barriers to work are regularly discussed.

4.67 The 2002 Pre-Budget Report also announced that each Working Neighbourhood pilot area will receive a discretionary fund allowing Jobcentre Plus, working in conjunction with local strategic partners, greater flexibility and discretion to increase their effectiveness in moving local people quickly into work.

Rapid Response Service

4.68 The Rapid Response Service (RRS) helps local areas adapt to large-scale redundancies, ensuring that individuals, employers and the local economy do not suffer long-term damage as a consequence of these redundancies. As long-term detachment from the labour market can lead to the erosion of labour market choice, the role that the RRS can play is significant.

Action Teams

4.69 Action Teams for Jobs have been introduced in 63 disadvantaged areas of the UK, many of which contain large ethnic minority communities. Action Teams focus on the long-term unemployed and inactive, using their resources in innovative ways to address specific local barriers to work. The Government is building on the success of Action Teams by announcing that, **from April 2004:**

- **the 63 existing Action Teams will be extended to 2006;**
- **two additional Action Teams will be introduced in Wear Valley and Barrow-in-Furness;** and
- **Jobcentre Plus District Managers and Action Team contractors will have greater discretion to direct resources towards the most disadvantaged people in their area.**

Public sector wage flexibility

4.70 The Government aims to increase the use of geographically differentiated pay across the public sector, within existing national bargaining frameworks. This will better recognise local and regional labour market conditions, ensure that employers and employees are making choices based on these labour market needs and conditions, and help government services to meet local recruitment and retention needs. The Government has amended the remits for the Pay Review Bodies to include a stronger local and regional dimension, and is now also working with the rest of the public sector to increase the focus on local pay, side by side with UK-wide guarantees of a National Minimum Wage and the tax credit system.

Balancing public and private provision

4.71 Ensuring people have the best chance of getting back into work requires striking the right balance between provision provided by the public and the private sector.

Employment Zones

4.72 Employment Zones are helping long-term unemployed people aged 25 and over back into work in 15 areas of England, Scotland and Wales. They provide jobseekers and their personal advisers with complete discretion over funds to overcome individual barriers to work, and so open up employment opportunities that may not have existed. Budget 2003 announced further steps to extend the help provided, including:

- **the extension of the Employment Zone approach to people who would otherwise return to the NDYP for a second or subsequent time from October 2003;**
- **from April 2004, replacing the NDLP in the five London Zones and for lone parents returning for a second or subsequent work-focused interview in the other Zones;** and
- to make the most effective use of resources through the use of multiple providers, **from April 2004, multiple providers will be introduced in the five London Zones, as well as in Birmingham, Liverpool and Glasgow.**

FUNDING FOR WELFARE TO WORK

4.73 The Department for Work and Pensions delivers the majority of the Welfare to Work programme, which is funded by the one-off Windfall Tax on the excess profits of the privatised utilities together with resources allocated in the 2002 Spending Review. The DWP annual report sets out expenditure plans and outturn information. Table 4.3 sets out that element of the Welfare to Work programme funded by the Windfall Tax.

Table 4.3: Allocation of the Windfall Tax

£million	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03[2]	2003-04[2,3]	2004-05[2]	2005-06[2]	TOTAL
Spending by programme[1]										
New Deal for young people[4]	50	200	310	300	240	260	170	0	0	1,530
New Deal for 25 plus	0	10	90	110	200	210	150	0	0	770
New Deal for over 50s	0	0	5	20	10	10	10	0	0	60
New Deal for lone parents	0	20	40	40	40	80	60	0	0	280
New Deal for disabled people[5]	0	5	20	10	10	30	30	0	0	100
New Deal for partners	0	0	5	10	10	10	10	0	0	40
Childcare[6]	0	20	10	5	0	0	0	0	0	35
University for Industry[7]	0	5	0	0	0	0	0	0	0	5
Workforce development[8]	0	0	0	0	0	40	50	150	80	320
ONE pilots[9]	0	0	0	5	5	0	0	0	0	10
Action Teams	0	0	0	10	40	50	50	0	0	150
Enterprise development	0	0	0	10	20	10	0	0	0	40
Modernising the Employment Service	0	0	0	40	0	0	0	0	0	40
Total Resource Expenditure	50	260	480	560	570	700	530	150	80	3,380
Capital expenditure[10]	90	270	260	750	450	0	0	0	0	1,820
Windfall Tax receipts	2,600	2,600								5,200

[1] *In year figures rounded to the nearest £10 million, (except where expenditure is less than £5 million). Constituent elements may not sum to totals because of rounding.*
[2] *Figures are provisional for the years from 2002-03 to 2005-06.*
[3] *Windfall tax expenditure on welfare to work programmes is reduced from 2003-04 onwards as windfall tax resources are exhausted. Remaining in-year expenditure will be topped up with general Government revenues.*
[4] *Includes funding for the Innovation Fund.*
[5] *Includes £10 million in 1999-2000, an element of the November 1998 announcements on welfare reform.*
[6] *Includes £30 million for out-of-school childcare. The costs of the 1997 Budget improvements in childcare through Family Credit are included from April 1998 to October 1999, after which the measure was incorporated within the Working Families' Tax Credit.*
[7] *Start up and development costs. Other costs of the University for Industry are funded from within Departmental Expenditure Limits.*
[8] *Includes £219 million funding for Employer Training Pilots.*
[9] *Funding for repeat interviews. Other funding is from the Invest to Save budget.*
[10] *Includes capital spending on renewal of school infrastructure, to help raise standards.*

5 BUILDING A FAIRER SOCIETY

The Government is committed to promoting fairness alongside flexibility and enterprise so that everyone can take advantage of opportunities to achieve their full potential in a modern, flexible economy. The reforms of the welfare state introduced by this Government reflect its aims of tackling child and pensioner poverty, promoting saving and ensuring security for all in old age. The Government is also committed to a modern and fair tax system which encourages work and saving and ensures that everyone pays their fair share of tax. This Pre-Budget Report sets out the next steps the Government is taking to support these aims, including:

- **increasing the child element of the Child Tax Credit by £180 to £1,625 a year from April 2004, equivalent to a weekly increase of £3.50. This will benefit 7.2 million children and means that the Government is on track to meet or exceed the target to reduce the number of children in low-income households by a quarter by 2004-05 on a before housing costs basis. The increase will enable the Government step by step to make progress towards its goal to halve child poverty by 2010 and eradicate it in a generation;**
- **promoting the provision of employer supported childcare, as part of the Government's ongoing commitment to help parents balance their work and family lives;**
- **consulting further on detailed proposals to simplify radically the taxation of pensions, increasing choice and flexibility for pension savers and promoting the take up of the Pension Credit, launched in October 2003, providing increased financial security for pensioners on low or modest incomes and helping to tackle pensioner poverty;**
- **bringing all Sandler Stakeholder medium-term products and life insurance products into the stocks and shares component of ISAs from 2005; and**
- **taking action to protect direct and indirect tax revenues and modernise the tax system.**

INTRODUCTION

5.1 Previous chapters have described the Government's strategy for delivering strong and stable growth, through a robust macroeconomic framework and reforms which promote an enterprising and flexible economy with high levels of employment. This chapter describes how the Government is working to extend opportunity and security across the economy. The Government is committed to ensuring flexibility and fairness are advanced together so that everyone can take advantage of opportunities to achieve their full potential in a modern, dynamic economy. This chapter details action to tackle child and pensioner poverty, promote saving and ensure security for all in old age. The chapter also describes the action the Government is taking to promote a modern and fair tax system and to achieve the Millennium Development Goals to reduce global poverty.

5.2 The principles which underpin the welfare state are those of opportunity, responsibility and security. Chapter 4 describes how the Government's goal of ensuring employment opportunity for all is central to avoiding poverty during working life and provides the best platform from which to save for security in retirement. This chapter describes the action the Government is taking to put into practice the principle of progressive universalism with support for all and more help for those who need it most, when they need it most.

5.3 Measures described in this Pre-Budget Report build upon the significant welfare reforms of recent years. A new external report from the Joseph Rowntree Foundation and the New Policy Institute highlighted the fact that income poverty in Britain is on a steady downward trend from a figure of around 13.4 million in the mid-1990s to 12.5 million people in relative low-income households in 2001-02. It is now lower than at any time in the 1990s, an indication of real and tangible progress. Making opportunity a reality requires a modern and fair tax and benefit system which offers real choice and acknowledges that people's lives have changed since Beveridge's reforms in the 1940s. Recent measures to expand choice include, for example:

- extending maternity leave and pay and introducing paid paternity leave to enable working parents to spend more time with their new babies;
- increasing the supply of childcare and providing greater support for childcare costs for working parents; and
- allowing people deferring their basic state pension to take a more generous pension or a lump sum.

SUPPORT FOR FAMILIES AND CHILDREN

Tackling child poverty

5.4 The Government believes that economic strength should be underpinned by fairness and social inclusion. All children should have the chance to fulfil their potential and take full advantage of the opportunities available to them, regardless of circumstances. Starting life in poverty can entail wide-ranging and long-term disadvantage, often passed on from one generation to the next.

5.5 In the mid to late 1990s, the UK suffered higher child poverty than nearly all other industrialised nations.[1] Over 20 years, the proportion of children living in relative low-income households had more than doubled. The Government therefore set an ambitious long-term goal to halve child poverty by 2010 and to eradicate it by 2020.

5.6 The Government's strategy for tackling child poverty involves ensuring decent family incomes, with work for those who can and support for those who cannot, and providing support for parents. It also involves delivering high quality public services and harnessing the power and expertise of the voluntary and community sectors.

Progress to date

5.7 As a first step towards eradicating child poverty, the Government is committed to a Public Service Agreement (PSA) target for 2004-05 to reduce by one quarter the number of children in low-income households[2] compared with 1998-99. The most recent data show that between 1998-99 and 2001-02 the numbers of children in low-income households fell by 0.4 million after housing costs (AHC) and by 0.5 million before housing costs (BHC), from 4.2 million and 3.1 million respectively.[3] The Government has therefore succeeded in arresting and reversing the long-term trend of rising child poverty and is making steady progress towards the 2004-05 PSA target. These data do not reflect the effect of increased support from the introduction of the new tax credits in April 2003.

5.8 The Institute for Fiscal Studies (IFS) has recently estimated[4] that, after allowing for this and the existing commitment to uprate the Child Tax Credit, there remains a need to lift

[1] *The dynamics of child poverty in industrialised countries*, Bradbury *et al.* (eds) 2001. Unicef, Cambridge University Press.

[2] Defined as those with less than 60 per cent of contemporary median income. Income is defined as household disposable income, adjusted for household size and composition.

[3] Data from *Households Below Average Income 1994-95 to 2001-02*, Department for Work and Pensions, March 2003. Income is measured on before housing costs and after housing costs bases to take into account variations in housing costs that themselves do not correspond to comparable variations in the quality of housing.

[4] *What do the child poverty targets mean for the Child Tax Credit? An update.* M. Brewer, Institute for Fiscal Studies, Briefing Note No. 41, December 2003.

a further 0.2 million children over the threshold in 2004-05 at a cost of £1 billion. There is an inevitable uncertainty over such estimates; as the IFS acknowledge the Government could lift 0.2 million children over the threshold and still miss the target.

5.9 The reduction in the proportion of children in low-income households is particularly notable as it has been achieved during a period of high growth in household incomes. Between 1998-99 and 2001-02 average annual real median income growth was nearly 4 per cent BHC and nearly 5 per cent AHC. This income growth reflects the wider success of a range of Government economic policies, but it means that progress against a purely relative measure of poverty is particularly difficult.

5.10 This is underlined by the substantial progress made against an absolute low-income measure. Between 1998-99 and 2001-02, the number of children in absolute low-income households fell from 2.8 million to 1.6 million BHC, and from 4.0 million to 2.5 million AHC.

5.11 Subsequent sections of this chapter highlight the Government's policies to tackle child poverty, new investment to help meet the 2004-05 PSA target and next steps for the longer term.

Financial support for children

5.12 The Government's financial support for children is based on the principle of progressive universalism, with help for all families and more help for those who need it most, when they need it most. This support is delivered through the combination of universal Child Benefit and the progressive Child Tax Credit (CTC). The CTC includes a family element available to 90 per cent of families with children, with an income of up to £58,000 a year, and a child element for each child in a low-income household, plus additional help for families with a baby or a disabled child.

5.13 By 2003-04, financial support for children through tax credits, Child Benefit and other benefits had been increased by £9.2 billion in real terms from its 1997 level, a rise of 64 per cent. The extra investment has funded improved financial help for all families through Child Benefit, along with extra help for children in poor families and children with disabilities. The financial support available to a low-income family for a young child has more than doubled in real terms since 1997 and the additional help to which a family with a disabled child is entitled has risen by 70 per cent.

Child Benefit

5.14 Child Benefit is currently £16.05 a week for the first child in every family and £10.75 a week for subsequent children. From April 2004, the rates of Child Benefit will rise in line with the Retail Prices Index (RPI) to £16.50 and £11.05 respectively. The rate for the first child therefore remains 25 per cent higher in real terms than it was in 1997.

Child and Working Tax Credit

5.15 The Child and Working Tax Credits introduced in April 2003 represent the biggest single change in the way government provides financial support for families since the Beveridge reforms of the 1940s. The tax credits:

- provide support for children which is independent of the work status of their parents, bridging the gap between welfare and work;
- pay support for children to the main carer, transferring approximately £2 billion to mothers;
- are more generous, providing financial support to 5.9 million families, so avoiding stigma for poorer families;

- target resources effectively on families with the greatest needs and are responsive to family circumstances, so families receive greatest support when they need it most;
- are based on annual family income, which is both fairer and easier to verify than income measured over a short period, as was the case with Working Families' Tax Credit (WFTC); and
- improve incentives to save and to work, especially for second earners, and provide families with greater flexibility and choice.

Child Tax Credit

5.16 Whether in or out of work, the CTC provides a single, seamless system of income-related support for families with children, replacing and improving upon the child elements of the WFTC and the Disabled Person's Tax Credits (DPTC) and the Children's Tax Credit. For 2003-04, families on Income Support or Jobseeker's Allowance are benefiting from the increased support in tax credits through the child allowances in their benefits and these families will be migrated onto tax credits during 2004-05.

5.17 Paid on top of universal Child Benefit, the CTC comprises:

- a family element of £545 a year – doubled to £1,090 for families with a child under the age of one – for all families with incomes of less than £50,000, gradually withdrawn for those with incomes above this amount;
- a child element for each child or young person in low-income families, gradually withdrawn for families with higher incomes; and
- increased child elements to reflect the greater needs of families caring for disabled children.

5.18 By October 2003, 10.5 million children were benefiting from the CTC. Compared with 1.4 million working families who benefited from the WFTC or the DPTC, 2.25 million working families were receiving support above the family element. The additional help available was also reaching more families with a disabled child and those with childcare costs. Further details of the support provided by the Working Tax Credit (WTC) are provided in Chapter 4.

New investment to help meet child poverty target

5.19 Building upon the introduction of the CTC, this Pre-Budget Report announces that the **child element will increase from April 2004 by £180 to £1,625 a year, equivalent to a weekly increase of £3.50**. This increase will benefit 7.2 million children in 3.7 million families. The disabled child elements of the CTC will increase in line with RPI.

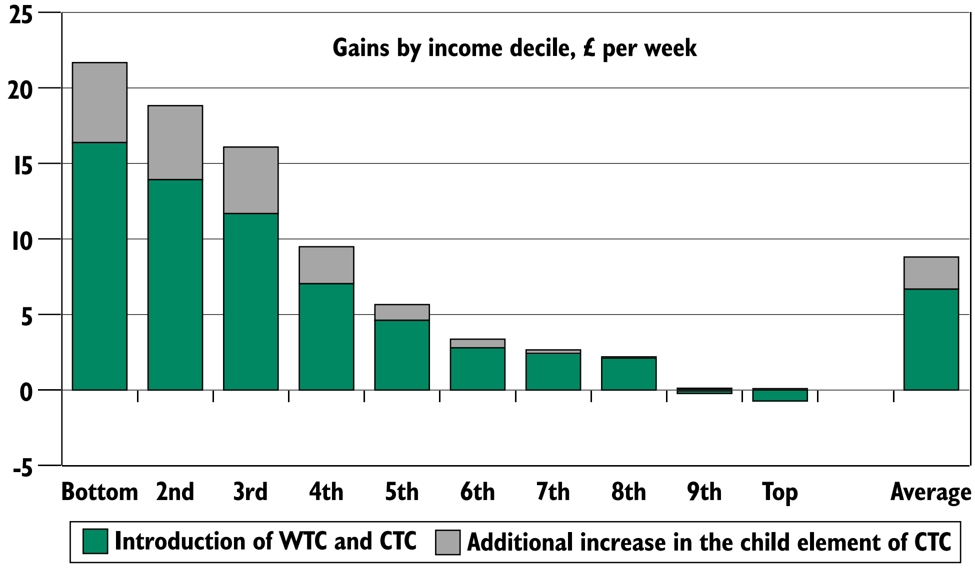
5.20 As a result of this new investment, the Government is on track to meet or exceed its PSA target to reduce by a quarter the number of children in low-income households by 2004-05 on a BHC basis, comparable to the European child poverty indicator. The target is more challenging on an AHC basis. The nature of the target means that there are uncertainties either way. Analysis by the Institute for Fiscal Studies suggests that this increase will enable the Government to make substantial progress on an AHC basis. This extra investment will enable the Government to make progress step by step towards its goal to halve child poverty by 2010 and eradicate it by 2020.

5.21 By 2004-05, financial support for children through tax credits, Child Benefit and other benefits will have increased by £10.4 billion in real terms from its 1997 level, a rise of 72 per cent. Table 5.1 shows the levels of support that the CTC and Child Benefit will provide for families from April 2004, including the new investment announced in this Pre-Budget Report. The precise amount a family receives depends on their income and circumstances, with support reduced as income rises. Chart 5.1 shows average gains for families as a result of the introduction of the WTC and the CTC and previously announced upratings, and identifies the additional increase in the child element of the CTC as announced in this Pre-Budget Report.

Table 5.1: Levels of support for families from April 2004

Family income (£ a year) *Per cent of families*	less than £13,480 *30*	less than £50,000 *85*	all families *100*
1 child	£3,030	£1,405	£855
2 children	£5,235	£1,980	£1,430
3 children	£7,435	£2,550	£2,005

Chart 5.1: Average gains for families as a result of Working and Child Tax Credits



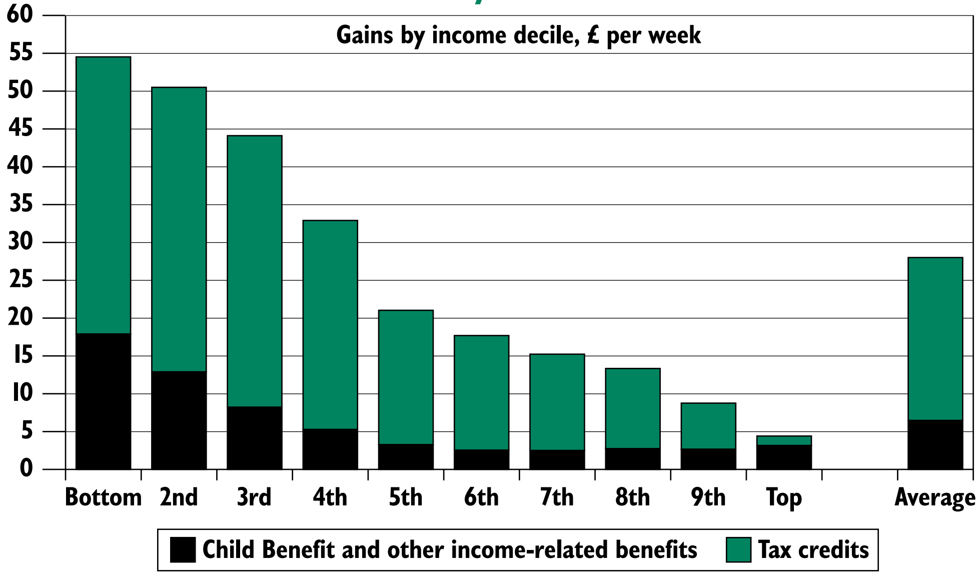
Source: HM Treasury.

Effects of measures to support families with children

5.22 Chart 5.2 shows the impact by decile, since 1997, of the Government's reforms for families with children. As a result of the Government's personal tax and benefit reforms since 1997, including measures due to take effect in 2004-05, by September 2004, in real terms:

- families with children will be, on average, £1,300 per year better off, while those in the poorest fifth of the population will be, on average, £2,900 per year better off;
- a single-earner family on half average earnings with two young children is £3,750 a year better off; and
- a single-earner family on average earnings with two young children is £310 a year better off.

Chart 5.2: Gains for families as a result of tax credits and other children's measures by 2004



Source: HM Treasury.

5.23 The Government remains determined to continue to make progress beyond 2004-05 and recognises that further investment and reform are needed to ensure the long-term goal of halving and eradicating child poverty is met. The Child Poverty Review, described below, is addressing this. Details of the public service reforms and support for parents that are contributing to reducing child poverty are provided later in this chapter.

Long-term strategy: 2010 and 2020

Long-term measure for child poverty

5.24 The Government is committed to achieving its long-term goal of halving child poverty by 2010 and eradicating it by 2020. It is important that any measure of child poverty helps target policies most effectively and enables the public to hold the Government to account. The Department for Work and Pensions (DWP) consulted last year on options for a measure beyond 2004-05, published preliminary conclusions in May 2003[5] and will report on this before the end of the year. Relative income will continue to play a key part in any long-term measure of child poverty.

The Child Poverty Review

5.25 In Budget 2003, the Chancellor announced a Child Poverty Review, which will set out the further welfare reform and public service changes required to meet the Government's long-term goal on child poverty. The Review is working across Government, drawing on expertise from the research community and the voluntary sector, and will inform the 2004 Spending Review. It intends to set out the policies necessary to:

- increase employment opportunities, raising incomes for those who can work, including looking at issues such as ethnicity and access to labour markets through public transport;
- support those who cannot work;

[5] *Measuring child poverty: A consultation document*, Department for Work and Pensions, April 2002.
Preliminary conclusions: Measuring child poverty consultation, Department for Work and Pensions, May 2003.

- improve the effectiveness of public services in tackling deprivation, for example housing and services to tackle debt and financial exclusion;
- increase the contribution of public services to improving the future life chances of children in households suffering low income, for example education, parenting and early years support, and ensure public services and the welfare system work well together when families face crisis points; and
- improve services for children and their families living in deprived areas, including targeted programmes.

The Children's Green Paper

5.26 Public services play an important role in contributing to positive outcomes for families and children, ensuring stability and enjoyment in childhood, extending choice for parents and children, and laying the foundations which allow today's children to guard against the risk of poverty and disadvantage. The Children's Green Paper,[6] published in September 2003, sets out a vision for transformed services for children, through policies including:

- support for parents and carers, such as the £25 million Parenting Fund;
- early intervention and effective protection, including ensuring that each child in contact with several services has a lead professional, and working to remove legislative and IT barriers to information sharing between professionals;
- accountability and integration to put children at the centre, including the appointment of Children's Directors in Local Authorities, moving towards integrated Children's Trusts at the local level, a major reorganisation of Whitehall responsibilities and the creation of a Children's Commissioner; and
- workforce reform, including a strategy which will review rewards, incentives and relativities across children's practice, and a Sector Skills Council for children and young people's services.

Since publication, the Government has conducted an extensive consultation on the Green Paper, including with children and young people, and a Bill will be introduced to legislate for Children's Directors, a Children's Commissioner and a duty to work closely with partners in the voluntary and community sectors.

Parenting support

5.27 The Government recognises that good parenting is vital for children's educational outcomes, health and social and behavioural development, so parents should be able to receive support long before compulsory schooling begins. The Government is therefore establishing links with primary and nursery schools in 500 communities to help parents give their children the very best start in life. This will help parents of young children to create a positive learning environment in the home and to prepare children for starting school.

[6] *Every child matters*, Department for Education and Skills, September 2003.

Support for young people

5.28 Opportunities for young people to continue in education after the age of 16 can be hindered by financial circumstances. In recognition of this, the 2002 Spending Review announced that Education Maintenance Allowances (EMAs) would be introduced in the UK from September 2004. Evidence shows that payments to young people in education have a positive impact on the numbers participating and thriving in education. EMAs will be paid directly to young people who stay on in further education after they reach statutory leaving age. They will be paid at three levels – £30, £20 or £10 a week – depending on household income. Young people may also receive bonuses of £100 if they remain on their course and make good progress with their learning. From September 2004, around 290,000 young people in England and Scotland will benefit from this extra help to stay on in post-16 education. Around 475,000 young people in England and Scotland will benefit from EMAs when the scheme is fully rolled out.

Review of financial support for 16-19 year olds

5.29 The improved package of financial support provided by EMAs, the Child Tax Credit and Child Benefit will enable more young people to remain in full-time education. The Government is also committed to supporting young people who choose other paths, such as vocational training and work. The Low Pay Commission is currently examining the case for a national minimum wage for 16 and 17 year olds. At the same time, the Treasury is leading a review of financial support for 16-19 year olds, working with children's groups, relevant Government departments and external stakeholders and in consultation with young people and parents. The review is considering ways of improving the system of financial support in the short term and longer-term reform.

Supporting parents: balancing work and family life

Enhancing choice and support for parents

5.30 The Government is committed to supporting parents in balancing their work and family lives. The Government's strategy involves increasing choice for parents and helping them to fulfil their responsibility for raising children, while working in partnership with business and employee representatives to promote the benefits of flexible working and to encourage the take up of best practice.

Pay and leave for parents

5.31 To help parents choose how to balance their work and family responsibilities the Government has implemented new rights for working parents. Mothers now have a right to up to one year of maternity leave, with 26 weeks paid Ordinary Maternity Leave and a further 26 weeks unpaid Additional Maternity Leave. Statutory Maternity Pay (SMP) has been increased to £100 a week, up from £60 in 2000. New fathers have the right to take two weeks paternity leave, paid at the same rate as SMP. Adoptive parents enjoy similar rights. Since April 2003, mothers and fathers of children under six and of disabled children under 18 have had a right to request flexible working. From April 2004, SMP will increase in line with the RPI from £100 per week to £102.80. This Pre-Budget Report announces that **from April 2004, the Government will uprate Statutory Paternity Pay and Statutory Adoption Pay in line with Statutory Maternity Pay**.

5.32 Although significant progress has been made since 1997, the Government is committed to taking further steps to help parents balance their work and family responsibilities. *Balancing work and family life: enhancing choice and support for parents,*[7] published in January 2003, set out the Government's strategy in this area and suggested possible next steps for reform. The Government has already implemented some of these steps

[7] *Balancing work and family life: enhancing choice and support for parents*, HM Treasury and Department of Trade and Industry, January 2003.

and announces further progress in this Pre-Budget Report. The Government is considering a number of further options concerning leave for parents, including:

- allowing parents to take parental leave in one block at the end of maternity or paternity leave;
- extending the period of paid paternity leave and/or introducing unpaid paternity leave;
- extending paternity leave in cases of multiple births and disabled babies;
- extending parental leave and pay rights to foster carers; and
- allowing unpaid maternity leave to count as being in work for tax credit purposes.

The Government will keep the impact of the new measures introduced in April 2003 under review, before considering any further changes.

5.33 The Government has also consulted on allowing fathers time off to attend key ante-natal appointments to enable them to become more involved with their baby from the earliest stages. This idea was favourably received by employees, and many employers already offer this option to their staff. The Government will work with employers to promote this as best practice.

Employer supported childcare

5.34 The Government believes that the provision of employer supported childcare can play an important role in helping employees to balance their work and family lives, and can improve staff morale and work performance. The Government consulted earlier this year on proposals to encourage more employers to help their staff with the cost of safe, good quality childcare.[8] Following the responses to this consultation, the Government is announcing new measures, to be implemented in April 2005, which include:

- **extending the current workplace nurseries tax exemption to cover any formal registered childcare or approved home-childcare contracted by the employer,** such as a parent's local nursery, out-of-school club or childminder;
- **removing the requirement for the employer to have management responsibility for the childcare provision;**
- **a new matching tax exemption for childcare vouchers;** and
- **a rule that where schemes operate, they should be generally accessible to all employees.**

5.35 To ensure that Government support is only provided for good quality care, **the tax and NICs exemption for employer-contracted childcare and childcare vouchers will be restricted to approved childcare**. It will be set at £50 per week per employee to ensure that the exemption is affordable and fairly targeted. The Government will monitor the effect of the financial limit and keep it under review. These measures will extend choice for many parents and employers whose needs are not currently met by a workplace nursery. They will offer real incentives to employers to support good quality, affordable childcare for their employees. The proposals build on the existing help available for good quality childcare through tax credits.

[8] *Employer Supported Childcare: Improving the Tax and National Insurance exemptions*, Inland Revenue and HM Treasury, February 2003.

Childcare support through tax credits

5.36 The childcare element of the WTC provides support to working parents for the costs of childcare, giving them more financial flexibility to choose the childcare arrangements which are most appropriate for them. Following the introduction of new tax credits, nearly 60 per cent more families are now benefiting from help with childcare costs, with 286,000 families receiving support in October 2003 compared to 180,000 under the WFTC and the DPTC.

5.37 The Government is introducing a number of improvements to the support offered through tax credits. Together with the CTC and its baby addition, these measures will improve financial support to working parents at a time when they need it most, helping to ease the transition to a new family life. From April 2004:

- first time parents who were working at least 16 hours a week before going on maternity, paternity or adoption leave will be able to **claim WTC from the date of birth or adoption of their first child**; and
- as announced in Budget 2003, **mothers on paid maternity leave will be able to receive help with the costs of childcare for their new babies**.

5.38 Parents can now claim support for the costs of using approved childcare in their own home. Currently only registered childminders can become approved home childcarers, so those new to the scheme need to register first as a childminder. The Government will bring forward proposals, for consultation in spring 2004, to streamline this process and widen home childcaring.

Investment in childcare places

5.39 In line with its determination to increase parents' ability to choose how they balance their work and family life, and its commitment to a thriving childcare market, the Government has invested heavily to support the creation of new childcare places. Childcare places for over 1.3 million children have been created since 1997, which puts the Government on course to meet its target of places for 1.6 million children by 2004 and over 2 million children by 2006.

Childcare Review

5.40 The Government has made considerable progress across a number of fronts to support childcare, but recognises that more work is needed. Budget 2003 announced a Childcare Review to inform the 2004 Spending Review, which will consider whether:

- the long-term projection for childcare and early years education is sufficient to meet the Government's aims for employment and educational attainment;
- the expansion is proceeding quickly enough; and
- there are areas where more remains to be done.

FAIRNESS FOR DISABLED PEOPLE

5.41 The Government is determined to ensure that disabled people have the opportunity to lead independent and fulfilling lives. As described in Chapter 4, the Government is piloting measures to trial earlier and more intensive employment support to people with health problems or a disability who have the potential to return to work, enabling them to have genuine choice and opportunity to gain employment.

5.42 Fairness for disabled people requires an end to discrimination in the workplace and beyond. The Government published a draft Disability Bill on 3 December 2003. The draft Bill would increase the opportunities for disabled people, ensuring that they have a greater say in how services are run and thus help to encourage diversity in society.

5.43 To provide extra help for families with disabled children, the disabled child element of the CTC was increased in April 2003 to provide extra help for families with disabled children. It is now worth more than £40 a week on top of the CTC or the child allowances of Income Support or Jobseeker's Allowance. There were 102,000 working families benefiting from the disabled child element of the CTC in October 2003, over three times higher than the 32,000 who benefited from disabled child credits in WFTC/DPTC.

FAIRNESS FOR PENSIONERS

5.44 A fair society guarantees security in old age. This means ensuring security for all pensioners. Building on the foundation provided by the basic state pension, the Government launched the Pension Credit in October 2003 to tackle pensioner poverty and ensure all pensioners can share in rising national prosperity. The Pension Credit, described in Box 5.1, provides extra income for those who need it most and rewards those who have saved modest amounts. Above this foundation, the Government is committed to facilitating effective choices so that individuals, where possible supported by their employers, are empowered to make their own decisions about their retirement and the level of income they will need. The Government is helping today's workers – tomorrow's pensioners – to work and to save more effectively for a secure retirement, through the range of proposals set out in the Government's Pensions Green Paper,[9] the subsequent document *Action on occupational pensions*,[10] and *Simplifying the taxation of pensions: The Government's proposals*,[11] the second consultation document, published alongside this Pre-Budget Report.

Security for all pensioners

5.45 To ensure that today's pensioners have security in retirement, and alongside other measures that help all households on low income, such as the 10 pence starting rate of tax, the Government has:

- increased the basic state pension by more than inflation in each of the last three years. **In April 2004, the full basic state pension will increase further to £79.60 a week for single pensioners and to £127.25 a week for pensioner couples**;
- guaranteed that every April the basic state pension will continue to rise by 2.5 per cent or the increase in the RPI for the previous September, whichever is higher;
- introduced winter fuel payments worth £200 per household each year for the remainder of this Parliament, increased to £300 for over-80 households. Around 11 million people aged 60 or over will benefit from this support this winter;
- introduced free TV licences for households with someone aged 75 or over and free eye tests for all those over 60;
- launched the Pension Credit to guarantee a minimum income and reward those with modest savings; and
- abolished hospital downrating to 52 weeks, introduced concessionary travel for those aged 60 and over and reduced VAT on fuel.

[9] *Simplicity, security and choice: Working and saving for retirement*, Department for Work and Pensions, HM Treasury and Inland Revenue, December 2002.

[10] *Action on occupational pensions*, Department for Work and Pensions, HM Treasury and Inland Revenue, June 2003.

[11] *Simplifying the taxation of pensions: The Government's proposals*, HM Treasury and Inland Revenue, December 2003.

Box 5.1: Pension Credit

To advance its goal of tackling pensioner poverty and to reward saving for retirement, the Government built on the success of the Minimum Income Guarantee (MIG) by introducing the Pension Credit in October 2003. From April 2004, the Pension Credit will guarantee an income of at least £105.45 a week for a single pensioner and £160.95 for pensioner couples. The guarantee element of the Pension Credit will be linked to earnings throughout this Parliament.

Around half of all pensioner households stand to gain an additional £400 a year on average under the Pension Credit, with some gaining up to £1,000 a year. As a result of the MIG and introduction of the Pension Credit, the poorest third of pensioners will be about £600 a year better off on average than if the equivalent amount had been spent on raising the basic state pension.

The Government is determined to help and encourage people to claim their entitlements. The Pension Service is promoting a range of measures to encourage claims and increase take up. Advance applications for the Pension Credit have been taken since April 2003, and all eligible applications received before October 2004 will be backdated to the start of the Pension Credit in October 2003 or to the date of the entitlement if that is later. The Government's strategy to maximise take up includes distribution of personal direct mail packs to every pensioner household, explaining the Pension Credit and inviting those likely to be eligible to apply. Widespread advertising, which began in summer 2003, is raising awareness of the Pension Credit. The Pension Service is also working closely with voluntary groups and local authorities to promote take up.

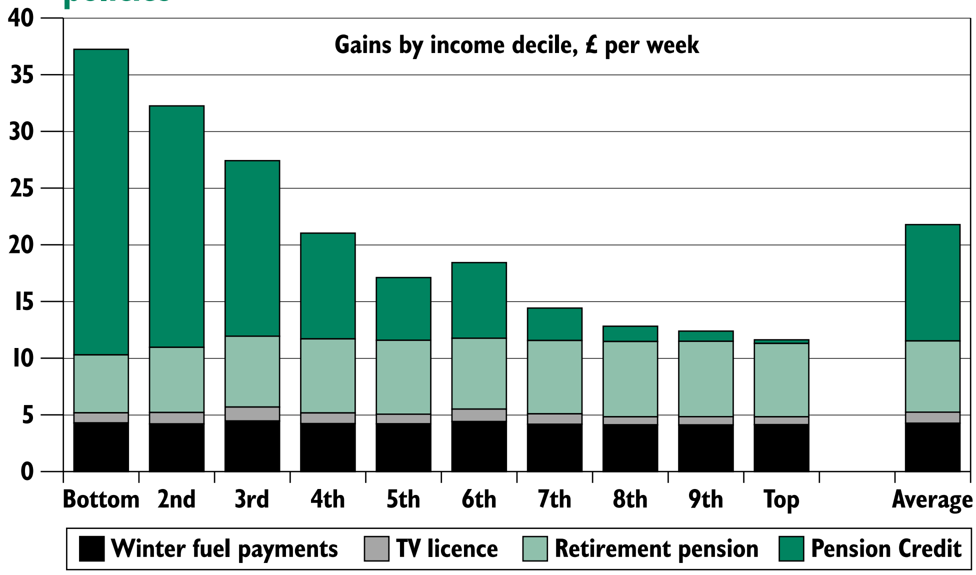
Effects of measures to support pensioners

5.46 From 2004-05, as a result of measures introduced since 1997, including the Pension Credit, the Government will be spending £9.2 billion more in real terms on pensioners. This is £5.7 billion more than the cost of indexing the basic state pension to earnings. Chart 5.3 shows the distributional impact, in current prices, of the Government's measures to support pensioners introduced before April 2004, including the Pension Credit.

5.47 Compared with the 1997 system, as a result of the Government's measures including the Pension Credit, on average, from October 2003:

- pensioner households will be £1,250 a year better off in real terms, or around £24 extra a week; and
- the poorest third of pensioner households will have gained £1,600 a year in real terms.

Chart 5.3: Overall gains for pensioner families from pensioner policies



Source: Department for Work and Pensions.

Support for pensioners who pay tax

5.48 Almost half of pensioners pay no tax, but for those who do, the age-related personal allowances in 2004-05 will rise in line with earnings to £6,830 for people aged between 65 and 74 and to £6,950 for those aged 75 or over. No pensioner aged 65 or over will pay tax on income of less than £131 a week in 2004-05. The age-related personal allowances will continue to rise at least in line with earnings rather than prices for the remainder of this Parliament.

Supporting tomorrow's pensioners

Taking forward the Pensions Green Paper

5.49 The Government is also acting to support and encourage private pension and other saving above the foundation provided by the state, and to help people work longer if they choose to. The 2002 Pensions Green Paper set out proposals to renew the voluntarist approach to pensions provision, based on a partnership between individuals, employers, the financial services industry and the Government. These proposals included measures to provide much improved information and education; to reinforce pension protection; to simplify the rules around pensions and provide simplified products; as well as a range of measures to help people work longer if they choose and to avoid a cliff edge of retirement.

5.50 The Government consulted widely on the Green Paper, receiving over 800 responses. These contributed to the Green Paper response, *Action on occupational pensions*, which sets out the Government's first steps in its programme of action. It includes a number of measures to safeguard the rights of members of private sector defined benefit schemes, including:

- the Pensions Protection Fund, the first ever protection scheme for Defined Benefit pensions in the UK, protecting pension rights accrued when a company becomes insolvent;
- ensuring that where a scheme is wound up and its sponsoring employer is solvent, members are more likely to receive the pensions they expected;

- providing a new minimum standard of pension protection for workers in the private sector affected by a Transfer of Undertakings (Protection of Employment) (TUPE) transfer; and
- a new kind of regulator for work-based pensions – taking a proactive, risk-based approach.

5.51 Taking forward improving financial education, John Tiner, Chief Executive of the Financial Services Authority (FSA) is leading work to produce a national strategy to provide consumers with the education, information and generic advice they need to make their financial decisions with confidence.

5.52 The Government is committed to making it easier for employers to provide pensions, and will:

- replace the Minimum Funding Requirement with scheme-specific funding arrangements;
- reduce the cap on the mandatory indexation of pensions from 5 per cent to 2.5 per cent; and
- review the regulation of employers providing advice and information to employees about workplace pensions.

Simplifying the taxation of pensions

5.53 There are currently eight different tax regimes governing pensions, depending on the type of pension and when the individual member joined the scheme. The complexity of these rules imposes unnecessary inflexibility, drives up costs and discourages people from saving in a pension. The proposals in the Government's consultation document, *Simplifying the taxation of pensions: Increasing choice and flexibility for all*, published by HM Treasury and Inland Revenue in December 2002, would radically simplify the taxation of pensions, sweeping away the existing eight different tax regimes for pensions and replacing them with a single lifetime allowance for pension savings that can benefit from tax relief. It also included proposals which would promote:

- flexible retirement, whereby people in occupational schemes will, where their schemes allow it, be able to draw benefits from their pension while continuing to work;
- a single set of rules on pensions in payment that sets the tax-free lump sum at 25 per cent of the value of an individual's pension fund; and
- more flexible annuity rules that stimulate innovation by allowing for the provision of limited period annuities and value-protected annuities.

5.54 The Government's second consultation document, *Simplifying the taxation of pensions: The Government's proposals*, published alongside this Pre-Budget Report, sets out how the simplified regime would work if introduced, and proposes a number of modifications following the consultation, including:

- reducing the rate of the recovery charge from $33^{1}/_{3}$ per cent to 25 per cent, where people exceed the lifetime allowance;
- a single, fair and reasonable factor for valuing defined benefits against the lifetime allowance – 20:1 at all ages;
- the ability to take funds above the lifetime allowance as lump sums, once the recovery charge has been applied;
- more generous transitional arrangements designed to ensure that there is no retrospection – either real or perceived – on contributions and service made or accrued before the simplified regime is introduced; and
- confirmation that unapproved, unfunded arrangements will be allowed, so employers will have a choice whether to offer unlimited pensions within or without the tax-privileged regime.

5.55 The purpose of the Government's proposals for pensions simplification is to cut red tape for business, to provide more flexibility and choice for those saving for a pension, and to give employers and individuals the flexibility to design schemes that suit their needs. They were never intended to raise revenue; with the Government's proposed modifications they would carry a modest cost to the Exchequer.

5.56 The Government has always wanted to proceed by consensus. However, the consultation so far has revealed contrasting views. Many people have expressed support for the proposed simplified regime and the significant benefits that arise including from being able to convert the existing annual cap into a lifetime allowance.

5.57 Others have argued that there is no reason to change the existing regimes, arguing instead that the Government should continue to allow the future build up of uncapped tax-privileged pension rights of those who are exempted from the post-1989 regimes because they joined their existing scheme before that date. They argue that for this group there is no need to apply any cap on the amount of future saving on which tax relief can be received.

5.58 The consultation so far has also revealed contrasting interpretations of the impact of the new proposals. The Government believes, as set out in the first consultation document, that around 5,000 people – either currently in, or previously in, a pre-1989 uncapped pension scheme – will have aggregated pension funds worth £1.4 million or more when these proposals come into force – for these people the Government has ensured that all of their accrued rights are fully protected; and that there may be a further 1,000 people a year, with pension funds currently worth below £1.4 million, who over the next ten years will retire and be affected by the lifetime allowance on account of membership of a pre-1989 regime – for these people the Government has ensured that they can opt out of the simplified regime and protect their accrued rights.

5.59 For all other pension savers, currently subject to the post-1989 regimes, the Government believes that £1.4 million is the lifetime equivalent of the existing annualised earnings cap, equivalent to the maximum pension available under the post-1989 occupational regime, and is therefore – balancing the need to incentivise saving, to ensure fairness, and of public expenditure priorities – the right level for converting the annual limit to a lifetime allowance.

5.60 In response to concerns expressed during the consultation so far, the Government will ask the National Audit Office (NAO) to consider, in the light of the proposals set out in this document:

- whether it is factually accurate that the £1.4m lifetime allowance is, using a factor of 20:1 to calculate the capital value of a defined benefit pension, equivalent to the maximum pension available under the current occupational pensions regime which includes the earnings cap;
- whether it is reasonable for the Government to estimate that around 5,000 people will have pension funds in excess of £1.4m at 5 April 2005; and
- whether it is reasonable for the Government to estimate that around 1,000 people a year may be affected by the lifetime allowance who would not have been affected by the earnings cap.

The NAO will report in advance of Budget 2004, in order to allow an announcement to be made in the Budget on whether or not the Government will introduce the simplified regime. If it is decided to proceed, the measures will be in the 2004 Finance Bill and will be introduced in April 2005. Otherwise the current eight different regimes will remain in place.

Defering the state pension

5.61 The Government is also acting to deliver its proposals to enable people who wish to work longer and more flexibly to do so, for example by extending choice on reaching state pension age to those who choose to extend their working lives. From April 2005, the Government is increasing the returns from deferring the state pension. People who defer and choose state pension increments will see their pension rise by 10.4 per cent a year instead of the current rate of 7.5 per cent a year. A person deferring a state pension of around £100 a week for five years could see their pension rise to around £152 a week – an increase of around £14.75 a week compared with the current system.

5.62 In addition, for the first time the Government is introducing the option of taking a deferred state pension as a taxable lump sum instead of higher weekly pensions payments. Those choosing to defer their state pension by at least one year from April 2005 will be able to take the lump sum. Interest will be payable on the deferred pension for those choosing the lump sum, which will be taxed at the recipient's marginal rate on their other income to ensure that pensioners do not move into a higher tax bracket as a result of their decision to take a lump sum. Neither will it affect their age-related income tax allowances.

PROMOTING SAVING AND ASSET OWNERSHIP

5.63 The Government's strategy for promoting saving and asset accumulation is founded on its core welfare principles:

- security – helping individuals accumulate a stock of financial assets for times of adversity;
- opportunity – assets enable individuals to take advantage of opportunities throughout life and widen choice; and
- responsibility – developing the saving habit to promote independence.

Building on these principles, the Government aims to widen the opportunities for saving, especially for those on low to moderate incomes.

The Child Trust Fund

5.64 The Government is committed to strengthening the saving habit of future generations and ensuring that all children have a stake in the wealth of the nation. Budget 2003 introduced a new Child Trust Fund (CTF) with entitlement backdated to include children born from September 2002 to align payments with the school year. The CTF will provide an endowment of £250 for every child at birth, rising to £500 for the poorest children – a reform which is both progressive and universal, benefiting every child and with more help for those who it most. The CTF will also be underpinned by increased financial information and education.

5.65 The Government published its detailed proposals for the CTF in October 2003, including an announcement that a further payment would be made at age seven. The Government will continue to work with industry on implementation issues to ensure the successful delivery of CTF accounts, expected in April 2005.

The Saving Gateway

5.66 The Saving Gateway is designed to be an ideal starting point for many low-income individuals who would otherwise have difficulty starting on the savings ladder. The aim of the Saving Gateway is to encourage saving by means of a Government-funded match of all money saved, up to a limit. Tailored financial information and education is provided alongside Saving Gateway accounts to help individuals make informed saving choices. The account would also provide an effective bridge to other forms of saving, such as Individual Savings Accounts (ISAs).

5.67 Pilots of the Saving Gateway are currently being run in Cambridgeshire, Cumbria, Gorton, Hull and Tower Hamlets, four of which are in conjunction with the Community Finance and Learning Initiative, led by the Department for Education and Skills. Nearly 1,500 accounts have been opened. The pilots have been designed to provide a regular stream of information and are being evaluated to assess their impact on savings behaviour, with a final evaluation due in February 2005. The latest interim evaluation results will be available on the HM Treasury website on 11 December 2003. The Government looks forward to further evaluation evidence to assess the effectiveness of matching as a tool to incentivise saving.

Treatment of capital in income-related benefits

5.68 The Government acknowledges that people on low and moderate incomes may be concerned that saving may affect their entitlement to benefits. The Government will keep under review the treatment of capital in income-related working age benefits so that it strikes a sensible balance between providing state support and not unfairly penalising those who have acted responsibly by saving. As a first step, the Government will consider increasing the £3,000 threshold above which savings reduce eligibility to Income Support, Jobseeker's Allowance, Housing Benefit and Council Tax Benefit.

Individual Savings Accounts

5.69 Individual Savings Accounts (ISAs) are the Government's primary vehicle for tax-free saving outside pensions. They have helped to make saving, and the benefits of saving, easier for ordinary investors to understand. Over 15 million people – around one in three adults – now have an ISA and over £120 billion has been subscribed to ISAs since their launch in 1999. Moreover, ISAs have reached groups that were under-represented in Personal Equity Plans (PEPs) and Tax Exempt Special Savings Accounts (TESSAs) – one in five ISA holders are from lower income groups compared with one in seven who had either a TESSA or a PEP. Similarly, the number of people under 25 with ISAs is more than double the number who had either a TESSA or a PEP.

The Sandler review of retail savings

5.70 In July 2002, the Sandler review made a series of recommendations, including the design of a simple product suite that could be marketed outside of the FSA's Conduct of Business regulations. Following a consultation with financial services representatives on this recommendation in February 2003, the Government published a response paper in July 2003,[12] in which it announced specifications for a simple set of low-cost products. The Government's specifications include that:

- the product range will include a pensions product, a medium-term savings vehicle with the option of a smoothed investment, a Child Trust Fund product and a re-branded Charges, Access and Terms (CAT)-mark cash-ISA;
- the medium-term product will have a 60 per cent equity cap and a requirement to diversify to meet the needs of a cautious investor investing for a 5-10 year period; and
- the Stakeholder pension product will require a life-styled default fund, so that investors do not have to make an investment decision unless they choose to do so. The DWP will be consulting on any changes to the Stakeholder Pension regulations in 2004.

[12] *Proposed product specifications for Sandler 'stakeholder' products*, HM Treasury and Department for Work and Pensions, February 2003.
Government response to the consultation on Sandler 'stakeholder' product specifications, HM Treasury and Department for Work and Pensions, July 2003.

5.71 The Treasury has been working closely with the FSA in developing these products. Research by the FSA has shown the simplified sales regime they have been working on needs further development. The Government is keen to continue to take forward work on the sales regime and the product design together, and will therefore delay a decision on the charge caps that will apply to the Stakeholder products until next year. At this time, the Government will publish independent research conducted by B & W Deloitte into the effects on the Stakeholder market of different charge structures and a consultation paper on the regulations for the non-pension products, including the charge caps that will apply.

5.72 The Government announces in this Pre-Budget Report that to help remove unnecessary barriers between different forms of pooled investment, **all Sandler Stakeholder medium-term products and life insurance products will be brought into the stocks and shares component of ISAs from 2005**. Maximum investment limits for the stocks and shares maxi ISA and cash component of the ISA will remain unchanged. This will facilitate the sale of Sandler Stakeholder products, which can have either life insurance or collective investment scheme form. As a consequence, the insurance element of ISAs will cease to exist.

5.73 Following a commitment in the 2002 Pre-Budget Report to amend the taxation of income from offshore funds, **a number of technical changes to the offshore funds regime will now be made**. Other technical changes will be considered to the way in which authorised investment funds are taxed following the FSA consultation on the regulation of authorised investment funds. In addition, the Government will continue to look at Sandler's tax proposals in the wider context of tax issues affecting the market for insurance and pooled investment products such as unit trusts. The Government has noted the views of industry, including the Association of British Insurers and Investment Management Association, on the need for considering longer-term reform and looks forward to hearing their views in more detail.

5.74 The formal period of consultation on the VAT treatment of fund management, announced in the 2002 Pre-Budget Report, has now closed. Responses to the consultation were helpful and expressed a wide range of views. The Government has decided not to make any immediate changes to the VAT treatment of fund management, but to keep the issue under review, especially in the context of the ongoing work on other Sandler tax proposals.

Promoting financial inclusion

5.75 Access to financial services is of central importance in tackling social exclusion and neighbourhood renewal. Many people in deprived areas of the UK are denied the opportunity to save or borrow at reasonable rates, and to accumulate the assets and security that others take for granted. Much has been done over recent years, including the introduction of basic bank accounts and the facilitation of growth and development of the Credit Union movement. However, the Government recognises there is a need for further action in this area and is developing a strategy for tackling financial exclusion going forward.

Access to credit

5.76 While some people on lower incomes would like to save, the Government recognises that for others the immediate priority may be the ability to borrow at reasonable rates. The Government is aware that many find it difficult to gain access to affordable credit. The Consumer Credit White Paper, published by the Department of Trade and Industry on 8 December 2003,[13] sets out measures to develop a fair and transparent credit market for all consumers, to minimise the number of consumers who become over-indebted and to improve support for those who do. The White Paper sets out the importance of working in partnership with the credit industry and the voluntary sector to address the issues of access to affordable credit and over-indebtedness.

[13] *Fair, Clear and Competitive: The Consumer Credit Market in the 21st Century*, Department of Trade and Industry, December 2003.

The Social Fund **5.77** The Social Fund provides a safety net of grants and interest free loans for the most vulnerable in times of crisis. Budget 2003 announced an additional £90 million for the budget of the Discretionary Social Fund over the three years to 2005-06. The Government has also implemented some administrative changes to improve monitoring and ensure existing resources are being directed to those most in need.

SUPPORTING COMMUNITIES, CHARITIES AND GIVING

5.78 The Government believes a thriving and active sense of citizenship – strengthened by an independent voluntary and community sector (VCS) and a culture of volunteering and giving – is vital for fair and enterprising communities. Voluntary organisations contribute around £5.8 billion to GDP and the economic value of volunteering is estimated to be over £15 billion. Individual donations, corporate donations and tax relief are together worth about £9 billion. Government support for the sector, which overall, is worth more than £2 billion a year, has been demonstrated by the wide range of tax and spending measures introduced since 1997, worth about £9 billion.

The Corporate Challenge **5.79** The Government launched the Corporate Challenge in July 2003 to increase business involvement in community activity in three main areas: corporate support for employee volunteering; corporate support for and promotion of Payroll Giving Schemes; and corporate charitable activity. More than 50 companies have now nominated Corporate Champions. The Government will work closely with these companies and with other organisations who are already successful in this field, to encourage more companies to contribute to developing healthy and active communities and increasing business involvement in community.

Amateur sport **5.80** Amateur sports clubs are an essential part of community life. Recognising their contribution, the Government introduced the Community Amateur Sports Clubs (CASCs) scheme in Budget 2002 to provide support for amateur clubs through tax breaks for clubs and individuals supporting them. The recent Local Government Act, which introduced mandatory rates relief of 80 per cent for CASCs based in England and Wales, further enhanced the benefits of CASC status. The relief is to take effect from April 2004.

5.81 Since the scheme was introduced, over one thousand sports clubs have now applied to register as CASCs. The Government has today announced its intention to double the corporation tax exemption thresholds for CASCs. **As a result, CASCs will be exempt from corporation tax on profits derived from trading, if their trading income is under £30,000, and on profits derived from property, if their property income is under £20,000. CASCs that do not exceed these thresholds will not have to complete a corporate tax return on an annual basis.** All eligible amateur sports clubs are encouraged to register for CASC status so that they can take full advantage of the reliefs available.

Football Supporters Trusts

5.82 Football Supporters Trusts can play a valuable role in giving football fans a voice in the running of clubs within the community, especially when clubs find themselves facing financial difficulties. The Government is keen to ensure that these trusts fulfil their potential in promoting supporters' interests, and helping clubs to remain viable. The Government will therefore consider how it can best help to support Football Supporters Trusts, in particular by a review of how they are treated by the Inland Revenue.

Museums and galleries

5.83 Every member of society has a right to access the UK's cultural heritage, made possible by public support for museums and galleries. Since the introduction of free entry to the main national museums and galleries, admissions have increased by 70 per cent. Building on this, in Budget 2003 the Chancellor announced a review of the support, exemptions and relief available from the Government for museums and galleries to acquire works of art and cultural property.

Guidestar UK project

5.84 The Guidestar project, financed from the Government's Invest to Save Budget, will compile a database for all charities so that many organisations can access the same information. Guidestar is planning a three-month period of consultation with voluntary and community sector organisations and other stakeholder groups, including Government departments, to scope what is most useful for the widest range of people, so that this can inform the development of the database.

5.85 Government support for the VCS, which overall, is worth more than £2 billion a year, has been demonstrated by the wide range of tax and spending measures introduced since 1997. These measures are set out in Table 5.2. The Review of the VCS is discussed in detail in Chapter 6.

Table 5.2: Measures to support charities and the voluntary and community sector

Tax measures introduced since 1997 for charities		Spending measures introduced since 1997 for the VCS	
1997	Transitional Tax Credit Relief		
1998	Millennium Gift Aid – tax relief to advance education and relieve poverty in poorest countries	**1998**	Compact on relations between Government and the voluntary and community sector published by the Home Office Comprehensive Spending Review allocated community support grant to Voluntary and Community Unit
1999	Review of charity taxation	**1999**	*Giving Time, Getting Involved* report published by the Working Group on the Active Community Report of the Policy Action Team on community self-help
Budget 2000	Getting Britain Giving package	**2000**	Active Communities cross-cutting review Spending Review allocated £120m as part of the Active Community settlement
April 2000	Simplification and abolition of minimum limit on Gift Aid Extended upper limit on Payroll Giving Introduced 10 per cent supplement on Payroll Giving for three years		
April 2001	Tax relief on gifts of shares VAT relief for museums and galleries	**2001**	Start up funding for the Experience Corps Listed Places of Worship Grant Scheme
July 2001	Launch of the Giving Campaign		
April 2002	Tax relief for Community Amateur Sports Clubs (CASCs) Tax relief for gifts of real property VAT relief for charity buildings	**2002**	Re-launch of the Home Office Active Community Unit Cross-cutting review of the role of the voluntary and community sector in service delivery, HM Treasury Spending Review allocated £188m to the Active Community Unit £125m *future*builders fund £25m Parenting Fund *Next steps on Volunteering and Giving in the UK* discussion document published by HM Treasury and the Home Office *Private Action, Public Benefit* published by the Cabinet Office Strategy Unit
November 2002	Extension of 10 per cent Payroll Giving supplement		
April 2003	Giving through the Self-Assessment Return	**2003**	Launch of the Corporate Challenge *Guidance to Funders*, published by HM Treasury *Voluntary and community sector infrastructure: a consultation document*, published by Active Community Unit
September 2003	Local Government Act. Includes mandatory 80 per cent rates relief for CASCs, to come into force from April 2004.		

DELIVERING A MODERN AND FAIR TAX SYSTEM

5.86 A modern and fair tax system provides incentives to work and save, adapts to changes in business practice and the global economy, and raises sufficient revenue to allow the Government to pursue its objective of providing world class public services.

5.87 In July 2003, the Chancellor announced a major review of the UK's organisations dealing with tax policy and administration, to be led by Gus O'Donnell, Permanent Secretary to the Treasury. The review was tasked with examining the best organisational arrangements for delivering the Government's objectives both now and in the future. The staff of the revenue departments work hard in support of the economic and social well-being of Britain, and the review is studying how their work can best be supported and enhanced. As a result the work is wide-ranging, covering institutional arrangements for delivery and policy issues. It has made good progress and will report very soon.

Protecting tax revenues

5.88 A central requirement of a modern and fair tax system is that everyone pays the proper amount of tax and receives the benefits they are entitled to. Tax avoidance and evasion distort the incentives that the tax system aims to deliver and unfairly shift a greater tax burden onto honest and compliant taxpayers. They also reduce the revenue available to the Government for delivering its objective of providing world-class public services. The Government is therefore determined to take the necessary steps to protect tax revenues for the benefit of all taxpayers, by tackling evasion and fraud, and by addressing areas where tax avoidance risks compromising the integrity of the tax system. The Government will continue to modernise and simplify the tax system to improve the way it delivers its objectives. It will also continue to identify and close down loopholes being exploited in the tax system.

Protecting direct tax revenues

5.89 The Government has introduced measures to increase compliance with the tax system in successive Budgets and Pre-Budget Reports. Budget 2003 announced a new compliance and enforcement package for direct tax and national insurance contributions (NICs), increasing the funds available to the Inland Revenue by £66 million. The Pre-Budget Report announces further steps, including:

- **changes to clarify the law where third parties, such as companies in the same group as an employer, make payments to employees which are not subject to NICs**. The change will ensure that these payments cannot be treated as gratuities which are exempt from NICS;
- **changes to the Foreign Earnings Deduction to ensure that it is only available to genuine seafarers;** and
- **action to close down abuse of film tax relief through exit schemes which seek to avoid tax on the income derived from the film.**

5.90 The Government is determined to tackle non-compliance in the construction industry by contractors who routinely ignore their responsibilities both as contractors and as employers, and by sub-contractors who use artificial schemes to try to pay as little tax as possible. As an element of the reform of the Construction Industry Scheme, set out in Chapter 3, **the Inland Revenue will introduce a new employment status declaration for contractors and will be stepping up its compliance activities in this sector** to ensure that everyone understands and meets their tax obligations.

5.91 The Government has introduced a range of measures and targeted tax reductions to support small businesses; including through reform of capital gains tax, reducing the rate of corporation tax for smaller companies and the introduction of a zero rate, Stakeholder Pensions, and the abolition of advance corporation tax. These measures are encouraging the creation of more small companies, including through self-employed people incorporating their businesses. The Government is keen to ensure the measures it has introduced provide support for these firms taking on the opportunities and responsibilities involved in that transition, and to encourage them to reinvest their profits and grow their businesses. At the same time, the Government is concerned that the longstanding differences in tax treatment between earned income and dividend income should not distort business strategies, or enable reductions by tax planning of individuals' tax liability, and that support should continue to be focused on growth. **The Government will therefore bring forward specific proposals for action in Budget 2004, to ensure that the right amount of tax is paid by owner managers of small incorporated businesses on the profits extracted from their company**, and so protect the benefits of low tax rates for the majority of small businesses.

5.92 The Government is also determined to protect the corporation tax system against legal challenges under EU law. Chapter 3 describes the specific measures the Government is taking to resolve uncertainty in the application of the UK's transfer pricing rules, following discussions with business in the wider context of the Government's proposals for the reform of corporation tax. These discussions on the specific measures, as well as the wider issues raised by legal developments, will continue.

Tackling tax avoidance using trusts

5.93 Trusts have a positive role to play in assisting people to manage their tax affairs, and in particular in holding assets on behalf of vulnerable people. However, the tax regime for trusts has not kept pace with the times and is not always fair. The Government is determined to tackle the exploitation of trusts and to make the system fairer for the less well-off. The Government will therefore act to:

- remove a distortion which provides tax avoidance opportunities for higher-rate taxpayers, by **increasing the tax rate applicable to trusts from 34 per cent to 40 per cent, and the corresponding dividend trust rate from 25 per cent to 32.5 per cent, from 6 April 2004**. Other taxpayers receiving income from trusts will continue to be able to reclaim any excess tax paid by the trustees on their behalf;
- **prevent, with immediate effect, capital gains tax gifts relief being used, either alone or in conjunction with the other reliefs, in schemes involving trusts** which are designed to eliminate, or reduce, the tax charge on capital gains arising on disposals of assets; and
- the Government has also announced that it will consult on a proposed new charge intended to deter abuses of the inheritance tax Gifts with Reservation rules that often involve trusts.

5.94 The Government wants to ensure that trusts set up for particularly vulnerable people are not disadvantaged by the measures set out above and that any existing disadvantages are removed. The Government will discuss how that can be achieved with the trust sector and others. These discussions will also explore ways to make the system of trust taxation less burdensome for those not using them for tax-avoidance purposes, and consider ways to reduce tax compliance costs for smaller trusts.

Tackling indirect tax losses

5.95 *Protecting indirect tax revenues,*[14] published alongside the 2002 Pre-Budget Report, set out the Government's approach to tackling indirect tax losses, including for the first time a strategy to tackle revenue shortfalls across the VAT system. *Measuring and tackling indirect tax losses,*[15] published today, reports progress on each of the strategies. New announcements and key results are set out below.

VAT strategy

5.96 The shortfall in VAT revenue – known as the VAT gap – is caused by a range of taxpayer behaviour, from simple accounting errors through to organised criminal fraud. The VAT strategy is designed to reduce the VAT gap to 12 per cent by 2005-06. It is based on an integrated approach, supporting those businesses trying to be compliant while cracking down hard on those who abuse the system. HM Customs and Excise began to recruit and deploy additional operational resources from April 2003 and over 1,000 staff will be deployed to key areas by 2005-06. In Budget 2003, the Government announced new measures to close VAT avoidance loopholes, as well as the launch of a VAT incentive scheme, to encourage unregistered businesses trading above the registration threshold to come forward and register.

5.97 The latest data show that the VAT gap for 2002-03 was 15.7 per cent. This confirms the problem identified by the Government and underlines the need for its strategic approach to tackling these revenue losses. There are encouraging signs that the VAT strategy and the associated new measures are starting to have an impact. The latest projections for VAT receipts for 2003-04 are running around £2 billion ahead of Budget forecast. To provide further support for the VAT strategy **additional resources are being provided to fund deployment of 450 further staff over the next two years on assurance activity** targeted at areas that represent a significant threat to the VAT yield, and on enhanced efforts to recover debt. In line with the cautious approach to public finances, the Government has included an additional £185 million in 2004-05, rising to £315 million in 2006-07, in the public finances forecast from the extension of the strategy.

VAT missing trader fraud

5.98 Missing Trader Intra-Community (MTIC) VAT fraud represents a concerted attack on the VAT system by organised criminals, resulting in losses that could have been as high as £2.75 billion in 2001-02. As a result of its strategic approach to tackling the problem, the Government now believes that the rapid growth of MTIC fraud seen up to 2000 has been stemmed. In 2002-03 fraud losses fell by about 5 per cent and the new legislative measures to tackle the fraud announced at Budget 2003 have since helped further to stem the revenue leakage. There are indications of a further sharp fall in the early part of 2003-04. Annex A describes the impact of MTIC on UK trade statistics.

VAT avoidance

5.99 The Government announces further steps in this Pre-Budget Report to tackle VAT avoidance schemes and close loopholes in the law, including:

- **immediate legislation preventing the avoidance of VAT when debts are assigned to connected businesses**;
- **new rules to stop businesses benefiting indefinitely by using unfair VAT partial exemption special methods**; and
- following consultation, **legislation tackling abusive VAT grouping**.

[14] *Protecting indirect tax revenues*, HM Customs and Excise, November 2002.

[15] *Measuring and tackling indirect tax losses*, HM Customs and Excise, December 2003.

Tackling tobacco smuggling

5.100 Tobacco smuggling undermines the Government's health objectives, involves serious and widespread criminality, and costs billions of pounds a year in lost tax revenue. In *Tackling Tobacco Smuggling*, published in March 2000, the Government launched a strategy to slow, stabilise and reverse the growth in tobacco smuggling within three years. The success of the first two years of the strategy has continued into 2002-03 with HM Customs and Excise reducing the illicit market share to 18 per cent against a target of 21 per cent.

Oils

5.101 In Budget 2002, the Government launched a comprehensive strategy to tackle the problem of oils fraud, particularly the misuse of duty-privileged fuels such as red diesel and kerosene. The Government set HM Customs and Excise the target of reducing the illicit diesel market in England, Scotland and Wales to not more than 2 per cent by March 2006. In the first year of the strategy the illicit market share fell from 7 per cent in 2001 to 5 per cent in 2002. HM Customs and Excise are also continuing to tackle oils fraud in Northern Ireland, and their activities have contributed to a second consecutive year of increased deliveries of legitimate road fuels into the region, after five years of decline.

Combating alcohol fraud

5.102 The Government is determined to extend further its successful approach to tackling indirect tax losses to alcohol fraud. HM Customs and Excise have already made considerable progress in tackling cross-Channel passenger smuggling of alcohol, which fell by 90 per cent between 2000 and 2002. However, evasion of duty on spirits remains a particular problem. This involves well-organised criminal gangs who abuse trade facilitation provisions in UK and EU law that enable alcohol products to be moved and to change ownership many times before duty is paid. Fraudsters obtain spirits products in duty 'suspense' and divert them for consumption on the domestic market without payment of duty. *Measuring and tackling indirect tax losses*, published alongside this Pre-Budget Report, shows that losses from spirits fraud have been increasing markedly, and in 2001-02 were higher than at any time in the previous decade.

5.103 In the last two years, HM Customs and Excise have taken steps to improve their capacity to identify and prevent alcohol fraud, including the implementation of recommendations made by the Roques report into excise diversion fraud.[16] However, the Government believes that more needs to be done. In late 2001, Customs consulted widely on Roques' recommendation that tax stamps should be introduced for spirits to protect both excise revenues and the UK spirits production industry. The consultation established that tax stamps would be an effective tool in the fight against fraud, enabling illicit product to be more readily identified. However, the Government decided, in view of trade concerns, not to proceed with tax stamps at that time, and instead to explore other options for preventing fraud, including establishing in partnership with the trade a Joint Spirits Fraud Task Force aimed at tracing and tracking illegal spirits consignments. Earlier this year, Customs launched a further consultation on a package of regulatory measures aimed at reducing the opportunities to commit alcohol fraud within the duty suspension system.

5.104 It is now clear that action focused on better detection and disruption of fraud or on simply restricting the duty suspension system is not sufficient to achieve a substantial and lasting reduction in the level of spirits losses. Decisive steps are needed to attack the capacity for diversion within the existing duty suspension system and the inability to distinguish duty paid from illicit product in market settings. The Government has therefore decided:

- **to introduce during 2004 new regulatory controls to support the fight against alcohol fraud,** including changes to the regulations governing warehousekeepers, producers and owners of duty-suspended alcohol, requirements for notification of cash transactions and advance payments, and a scheme for recognising transporters with good compliance histories;

[16] *The collection of excise duties in HM Customs and Excise*, Report by John Roques and the Response by Her Majesty's Government to the recommendations in the report, July 2001.

- **to make preparations for the implementation from early 2006 of the Roques report recommendation to introduce tax stamps for spirits.** This would enable UK duty-paid spirits to be clearly identified by consumers, traders and Customs, and reduce both the opportunities for and profitability of diversion fraud. The Government plans to legislate for tax stamps in the 2004 Finance Bill. **However, it will also consider any new proposals the spirits industry wishes to put forward in the coming months for alternative measures that would be as effective in tackling spirits fraud as tax stamps**; and
- **to set a target for Customs to reduce substantially the illicit share of the spirits market.** Precise details of the target will be announced as part of the 2004 Spending Review.

Details of the new regulatory controls, and of the call for alternative proposals, are set out in a Customs business brief published today. Plans for the implementation of tax stamps and draft 2004 Finance Bill legislation will be published in the spring, along with a draft Regulatory Impact Assessment.

5.105 The Government believes that the action it is taking is both targeted and proportionate to the scale of the problem, and consistent with its wider efforts to reduce losses from fraud across the indirect tax regime. However, the Government recognises that the implementation of tax stamps in particular would involve increased costs to the legitimate trade. Therefore, **once tax stamps were implemented, the Government would consider:**

- **how the current deferment arrangement for spirits duty could be extended as far as practical in recognition of the cash flow effects of purchasing tax stamps**; and
- **freezing spirits duty for the remainder of this Parliament.**

Modernising and simplifying the tax system

Stamp Duty **5.106** In October 2003, the Government announced the next steps in the process of modernising Stamp Duty on land transactions, following the announcement of the main proposals in Budget 2003. The new regime, which took effect from 1 December 2003, will result in a modernised tax which promotes fairness between taxpayers, reduces distortions and prevents avoidance. The recent announcements included a significant change to the proposed charge on the rental element when a new lease is granted, reducing tax bills by £1,500 per lease on commercial transactions and £600 per lease on residential transactions compared to the Budget proposals. The Government has also published a consultation on how the new regime applies to partnerships with introduction from Royal Assent of Finance Bill 2004.

Income tax and NICs **5.107** The income tax personal allowances for those aged under 65 will increase in line with inflation in 2004-05. NICs threshold and limits will also increase in line with inflation. There will be no change in NICs rates for employers and employees, or the profit-related NICs paid by the self-employed, in 2004-2005.

Residence and domicile

5.108 At Budget 2003, the Government published a discussion paper on reform of the residence and domicile rules[17] which set out the principles which the Government believes should underpin any modernisation. The paper promoted a wider debate on the extent to which the tax system might need to change to reflect those principles. Many respondents emphasised the attractiveness of the UK as a place to do business and invest, and identified the tax treatment of skilled workers from overseas as one factor in this attraction. Many also recognise that the current rules may not be appropriate in their treatment of people who stay in the UK for long periods, though there was also a concern that people in this position are treated fairly. Responses to the paper have also signalled a potential need for greater clarity and objectivity in the rules, which have not kept up with increases in international travel and commuting, and the globalisation of parts of the labour market, and so have added to compliance costs for businesses and individuals.

5.109 The Government recognises that this is a complex and far-reaching issue and is determined to proceed on the basis of evidence and in keeping with its key principles. The Government is continuing to examine responses to the background paper and welcomes further contributions. Once this process is complete it will move forward with a formal consultation paper on possible approaches to reform.

Gambling duties

5.110 HM Customs and Excise will shortly publish a summary of responses to the consultation, launched in summer 2003, on options for changes to the current licence-based approach to taxing amusement and gaming machines. The Government is considering the range of views expressed, together with the data provided by the industry and its own analysis, before deciding on the scope and timing of any major changes to the structure of taxation of machines. Any further reform of the gambling taxes will take account of the Government's wider proposals for modernising gambling regulation.

Charitable donations

5.111 The Government recognises the important role that charities play in creating a better society. Budget 2002 announced plans to enable taxpayers to donate tax repayments to charities using the tax return from April 2004. To help ensure as many charities as possible benefit, the Government will reopen the list of charities registered to receive these repayments, and will update this on a quarterly basis.

Gift Aid

5.112 Improvements to the Gift Aid scheme introduced in Budget 2000 have had considerable benefits for the charitable sector. However, they have also had the unintended effect of widening the impact of the special statutory exemption available to some heritage and conservation charities. An increasing number of these charities have introduced schemes which grant free day admission in return for a donation which attracts Gift Aid. The charities can then reclaim the basic rate of tax on the donation. It was not the intention of the exemption to treat admission charges as donations which attract Gift Aid. This has given a considerable benefit to a small group of charities. The Government is determined to maintain the integrity of the Gift Aid scheme and will close this loophole in the legislation. The Government will consult closely on the detail of how this may best be achieved with the charities concerned.

VAT exemption for cultural organisations

5.113 Many cultural attractions such as theatres, galleries, zoos and museums will no longer be required to charge VAT on visitor admissions, giving many attractions scope to reduce their admission charges. To allow affected organisations time to consider and prepare for this change, they will not be required to exempt their admission charges until 1 June 2004. In addition, transitional arrangements are being put in place to protect the position of affected cultural attractions in respect of major building projects in progress on which they had expected to be able to reclaim VAT.

[17] *Reviewing the residence and domicile rules as they affect the taxation of individuals*, Inland Revenue and HM Treasury, April 2003.

EU review of VAT reduced rates

5.114 The Government has been negotiating with its European partners on a review of the EU rules governing VAT reduced rates. At this time the future of the negotiations is uncertain. It remains the Government's objective to achieve reduced rates of VAT for the purchase of energy-saving materials for DIY installation and for repairs and maintenance to listed places of worship. In the meantime, **the Pre-Budget Report confirms that funding for the listed places of worship grant scheme is in place for a further two years, until the end of March 2006**.

TACKLING GLOBAL POVERTY

5.115 The Government is committed to achieving the Millennium Development Goals (MDGs) – internationally shared targets to halve extreme poverty, reduce child mortality, achieve universal primary education and reverse the spread of HIV, malaria and other diseases of poverty by 2015. Progress towards the goals is slow and uneven, and many developing countries particularly in Africa will fail to achieve the MDGs unless there is an urgent change of action globally. On current trends, only two out of the 18 global targets are likely to be met by 2015. The Human Development Report 2003[18] stated that while there has been good progress in some areas – such as increasing life expectancy and reducing poverty and illiteracy – many developing countries are worse off now than they were a decade ago. The situation in sub-Saharan Africa is especially critical. At the current rate of progress, sub-Saharan Africa will not meet the poverty MDG until 2147 or the child mortality MDG until 2165.

5.116 The Government believes that meeting the targets requires a new compact for development between the richest and the poorest countries, with shared obligations. This global plan is based on four pillars:

- a substantial increase in global aid flows, which the Government has proposed in the near term should be done through an International Finance Facility (IFF), coupled with further improvements in aid effectiveness;
- the sequenced adoption of an improved regime for trade that allows developing countries to benefit from and participate on fair terms in the world economy;
- the creation in developing countries of the right domestic conditions for business investment and adoption of high corporate standards by the international business community for engagement as reliable partners in the development process; and
- a new rules-based system for global economic growth and stability under which all countries can prosper, with all countries pursuing agreed codes and standards of fiscal and monetary policy transparency.

The UK's commitment

5.117 Total UK aid will reach 0.4 per cent of national income by 2005-06, as announced in the 2002 Spending Review. This represents a near doubling of aid resources in real terms since 1997 and fulfils the UK's obligation in line with the EU's commitment to reach an aid ratio of 0.39 per cent by 2006. The Government remains committed to reaching an aid target of 0.7 per cent of national income.

[18] Human Development Report 2003 – *Millennium Development Goals: A Compact among nations to end human poverty*, an independent report commissioned by the United Nations Development Programme.

5.118 The focus of the Department for International Development (DfID)'s support is country-owned poverty reduction strategies. Improved health and education remain key elements as investment in human capital, vital to economic development and poverty alleviation. Since 1997, DfID has committed £1.5 billion to the development of health systems in poorer countries. DfID's bilateral expenditure on HIV/AIDS programmes has risen from £38 million in 1997-98 to over £270 million in 2002-03. The Government has also recently increased its commitment to the Global Fund to fight AIDS, Tuberculosis and Malaria by an extra \$80 million. The Government plans to expand its support for universal primary education to over £1 billion over the next five years and remains committed to making the revised framework of the Education Fast-Track Initiative work to help deliver on the collective pledge at Dakar three years ago to ensure that no sound plans to deliver education for all (EFA) are left unfunded.

5.119 However, progress can only be made through greater international collective action. Additional aid, the first pillar of the global compact, is essential for greater investment in poverty reduction, health and education but also to provide funding for public investment in human, social and physical infrastructure. This investment is the essential counterpart for ensuring that in addition to getting improved access to trade, poorest countries have the capacity to benefit from the opportunities provided by this access; for attracting greater and more stable private investment; and to fund additional debt relief needed to provide a sustainable exit from debt. All of these elements are essential pre-requisites to meet the MDGs by 2015 and are underpinned by the need for additional aid. The best available estimates suggest that an extra \$50 billion a year of development assistance is needed. Donors have pledged an additional \$16 billion by 2006 which leaves a significant funding gap. The Government has therefore proposed an IFF, described in Box 5.4, to raise the resources required.

Box 5.4: International Finance Facility

The Government's aim is to ensure that no country genuinely committed to poverty reduction and good governance should be denied the opportunity of pursuing this goal through lack of resources. Substantial extra resources are needed to achieve this. In order to bridge the gap between what has been pledged and what is still required, the UK has proposed an International Finance Facility (IFF). The IFF is designed to deliver the \$50 billion per year in aid flows necessary to meet the MDGs by frontloading aid through the international capital markets. The Facility would improve aid effectiveness by delivering untied predictable aid flows targeted at the poorest countries, by locking in long-term commitments from donor countries. Funds would then be leveraged from these commitments and disbursed mainly in the form of grants and also additional debt relief. The IFF has the potential to deliver at least an additional \$25 billion a year to Africa.

The Government is working closely with the international community to take this proposal forward. The September 2003 meeting of EU Finance Ministers agreed an EU position ahead of the 2003 Dubai Annual Meetings in support of more work on financing for development, including the IFF. At the Annual Meetings, the World Bank and International Monetary Fund (IMF) were called upon to report back at the Spring and Annual Meetings in 2004 on financing for development issues including aid effectiveness, capacity absorption and financing mechanisms, including the IFF, in order to urgently mobilise the substantial necessary additional resources. Developing and emerging market countries will be closely consulted throughout this process, including a Ministerial conference in spring 2004 focusing on financing for development.

The IFF proposal continues to receive strong support from developing countries, NGOs, faith communities and business.

Trade **5.120** Aid and trade – the second pillar of the global compact – are inextricably linked for poverty reduction, as increased and effective aid is vital to help build infrastructure and ensure a domestic environment in developing countries in which people and firms can produce goods and services efficiently and get them to international markets. The Government continues to be a leading advocate of the multilateral approach and is fully committed to the Doha Development Agenda. A successful conclusion of the WTO trade negotiations is vital for global growth and development. The World Bank estimates that a pro-poor agreement would produce gains for developing countries of nearly $350 billion in additional income by 2015. Box 5.5 describes the Government's approach to WTO negotiations.

Box 5.5 Trade and the WTO negotiations

Despite the reform to the EU's Common Agricultural Policy (CAP) agreed in June 2003, discussed in Chapter 7, which should reduce trade-distorting EU agricultural support, and the WTO agreement to improve future access to medicines for the poorest people of the world reached in September 2003, the WTO Ministerial session in Cancún failed to secure any significant progress on the Doha Development Agenda.

At Cancún, it was agreed that negotiations would continue in Geneva. The Government is working closely with the EU and other international partners to ensure full political commitment to a multilateral approach to trade liberalisation and to secure substantial and concrete progress. Negotiations should focus on the core issues of importance to developing countries for open and fair markets, especially in agriculture.

The Government is pressing for further flexibility in the EU on the Singapore Issues (investment, competition, transparency in government procurement and trade facilitation) and for significant reform of the EU's CAP regimes which were not included in the June 2003 agreement. In particular, the Government believes that reform of the sugar and cotton regimes, key products for developing countries, is an urgent priority.

Debt relief **5.121** The Government is committed to the rapid and full implementation of the Heavily Indebted Poor Countries (HIPC) Initiative. The 27 countries that have reached Decision Point will benefit from debt relief worth over $70 billion already committed under the HIPC Initiative, reducing their debt payments by around $1.3 billion each year. Eight of these countries have also reached Completion Point and had their debts irrevocably cancelled. Up to 16 countries could reach their Completion Points before the end of 2004. The UK already provides 100 per cent debt relief to those countries that have demonstrated a commitment to poverty reduction and has provided $474 million to multilateral institutions to support the HIPC Initiative.

5.122 The Government is committed to ensuring that the HIPC Initiative delivers a robust exit from unsustainable debt for the world's poorest countries and is concerned that a number of countries may exit the HIPC Initiative facing unsustainable levels of debt. This is due to a variety of factors, including inherent vulnerability to exogenous shocks, such as adverse terms of trade and bad weather conditions, and governance and political factors, including conflict and security issues. The Government has called for donor countries, the IMF and the World Bank to consider how to ensure debt sustainability for these countries and looks forward to receiving their report due in February 2004. Any approach that requires further debt relief needs to be funded from resources, additional to current aid flows, otherwise debt relief merely reallocates resources and moves them from non-indebted poor countries to indebted poor countries. The Government's proposal for an IFF is therefore critical in providing additionality of resources that can be used to fund further debt relief.

Post-conflict support for Iraq

5.123 The UK is working alongside its international partners, including the United Nations and the International Financial Institutions to support the reconstruction of Iraq. At the International Donor's Conference in Madrid in October, the Government pledged a total of £544 million to support the reconstruction of Iraq over the three years from 2003. Of this, £300 million will be for the next two years, including bilateral funds and the UK's share of the proposed EU contribution in Iraq. The commitment announced at Madrid is in addition to the UK's significant contribution towards the costs of maintaining security, which is an essential foundation for reconstruction. The new allocation for reconstruction in Iraq will not affect the UK's continuing commitment to increase aid to poor countries. The Government remains committed to provide £1 billion of bilateral aid for Africa by 2005-06 and to ensure that 90 per cent of bilateral aid goes to the poorest countries who need it most by the same date. In addition, the UK's work on implementing and enforcing UN financial sanctions has led to a transfer of £112 million to the Development Fund for Iraq. This contribution represents the frozen financial assets of the former Iraqi regime that were held in the UK.

6 DELIVERING HIGH QUALITY PUBLIC SERVICES

The Government's goal is to build a stronger, more flexible economy and a fairer society. World class public services are crucial to achieving this goal. A healthy and educated workforce, modern and reliable transport network, and adequate supply of affordable housing promote productivity and flexibility in the wider economy and help to ensure opportunity and security for all. The Government's commitment to continuous improvement in the public services through sustained investment and reform is contributing to a stronger and fairer economy, and is helping to ensure that taxpayers receive value for money from their investment.

The 2002 Spending Review set departmental spending plans for the three years to 2005-06, and to 2007-08 for the NHS, consistent with the fiscal rules. Building on previous Spending Reviews, these plans are delivering substantial extra investment in key public service priorities. Recognising the crucial role of local government in delivering public services, the Government is increasing the Revenue Support Grant in England in 2004-05 by £340 million to support local authorities as they improve services in key areas. Combined with wide-ranging reform to improve public service productivity, increased investment is delivering improved results across a range of services.

In Budget 2003 the Government made a special contingency provision of £3 billion to meet the costs of the military conflict in Iraq and its other international obligations, £1 billion of which was allocated to the Ministry of Defence in 2002-03. The Government is carrying forward the £2 billion unallocated special reserve into 2003-04 and is adding £500 million. A further £300 million is being added in 2004-05 to ensure that the Government is able to meet its international commitments in Iraq and elsewhere in the war against terrorism.

The 2004 Spending Review concluding next summer will lock in the step change in funding for key public services delivered in previous Spending Reviews. The Review will determine new departmental spending plans for 2006-07 and 2007-08 and a new set of Public Service Agreements. Additional funds above existing baselines will be targeted at front line public service priorities on the basis of a rigorous assessment of where new resources will have the greatest impact on outcomes.

In setting out the next steps in public service reform, the Review will in particular focus on increasing devolution to the front line, enabling public service providers to respond flexibly to local needs. Demonstrating the Government's commitment to reducing burdens on the front line and giving service providers maximum flexibility in the way they deliver key priorities, this Pre-Budget Report announces the abolition of Service Delivery Agreements for the 2004 Spending Review, removing over 500 lower level input, output and process targets.

To inform the outcome of the 2004 Spending Review, Budget 2003 announced a number of reviews of key issues focusing on the drivers of performance and efficiency in the public services. This chapter sets out details of progress in a number of these reviews.

INTRODUCTION

6.1 The Government's long-term goal is to deliver efficient and responsive public services that meet public expectations throughout the country through sustained increases in investment and reform. Strong and dependable public services lay the foundations for a flexible, high productivity economy, supporting greater efficiency among businesses and adaptability within the workforce. They also promote opportunity and security for all, helping to tackle poverty and social exclusion and improving quality of life.

RESOURCES

6.2 Sound public finances that are sustainable over the economic cycle are not only essential to ensure economic stability; they are also necessary to deliver the sustainable investment in public services required to deliver standards that meet public expectations. The Government's fiscal rules, described in Chapter 2, are the foundation of the public spending framework, ensuring that the public finances are sustainable over the economic cycle and that spending and taxation impact fairly between generations. The rules have important consequences for the budgeting regime, removing the past discrimination against investment and ensuring that borrowing for investment is conducted in a responsible way. For the second year, an analysis of long-term fiscal sustainability, the *Long-term public finance report*, is published alongside this Pre-Budget Report, providing a comprehensive analysis of long-term economic and demographic developments and their impact on the UK public finances.

6.3 Consistent with the longer-term expenditure planning horizon allowed by the fiscal rules, the Government has introduced a system of firm and fixed Departmental Expenditure Limits (DELs) for departmental spending stretching over three years, and reviewed every two. Departments now have certainty over their budgetary position for well over a year ahead, enabling them to plan and manage their programmes sensibly without the risk that crucial funding will be removed. Departments are also able to draw on their stock of end-year flexibility (EYF). EYF allows departments to carry forward resources not fully spent at the end of the year for use in future years, enabling them to plan their spending effectively and helping to avoid inefficient end-year surges in departmental spending.

6.4 Expenditure items that are large, potentially volatile and demand-led – such as social security benefits and debt interest payments – are collectively known as Annually Managed Expenditure (AME). These items are subject to tough scrutiny twice a year as part of the Budget and Pre-Budget Report process to ensure that volatility in AME does not threaten fiscal stability. The Government recognises the uncertainties in planning public expenditure, allows for this through the DEL reserve and AME margin and remains vigilant to pressures and risks. Taken together, DEL and AME add up to Total Managed Expenditure (TME), the broadest measure of total public expenditure.

2002 Spending Review

6.5 The 2002 Spending Review set spending plans for 2003-04 to 2005-06 for public services other than the NHS, for which spending plans to 2007-08 were fixed in the 2002 Budget. Building on previous Spending Reviews, these spending plans allow for significant increases in investment in key public services, including:

- planned UK spending on the NHS increasing by an average of 7.1 per cent a year in real terms over the five years to 2007-08; and
- planned UK spending on education increasing by 6.0 per cent a year in real terms between 2002-03 and 2005-06.

6.6 As shown in Chapter 2 the Government's spending plans are fully consistent with meeting its strict fiscal rules. In 2003-04 total public spending is planned to rise by 6.9 per cent in real terms over the year as a whole relative to 2002-03, with DEL spending rising by 7.3 per cent and AME spending rising by 6.4 per cent. This year departments have chosen to draw down £2.5 billion of EYF so far to add to their authorised spending limits. The Government expects this net addition to spending to be offset by the end of the year by underspends elsewhere within DEL.

6.7 Since September 2001, the Government has spent nearly £2 billion on the war in Afghanistan and to combat terrorism both domestically and abroad. In Budget 2003, the Government made a special contingency provision of £3 billion to meet the costs of the military conflict in Iraq and its other international obligations. Of that special reserve, £1 billion was allocated to the Ministry of Defence DEL in 2002-03 with the rest remaining unallocated. A further £1.3 billion of current spending has been charged against the special reserve in 2003-04. **In this Pre-Budget Report, the Government carries forward the £2 billion unallocated special reserve into 2003-04 and adds a further £500m taking the total special reserve for this year to £2.5 billion. A further £300 million is being added in 2004-05** as a prudent allowance against continuing commitments. This will ensure that the Government is able to meet its international commitments in Iraq and elsewhere in the war against terrorism.

2004 Spending Review

6.8 The 2004 Spending Review will set new spending plans that lock in the step change in funding for key public services delivered in previous Spending Reviews. The Review will determine new departmental spending plans for 2006-07 and 2007-08 and a new set of Public Service Agreements. Departmental spending plans for 2005-06 determined in the 2002 Spending Review will not be changed. Increases in departmental plans above the 2005-06 baseline will be rigorously targeted where they will have the greatest impact on front-line delivery, and settlements will be conditional on real efficiency savings being achieved by departments. More detail about the 2004 Spending Review is set out below.

Funding local services

6.9 The Government has increased grant to local authorities by 25 per cent in real terms since 1997, recognising the crucial role of local government in delivering public services. Alongside this increase in resources, the Government is committed to increasing local flexibility to improve efficiency and allow local authorities to respond to local priorities. The 2002 Spending Review announced a commitment to reduce the proportion of ringfenced funding to 10 per cent by 2005-06 and an additional £750 million of funding will have ringfences removed from next year. More widely, Nick Raynsford, the Minister for Local Government, is chairing a high-level committee looking at the balance of funding, reviewing the evidence and identifying long-term reform options to improve the sustainability of local government finance.

6.10 **The Government will increase the Revenue Support Grant in England in 2004-05 by £340 million to support local authorities as they improve public services in key areas.**

6.11 In particular, local authorities' role in services for children was emphasised in the recent Green Paper, *Every Child Matters*.[1] Working towards the Government's commitment to eradicate child poverty, local authorities should make progress on the objectives in the Green Paper to protect all children and ensure that every child has the best start in life. Local authorities are also at the centre of the Government's aim to create sustainable communities. They have an important role in improving liveability, eliminating anti-social behaviour and making their communities places where people want to live.

6.12 The grant will not be ringfenced. It comes in addition to the planned £300 million which was part of the package announced in July to enable councils to meet the Government's expectations for funding schools without damaging other services, and the £120 million extra for school funding announced last month, adding up to an increase of £760 million for 2004-05 in total.

[1] *Every Child Matters*, Department for Education and Skills, September 2003.

6.13 This additional resource will mean that local government grant will increase by 7.1 per cent for next year. The new £340 million brings the total newly unringfenced resource available for 2004-05 to well over £1 billion. Including these new resources, by 2004-05 the Government will have increased grant to local authorities by 30 per cent in real terms since 1997. This will enable local authorities to provide the public services people expect without excessive council tax rises.

Box 6.1: Public sector pay

Pay is of crucial importance to the delivery of high quality public services.

Pay must be set at levels that allows the necessary recruitment, retention and motivation of staff. Over the last three years, the public sector average earnings index has increased by 15.9 per cent, which is 4.8 per cent more than the private sector. This has enabled reforms to pay systems and working practices needed to support delivery of improved public services, including for teachers, nurses and NHS support staff. However, excessive paybill costs would eat into money intended to improve public services and must therefore be avoided. Chapter 4 sets out how the Government aims to increase the responsiveness of public sector pay systems to local circumstances to support service delivery.

Departments have been putting strategies in place to cover all aspects of pay and workforce over the medium term. The strategies determine what workforce capacity they need to deliver their PSA targets, and set out how they will achieve this capacity. They will also cover how staff can be most efficiently deployed and where they should be located, incorporating the results of the efficiency review being conducted by Peter Gershon and Sir Michael Lyons' review of the case for public sector relocation.

RESOURCES, REFORMS AND RESULTS

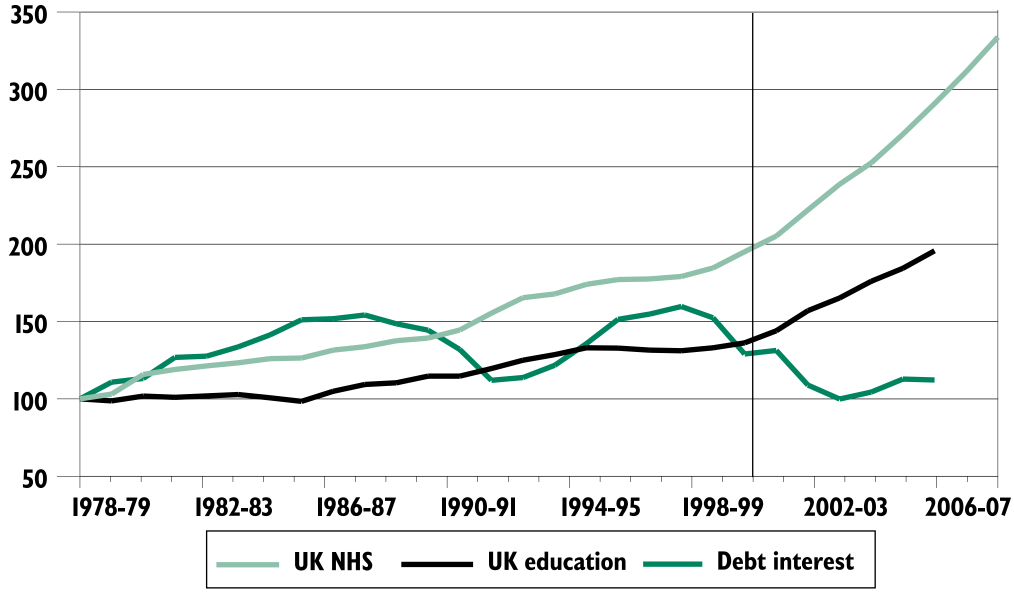
6.14 The UK has historically invested less of its national income in key public services than comparable economies such as the US and many EU countries. OECD data shows that throughout the 1970s, 1980s and 1990s, the UK spent a significantly lower share of its GDP on health than France, Germany and the US. In 1997, total health spending per capita in the UK was lower than in every other EU country except for Greece, Ireland, Portugal and Spain.[2] Spending on educational institutions as a proportion of GDP in the UK has also lagged behind that in the US and many EU countries.[3]

6.15 Extensive reform of the system for managing public expenditure, underpinned by the new fiscal framework, and prudent management of the economy and the public finances have enabled the Government to deliver a step change in resources for key public service priorities in the three Spending Reviews since 1998. After a period of relative stagnation in the mid-1990s, since the 1998 Comprehensive Spending Review health and education have benefited from significant and sustained real increases in investment. By 2006, public spending on education in the UK is set to be about 50 per cent higher in real terms than in 1997, and by 2008 spending on the UK NHS will be approximately 90 per cent higher in real terms than in 1997.

[2] *OECD Health Data 2003*. Total expenditure on health per capita, measured on a US dollar PPP basis.

[3] *Education at a Glance*, OECD, 2003.

Chart 6.1: Long-term trends in spending on key public services[1]



[1] *Real spending on UK NHS, UK education and central government debt interest rebased to 1978-79 = 100. Vertical line at 1999-00, the first year covered by the 1998 Comprehensive Spending Review.*
Source: HM Treasury.

6.16 A prerequisite for delivering high quality public services is having the right public service infrastructure in place. In 1997-98, public sector net investment stood at just £5.6 billion, or 0.7 per cent of GDP. Investment in public services had been on a declining trend since the mid-1970s, in part reflecting a budgeting system that encouraged short-termism and a bias towards spending on current pressures rather than on capital investment. The new fiscal framework, which removes the previous bias against capital investment, and the introduction of separate capital and resource budgeting for departments have helped reverse the declining trend in public sector net investment, which is now set to rise to 2 per cent of GDP by 2005-06. This substantial increase in investment is allowing departments to deal with inherited maintenance backlogs and establish the asset base necessary to deliver high quality public services. For example, substantial increases in NHS treatment capacity through additional hospital beds and treatment centres will continue to help reduce patient waiting times and improve health outcomes.

Raising public service productivity

6.17 The Government's aim is to build a stronger, more flexible economy and a fairer society, with opportunity and security for all. This implies a role for the Government both to tackle market inefficiencies where it can do so effectively, and to intervene where market-based provision of vital services to the public would be inefficient and where markets would lead to unacceptable disparities in the quantity and quality of services provided.

6.18 Chapter 3 sets out details about how the Government is tackling inefficiencies in markets to achieve a more flexible and productive economy. In the case of certain services, the level of government intervention required to ensure efficient market-based provision and fairness in outcomes would be so high that public funding and sometimes public delivery may be appropriate. This is particularly the case where information failures are so extensive that markets would be unable to function properly, and where market provision would lead many to be deprived of key basic entitlements such as healthcare, a decent education and protection from crime. In these circumstances the principle of consumer choice applied in the wrong way would risk leading to both inefficient and inequitable outcomes.

6.19 Where in principle the public interest is best served through public funding and, in some cases, delivery of services, it is vital both that those services are properly resourced and that the Government's interventions are undertaken effectively and efficiently. Effective public services that respond to customers' needs contribute significantly to quality of life both through their direct impact on people's lives, and through enhancing the productivity of other sectors of the economy.

6.20 Earlier sections of this chapter set out how the Government has addressed historic underinvestment in the UK's public services as a prerequisite for improving their performance. The Government recognises that while UK public services perform well in some areas there is considerable scope for improvement in others. As well as providing the necessary resources, it is committed to implementing reforms to raise the productivity of the public services and thereby maximise their contribution to a flexible and productive wider economy. The Government's approach to meeting this public service productivity challenge[4] is underpinned by:

- clear long-term goals expressed as desired outcomes;
- greater devolution of decision-making to local service providers, combined with effective governance structures;
- improved information about performance; and
- better incentives for service providers to meet users' needs.

6.21 Reliable measures of public sector output are crucial to gain an accurate sense of how public service productivity is changing and to inform policy decisions. The National Statistician has therefore asked Sir Tony Atkinson to undertake a review of the future development of measures of government output, productivity and associated price indices so as to advance methodologies. Box A4 sets out more detail about the review.

6.22 A critical reform underpinning the Government's approach to raising public service productivity has been the introduction of Public Service Agreements (PSAs) in the 1998 Comprehensive Spending Review. These represent a contract between the Government and the public, setting out clear, ambitious targets for improvements in public service performance. In Spending Reviews since 1998 the PSA framework has been continually refined by reducing the number of high-level targets, from around 350 in 1998 to about 130 in 2002, and by ensuring that they are focused on the outcomes that matter to the public. PSAs enable increased devolution of decision-making by providing a framework of clear long-term goals, within which departments and delivery agents are free to determine how best to deliver. They are an important driver for better performance information, and regular web-based reporting of progress provides unprecedented transparency about the results that investment in the public services is delivering.

[4] See *Public Services: Meeting the productivity challenge*, HM Treasury, April 2003.

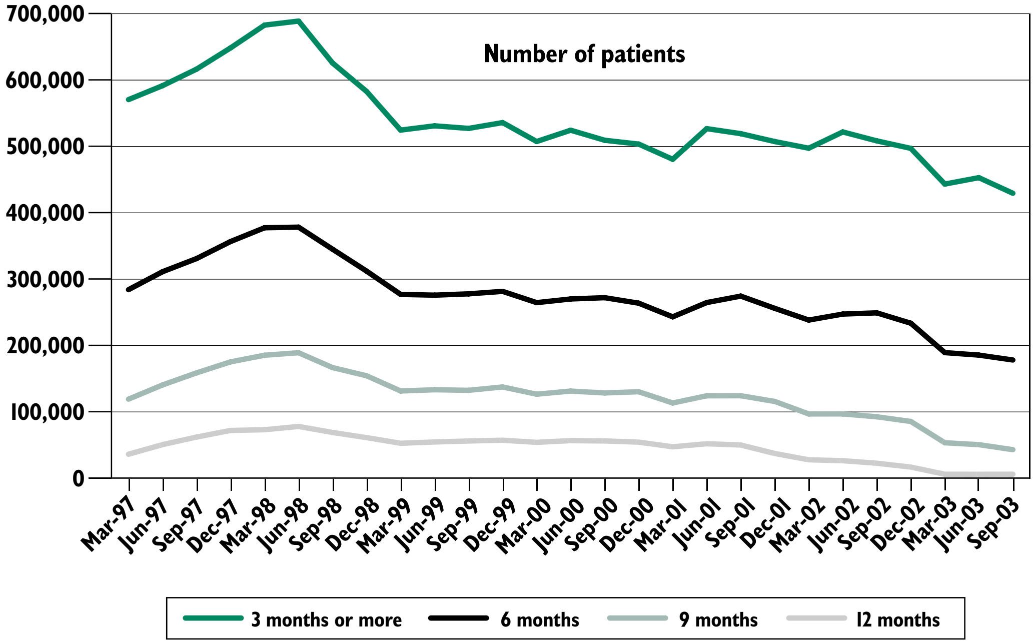
Delivering results

6.23 This approach to improving public service productivity is being put into practice across the public services, and investment matched with reform is delivering real improvements in standards and in outcomes. The 2004 Spending Review will seek to consolidate and build on progress so far, and will set out the next steps in reform that will help drive continuous improvement in performance.

Health **6.24** Record increases in investment in the NHS combined with extensive reform are helping to deliver a more effective and responsive health service. Compared with 1996-97, there are now 450,000 more operations each year and there are nearly 186,000 fewer patients waiting for treatment than in March 1997. Almost no patient now waits over 12 months for an operation, 67 per cent fewer patients are waiting over nine months than in March 1997, and the number of patients waiting over six months is almost 42 per cent lower. The NHS is on target to deliver maximum waiting times of six months for inpatients and three months for outpatients by the end of 2005. Progress is also being made in tackling the major killers, cancer and coronary heart disease:

- an estimated 6,700 lives a year are saved through the provision of statins, lifesaving drugs that reduce blood cholesterol levels, which are now prescribed for around 1.5 million people; and
- almost all suspected cancer patients are now seen by a specialist within two weeks, and 31,000 patients can now benefit from new anti-cancer drugs following National Institute for Clinical Excellence appraisals.

Chart 6.2: Cutting waiting times



Source: Department of Health

6.25 The Government is building on the existing base of reforms implemented since 1997, with a particular focus on:

- reducing health inequalities. Earlier this year, a cross-Government action plan[5] set out the key areas where further progress is needed. The greatest challenges now lie in developing a stronger evidence base for policies, and in delivery. Derek Wanless' review *Securing Good Health for the Whole Population* will discuss this further (see below); and

- better cross-working between health and social services. Creating seamless pathways of care between the NHS and social care providers will help to deliver improved, patient-centred services for the most vulnerable sections of the population.

Box 6.2: Choice in the NHS

As capacity in the NHS grows, the Government is committed to extending choice for patients as a means to improving the patient and user experience. Extension of choice enables patients, users and professionals to make shared and sustainable decisions, and will support the NHS and social care in delivering more responsive services that help tackle unfairness. In this way choice and equity can go hand in hand.

A national initiative offering a choice of hospital is already being implemented for patients waiting over six months for elective surgery, and from December 2005 a choice of hospital will be offered to every patient at the point of referral from their GP.

***Building on the Best,* published this month by the Department of Health, sets out further proposals for extending choice across the NHS through:**

- **giving patients a greater say over their own treatment, including enabling them to record their own information and preferences in their health record;**
- **widening choice for patients in primary care, in maternity care and over where, when and how they receive their medicines; and**
- **fulfilling the potential of information technology to ensure that patients have access to high quality information and support, enabling them to make real choices about their health and health care.**

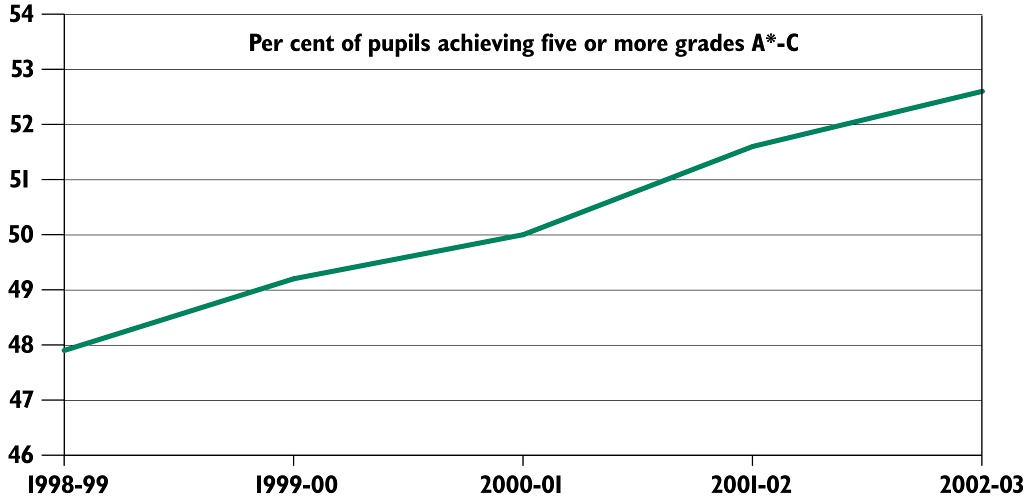
Education

6.26 The 2002 Spending Review announced record levels of new investment for education coupled with a reform agenda that aims to widen access to the benefits of increased freedom and flexibility for high performing schools. Higher performing schools have gained from a flexible approach in areas such as workforce reform and curriculum balance.

6.27 Investment and reform have enabled considerable progress to be made in raising standards and improving attainment across the education system. For example, in schools between 1997 and 2003 the proportion of 11 year-olds reaching expected levels in English and maths rose by 12 percentage points and 11 percentage points respectively, to 75 and 73 per cent. The proportion of 16 year-olds achieving five A* to C grades at GCSE rose over the same period from 45 per cent to 52 per cent.

[5] *Tackling Health Inequalities: A Programme for Action,* Department of Health, July 2003.

Chart 6.3: Improving GCSE performance



Source: Department for Education and Skills

6.28 Despite these gains and strong progress in reducing the number of the poorest performing schools and providers, the Government recognises the continuing challenge of driving improvement at all levels of the education system. Education reform priorities for the future will be in areas such as administration, inspection, funding, local decision-making and child poverty, and will build on the reviews being undertaken in the run up to the 2004 Spending Review (see below).

6.29 Higher education is central to the development of a highly skilled workforce. The Government's aim is that, by 2010, 50 per cent of young people will have the chance to participate in higher education. To achieve its target, the Government is seeking to widen access to higher education and to improve the current funding system to ensure that universities are better able to sustain teaching and research excellence. The 2002 Spending Review provided additional resources to support improvements in the UK's international research competitiveness.

Box 6.3: Choice in education

The Government is committed to widening the variety of choices in education to enable all pupils to learn the essential skills that best match their needs and interests. Reform must ensure that every pupil has real and effective choice options – which in the past were constrained by the existence of weak and failing schools.

As new investment increases capacity in schools – with more and better head teachers, teachers, assistants, IT equipment and buildings – effective choice is improving for everyone. The number of failing schools is now lower than ever before. However, the Government is committed to making greater progress in reducing the scale of underperformance in coasting schools. Plans for personalised learning will lead many schools to become more responsive to individual pupils' needs, supported where appropriate by workforce reform, curriculum flexibility, extended schools and better links to children's and other local services. The enterprise pilots that started in September 2003, following the Davies review of enterprise and education, provide a good example of different learning experiences and skills that can widen meaningful choice options in line with particular pupils' needs.

6.30 The January 2003 White Paper, *The future of higher education*, set out a range of proposals to widen participation in higher education and to ensure that universities are equipped to compete in the world economy, including:

- major improvements in the funding of research and knowledge transfer;
- measures to support participation by those from disadvantaged backgrounds; and
- a new Graduate Contribution scheme from 2006.

Transport

6.31 The Ten Year Plan for Transport, announced in 2000, set out an unprecedented £180 billion programme of transport investment, aimed at tackling the legacy of decades of under-investment and addressing rising demand for travel. This was set against ambitious targets and stretching reforms to ensure resources were used efficiently and effectively. As the plan progresses these reforms are gathering pace, and in particular the Department for Transport has:

- begun a programme of consultation with key local authorities to set out shared priorities, and to develop local targets for delivery against national transport objectives, with a particular focus on urban congestion; and
- been developing improved methods for the appraisal of transport investments to inform spending decisions across different modes and locations.

6.32 The Department for Transport is making good progress against its road safety and local public transport targets, and the Department has announced a number of measures to tackle the growth in congestion on the trunk road network. On the railways the focus has shifted from growth to the twin challenges of performance (punctuality and reliability) and cost control. The ability of all parts of the rail industry to deliver efficiency improvements, control costs and raise performance levels will be key issues for the 2004 Spending Review and the parallel review of the Ten Year Plan, the horizon for which will be rolled forward from 2010-11 to 2015-16.

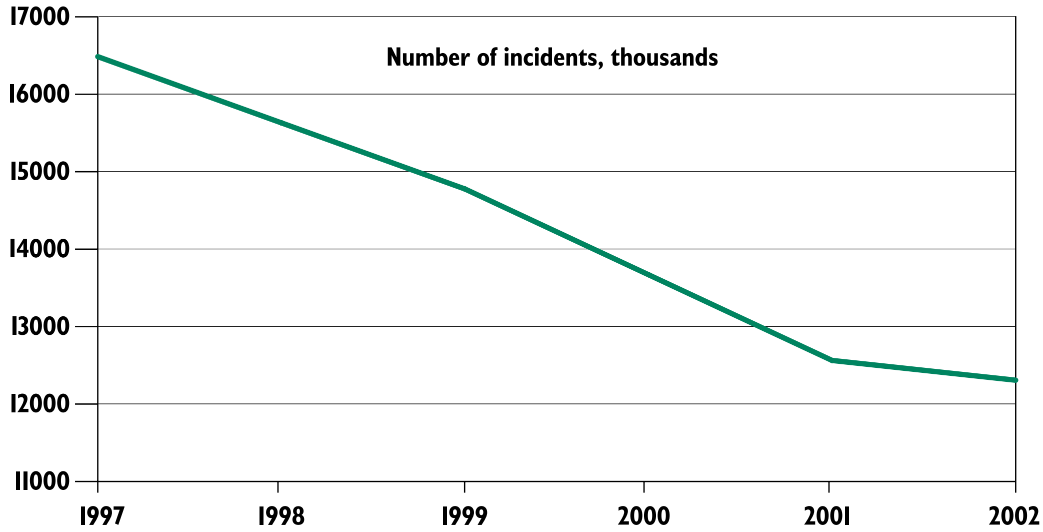
6.33 Other transport reform priorities for the Department for Transport being considered as part of the Spending Review and review of the Ten Year Plan include:

- delivering the Highways Agency's new role on active traffic management, making demonstrable impacts on congestion on key parts of the strategic network by the end of 2005; and
- investigating with regional and local stakeholders ways to improve regional planning and regional choice in transport investment.

Crime

6.34 According to the British Crime Survey, overall crime has fallen by 28 per cent since 1997, with a 34 per cent reduction in vehicle crime and a 41 per cent reduction in domestic burglary over the same period. With police numbers at a record high of 136,000 across England and Wales, the challenge now is to sustain this downward trend by continuing to improve police performance. Key to this is the role of Crime and Disorder Reduction Partnerships, which bring together the police and other key public services to develop local strategies to tackle crime and anti-social behaviour.

Chart 6.4: Tackling crime



Source: British Crime Survey.

6.35 The Government's ambitious programme of reform to policing will help to deliver improvements in police performance, in particular through:

- improved transparency and accountability through the publication of the second set of annual Police Performance Monitors, allowing the public to compare the performance of their local police force with that of similar forces across a range of performance indicators;
- a tailored intervention programme, developed by the Police Standards Unit and HM Inspectorate of Constabulary, to share operational best practice across all police forces and to aid individual police forces to improve their performance; and
- considering further radical reform, centred on giving local people a greater involvement in policing decisions and solutions. The Government is seeking the public views on these ideas through the *Policing: Building Safer Communities Together* consultation document.[6]

Housing

6.36 The Office of the Deputy Prime Minister aims by 2004 to have reduced by around 1 million the number of non-decent homes, and aims to make all social housing decent by 2010. It is also making significant progress in addressing the imbalances in regional housing markets. Housing completions are now at the levels set in Regional Planning Guidance for London and the South East, and recent figures for planning decisions have shown their best rate of improvement for more than a decade. Meanwhile, almost all of the nine Market Renewal Pathfinders in areas experiencing low demand are expected to have submitted their prospectuses and plans by January 2004, with that for Manchester/Salford already approved and being implemented. Further details on the Government's strategy for housing and planning is provided in Chapter 3.

[6] *Policing: Building Safer Communities Together,* Home Office, November 2003.

6.37 A single housing inspectorate under the Audit Commission came into operation on 1 April 2003, unifying the separate inspection regimes for local authority and housing association landlords to drive up standards in social housing provision. Regional Housing Boards were established in February 2003 and submitted their first Regional Housing Strategies to the Office of the Deputy Prime Minister in July. These have informed capital funding allocations to local authorities and housing associations for 2004-05 and 2005-06. The Government intends to build on these reforms in the 2004 Spending Review. In delivering the Communities Plan, it will consider the scope for a more strategic approach to housing and related services at regional and local levels and options to improve the functioning of the housing market to ensure a better match between supply and demand.

Local government

6.38 Local government plays a key role in representing local communities and in delivering, commissioning and overseeing a wide range of services for local people. The Government wants to see vibrant, innovative and responsive local government delivering high quality public services for their communities. To this end, central and local government are working together, including through the Devolved Decision-Making Review (see below), to ensure that local organisations, supported by appropriate performance frameworks and accountability arrangements, have sufficient flexibility to respond effectively to local needs.

6.39 The Local Government Act 2003 introduces new freedoms and flexibilities for local authorities to deliver local priorities. From 2004-05 the prudential regime will come into effect, offering new financial flexibilities for local authorities to borrow for capital investment. Local authorities will also have new powers to trade, which will increase diversity and choice in the delivery of public services. Trading will support the development of a dynamic and entrepreneurial public sector by introducing new players to the market and encouraging best value authorities to extend and improve the range of services they offer to local people.

6.40 Local PSAs encourage authorities to deliver service improvements above and beyond what would normally be expected in return for financial rewards. Last week the Government launched the second generation of local PSAs with an increased focus on addressing local priorities for improvement and building more effective local partnerships.

6.41 These reforms are being matched by greater accountability. The Comprehensive Performance Assessment (CPA) brings together, for the first time, assessments of the individual services for which the authorities are responsible, with an overall assessment of the council's ability to lead the community, forge change and effect cross-service delivery improvements. In the first CPA for single-tier and county authorities over half were rated good or excellent and therefore benefit from increased freedoms and flexibilities over and above the general reforms. The Government is actively engaging with those authorities judged poor to ensure they can provide their communities with the high quality public services they deserve. CPA is now being extended to all lower-tier councils and refreshed scores for upper and single-tier authorities will be announced shortly.

2004 SPENDING REVIEW

6.42 The 2004 Spending Review will set new spending plans that lock in the step change in funding for key public services delivered in previous Spending Reviews. The baseline year for the Review will be 2005-06 and it will set new plans for 2006-07 and 2007-08 other than for the NHS, for which plans were set in Budget 2002. Departmental spending plans for 2005-06 determined in the 2002 Spending Review will not be changed. The Review will examine the effectiveness of existing programmes in delivering the Government's objectives. Additional funds above existing baselines will be targeted at front-line public service priorities on the basis of a rigorous assessment of where new resources will have the greatest impact on outcomes. Settlements will be conditional on the achievement of real efficiency gains by departments. In setting out the next steps in reform, the Review will in particular focus on increasing devolution to the front line, enabling public service providers to respond flexibly to local needs.

Next steps in public service reform – the Budget 2003 reviews

6.43 In Budget 2003, the Government announced that it would investigate a number of key issues to make the best of funding allocated in the 2002 Spending Review and to prepare the ground for the 2004 Spending Review. These reviews are focusing on the drivers of performance and efficiency in the public services, to help ensure that the public receives value for money for its investment and enjoys consistently high and continuously improving standards. Progress in these reviews, which will feed into the outcomes of the 2004 Spending Review, is set out below. Details of the Child Poverty Review and Childcare Review, also announced in Budget 2003, are set out in Chapter 5.

Efficiency in the public sector

6.44 The Government's commitment to improving standards in the public services has been matched by a focus on the efficiency of its spending. For instance:

- the implementation of resource accounting and budgeting is helping to improve the efficiency of public sector asset use;
- the Office of Government Commerce (OGC), established in 2000, is helping departments to improve the efficiency of government departments' procurement activity; and
- every department has a PSA target specifically focused on improving efficiency or value for money.

6.45 Building on this focus, the independent review of efficiency in the public sector announced in Budget 2003, led by Peter Gershon, aims to release significant resources for the front-line services that address the public's highest priorities. It will consider for example how significant new investments agreed in the 2002 Spending Review can be used to deliver efficiencies in the public sector, and how the bureaucracy faced by front line professionals can be reduced to free them up to respond to the needs of their customers.

6.46 Initial work by the Gershon Review and the results of consultation with the public and private sectors suggest that there is substantial scope to generate efficiency savings in public spending, in particular through exploiting opportunities to join up delivery and adopt current best practice. Potential savings are particularly large in:

- procurement (current annual spend in excess of £100 billion), for example building on OGC work generating economies via shared purchasing strategies, use of electronic purchasing, and the development of capacity in contract management;
- the corporate back office (some £28 billion annually), exploiting opportunities to provide shared services across public sector bodies in activities such as Finance, Human Resources management, and procurement; and
- transactional services – such as payments of benefits and tax – between people, businesses and the public sector (some £11 billion annually), for example through maximising the benefits of investment in more efficient communication channels such as the web interfaces and call centres.

6.47 As a result of the Gershon Review's initial work, the Government will look radically at the way in which policy is set for, funding provided to and quality regulated in front line public service delivery organisations such as hospitals, schools and police forces (current annual spend on these activities is around £9 billion) and comparable policy, funding and regulation activity which impacts on the private sector (£3 billion). Finally, the Government will seek to ensure significant improvements in the productive time of front line public service professionals by realising benefits from investments agreed in the 2002 Spending Review in information and communications technology, workforce reform and sharing of best practice.

6.48 2004 Spending Review settlements will be conditional on real efficiency savings being achieved in these areas. Departments will be asked to bring forward proposals for unlocking substantial efficiency savings as part of their Spending Review submissions. The Government will be considering how best to ensure that departments and public sector managers have incentives to identify and deliver those savings.

Improving the efficiency of public sector procurement

6.49 The Government purchases over £100 billion of goods and services every year, and achieving value for money in procurement is therefore fundamental to improving the quality and cost effectiveness of public services. The Government's key objectives are to:

- leverage economies of scale and scope in procurement, while maximising local decision-making and flexibility;
- develop and embed world class procurement policy and practice throughout the public sector by building expertise in key areas and rolling out successful tools and techniques;
- manage supplier relationships to strike the right balance between ensuring competitive markets and building longer-term, strategic relationships; and
- minimise the costs of procurement for both the public and private sectors.

6.50 A good start has been made in working towards these objectives. The OGC is today reporting value for money gains of £1.6 billion to March 2003. New best practice tools, such as the Gateway process, have placed the UK public sector amongst world leaders for structured procurement review methodology, and Centres of Excellence have been set up in departments to embed programme management skills.

6.51 The Government is committed to accelerating this improvement and securing greater efficiencies from its purchasing activity. The new measures identified in Chapter 3 to increase competition and reduce costs for business are an important component of an enhanced approach to public sector procurement.

6.52 The Government is also considering further steps to unlock additional value for money gains more quickly. In moving forward careful consideration will be required to ensure that a new approach to public sector procurement complements a range of existing, successful initiatives across the wider public sector. But it is clear that much more can be done to meet the Government's procurement objectives; to optimise engagement with suppliers and markets; to bring to bear the right capabilities on the right projects at the right time; and to ensure a more joined-up approach across the public sector.

6.53 The Government will now consider in detail how its approach to procurement will evolve with a view to finalising the way forward in the 2004 Spending Review and implementing this by the end of 2004. There are two key elements to this work. First, departments will be expected to identify and deliver significant procurement efficiencies in the context of the Gershon Review. Second, the Government will explore in detail radical options for reforming its approach to public sector procurement with departments and the wider public sector. Potential models include:

- stronger central co-ordination and strategic direction on procurement across the wider public sector, providing clearer links into key business processes and improved performance management;
- greater devolution to centres of commercial excellence within the public sector to lead and embed best practice, ensure that procurement expertise is close to service delivery and significantly improve collaboration in key areas; and
- greater focus on market sectors such as construction and IT, with improved coordination across the public sector to achieve deeper commercial expertise, enable procurement professionals to deliver the best results, and enhance the public sector's ability to influence markets and the nature of provision.

Public sector relocation

6.54 The independent review of public sector relocation, led by Sir Michael Lyons, will make recommendations on relocating government activity from London and the South East. Box 6.4 describes the provisional interim findings of the Lyons Review.

Box 6.4: The Lyons Review of public sector relocation

The independent review of public sector relocation announced in the 2003 Budget is being led by Sir Michael Lyons. The Review published an interim report in September 2003 confirming that at least 20,000 government jobs could be relocated from London and the South East. The review's final report will be published in March 2004.

Sir Michael will shortly be publishing new evidence, which further demonstrates the benefits for efficiency and quality of public services in relocating government activities. Work based unnecessarily in London and the South East imposes extra costs on departments, through higher accommodation and staff costs and lower recruitment and retention rates, and affects the delivery of public services. As well as reducing these costs, well planned and executed relocations can trigger business and culture change in organisations. There is a close read-across between these themes and the Gershon Review of efficiency in the public sector.

The latest evidence shows that relocation is likely to have a positive economic impact on the areas receiving government activity, with potential benefits for the UK economy as a whole. Sir Michael will also be exploring other potential benefits of relocation, including a contribution to regeneration and urban renewal, delivery of the Government's PSA target for regional economic growth, improving the visibility and accessibility of government functions and preparing for future devolution.

In the light of Sir Michael's work the Government has committed to take forward relocation as a key strand of the public service reform agenda, underpinned by a clear responsibility on civil service heads to realise the benefits of relocation for their departments, the need for suitable incentives and a tighter coordination of the Government estate. Work on these elements will be taken forward by the Government over the coming months.

Voluntary and community sector

6.55 The Government believes that voluntary and community sector (VCS) organisations have a crucial role to play in the reform of public services and the reinvigoration of civic life, building a bridge between the needs of individuals living in communities and the capacity of the state to improve their lives. The cross cutting review of the role of the voluntary sector in public service delivery undertaken in the 2002 Spending Review was an important start in this process. The review's recommendations were focused on developing the capacity of the sector to enable it to engage with government more effectively, resulting in real change in service delivery where the sector is in a position to provide added value.

6.56 The key to this improvement in capacity lies with the new fund, *future*builders, details of which were published in September 2003.[7] This fund will have the flexibility to invest through a range of finance, tailored to the needs of individual organisations, in schemes delivering improved and expanded public services, offering greater choice to service users. A preferred provider to manage the fund is being selected through an open competition. The fund will transfer to the Active Communities Directorate (ACD) in the Home Office in the New Year and the ACD will take forward implementation.

[7] *futurebuilders: An Investment Fund for Voluntary and Community Sector Public Service Delivery*, HM Treasury and the Compact Working Group, September 2003.

6.57 The Treasury issued *Guidance to Funders*[8] in September 2003 to help departments and VCS organisations to develop better arrangements when they are negotiating service contracts. This will enable the sector to deliver priority services more effectively, especially when the aim is to engage with harder-to-reach groups.

6.58 The 2002 cross cutting review was the first step in considering ways to develop the important partnership between government and the sector. As part of the Voluntary and Community Sector Review announced in Budget 2003, key delivery departments and local government will be considering how they can work more constructively with VCS organisations to deliver their PSAs. The review is focusing on how both central and local government can better engage with the VCS and social enterprise to aid delivery in top priority areas including children and families, housing and homelessness, education and employment, crime and social cohesion, and health and social care.

Box 6.5: Securing good health for the whole population

Budget 2003 announced that Derek Wanless would provide an update on the long-term challenges in implementing the 'fully engaged' scenario set out in his 2002 report on long-term health trends, with a particular focus on the efficiency of cross-departmental work on preventative health and health inequalities.

The review will consider how public health spending decisions are taken and will examine how to ensure that they can be taken as cost-effectively and consistently as possible, in order to improve health outcomes through the efficient use of resources. Underpinning this work is a preliminary report outlining the main causes of mortality, morbidity and key risk factors amenable to public health interventions in England, including trends over time.

England performs poorly compared to other countries on some key measures of health outcomes and chronic disease such as coronary heart disease (CHD), cancer and particularly respiratory diseases. Chronic diseases such as CHD and cancer are also strongly related to lifestyle factors such as smoking, poor diet, high blood pressure, obesity, physical inactivity and alcohol.

In addition, a significant proportion of avoidable ill health is related to socio-economic deprivation. Mortality rates are much higher for lower socio-economic groups, and this is strongly linked to socio-economic differences in lifestyle factors, as well as to social and environmental factors such as poverty, lack of education, unemployment, and poor housing and access to health services. For example, it is estimated that half the difference in the numbers of people surviving to 70 years of age between the highest and lowest socio-economic groups is due to the higher prevalence of smoking in the lowest group.

The background report describing these health trends has been published on HM Treasury's[a] and the Department of Health's websites to provide a backdrop to the final report, *Securing Good Health for the Whole Population,* due in February 2004.

[a] www.hm-treasury.gov.uk/wanless.

Devolved decision-making

6.59 The Devolved Decision-Making Review announced in Budget 2003 is considering how best to achieve decentralised delivery and responsive local and regional services in a way that is consistent with equity and efficiency, against a clear framework of national standards.

[8] *Guidance to Funders*, HM Treasury, September 2003.

6.60 PSA targets, combined with increased investment and local capacity, provide the framework within which the Government can develop a more devolved system of public service delivery. This requires a new relationship between central government and local and regional bodies, based more on trust, negotiation and greater local accountability and less on control. A more devolved approach can lead to:

- improved efficiency and an increased range of choices available to users through greater flexibility to tailor services to local needs based on better local information and knowledge;
- improved organisational morale and internal management capacity through empowering local leadership and frontline staff, thereby improving productivity by harnessing internal drivers of continuous improvement; and
- more local engagement with public services and greater accountability of local service providers.

6.61 In terms of targets and performance management, such an approach will require change in two key areas:

- continuing the evolution towards fewer nationally set targets, reflecting only the Government's key priorities, with greater scope for local flexibility to determine outcomes and methods of delivery; and
- improving efficiency by creating sharper, clearer roles, accountabilities and incentives.

6.62 Refining the approach to targets and controls will require much greater discipline and local consultation in national target-setting. The focus and impact of PSAs must be maintained. To achieve this, it is necessary to reduce substantially the aggregate number of external controls such as ringfencing, inspection and targets unrelated to the PSA framework that are faced locally by schools, hospitals, local authorities and others. In addition, the transmission of PSA targets must take more account of local circumstances and performance and allow greater local flexibility in delivery. To this end, **this Pre-Budget Report announces the abolition of Service Delivery Agreements (SDAs) for the 2004 Spending Review, removing over 500 lower level input, output and process targets** and thereby increasing flexibility for local managers to determine how to deliver desired outcomes. Furthermore, once local organisations meet a national standard and have demonstrated their capacity to maintain and improve service levels, externally set target levels should not generally need to be increased. Local organisations should be given the freedom to choose targets and measures against the outcomes most important to their local communities, building on approaches such as local PSAs.

6.63 To strengthen incentives for continuous improvement it is necessary to remove overlapping accountabilities that exist between front-line units, intermediate tier organisations (such as police forces and local authorities) and government departments. In particular the respective performance management roles of these organizations must be clarified. Improved accountability needs to be supported by a clearer framework of rewards and sanctions for local organisations, including through greater application of the earned autonomy principle.

6.64 These changes require further improvements to the culture of performance management at the local level and within central government. Building on policies such as the Comprehensive Performance Assessment (CPA) in local government, departments and inspectorates should focus on spreading best practice in local performance management and on creating incentives to introduce improved approaches.

6.65 Greater local flexibility must be underpinned by improvements to the quality, use and transparent reporting of robust and timely performance data. Improved information plays a key role in strengthening accountability to the public by increasing transparency and engendering trust. An example is the introduction of the Police Performance and Assessment Framework (PPAF), which provides a clear comparison of how police forces around the country are performing in key areas. Driven by the need to measure performance against a national PSA target, this is a clear example of how performance at local levels can be effectively reported.

6.66 The Government will publish the findings of the Devolved Decision-Making Review's work on targets and performance management next month. This will allow the approach to be considered and developed by departments in the run up to the 2004 Spending Review as the Government develops a more devolved, less bureaucratic approach to public service reform within a clear framework of national standards.

7 PROTECTING THE ENVIRONMENT

Sustainable development is vital to ensure a better quality of life for everyone, today and for generations to come. Economic growth and social progress must be balanced with action to protect and improve the environment. The Government is using a range of economic instruments to address the challenges posed by sustainable development, tackling local environmental threats and controlling and reducing emissions of the gases responsible for climate change and poor air quality. This Pre-Budget Report describes the next steps in the Government's strategy, including:

- **the establishment of an Alternative Fuels Framework to guide the duty regime for alternative fuels, including a commitment to providing rolling three-year certainty on duty differentials for all alternative fuels. Consistent with this framework the Government is today announcing a gradual increase in the duty rate for Liquefied Petroleum Gas (LPG) to a level which better reflects its relative environmental benefits;**
- **the extension, subject to state aid approval and satisfactory negotiated agreements with the industry, of relief from the levy for aggregates used in processed products and virgin aggregate in Northern Ireland;**
- **announcing plans for changes to the eligibility criteria for climate change agreements that will provide better incentives for businesses to encourage energy efficiency;**
- **how it proposes to recycle landfill tax revenues to businesses; and**
- **a consultation in early 2004 on tackling diffuse water pollution, including a consideration of the pros and cons of economic instruments.**

INTRODUCTION

7.1 The Government is committed to delivering sustainable growth and a better environment. Environmental progress must go hand in hand with economic and social objectives, and policies should take account of the relationship between these different objectives. The Government believes economic instruments can help do this fairly and efficiently.

7.2 The Government has made strong progress on this agenda and has introduced a range of economic instruments to help achieve environmental objectives in a cost effective way. The Climate Change Levy (CCL), introduced in 2001, provides businesses with incentives to be more energy efficient. This was followed in 2002 by the introduction of the world's first economy-wide emissions trading scheme. The aggregates levy, which tackles the environmental costs of aggregates extraction, was also introduced in 2002. On transport, progress has been made through the use of price differentials on fuels and vehicles, which reflect variations in environmental impact.

A strategy for environmental taxes

7.3 These policies are based on a principled approach. In 1997, the Treasury published a Statement of Intent of Environmental Taxation, which set out the role that the tax system can play in delivering environmental objectives. The 2002 report, *Tax and the environment: using economic instruments*,[1] built on this by setting out a more detailed framework for developing and implementing environmental economic instruments. Key features of the approach include establishing the environmental objective, extensive consultation before decisions are made, giving early signals about the need to act, and providing households and business with sufficient opportunity to plan changes and invest appropriately. Within this framework, the Government will also explore the development of revenue-neutral proposals to reinforce responses to measures and reduce excessive impacts on those groups that face the greatest challenge in changing their behaviour.

7.4 The Government's environmental tax strategy is consistent with its aim of creating an enterprising, flexible economy which provides opportunity for all. Environmental taxes and economic instruments allow people and businesses to choose how they respond to the incentives created. This approach is in accordance with the polluter pays principle, under which those that pollute more, pay more. As with all policy instruments, they must be well designed to protect the international competitiveness of UK industry and take account of distributional objectives. These instruments can also encourage innovation in environmental technologies and so promote enterprise.

The Treasury's environmental objective

7.5 To reflect the importance of sustainable development, HM Treasury updated its central aim in 2002 and included a new objective: *to protect and improve the environment by using instruments that will deliver efficient and sustainable outcomes through evidence based policies*. This will result in greater weight being attached to quality of life and sustainable growth when developing policies.

7.6 Despite considerable progress, the Government recognises that there are more opportunities and challenges ahead. Tackling the remaining environmental problems is vital to delivering a better quality of life for everyone, today and for future generations. This chapter sets out the action the Government is taking to meet these challenges by tackling climate change and air quality, improving waste management and protecting Britain's countryside and natural resources.

TACKLING CLIMATE CHANGE AND IMPROVING AIR QUALITY

7.7 The Government is committed to tackling climate change and improving air quality. This requires action across all sectors with a central role for environmental taxes and economic instruments such as the CCL and the EU Emissions Trading Scheme (EU ETS), which is due to be introduced in 2005.

7.8 There is strong evidence that global temperatures are rising. Average global temperatures have increased by 0.6°C over the twentieth century and nine of the ten hottest years on record occurred between 1990 and 2003. Studies of temperature trends show that these increases are unlikely to be entirely natural in origin. Temperatures in the UK have followed the twentieth century global trend with annual average temperatures warming by about 1.0°C. By the end of this century, models predict that global temperatures will rise by a further 1.4°C to 5.8°C and UK temperatures by 2°C to 3.5°C. Sea levels are predicted to rise by 9 to 88 centimetres.

[1] *Tax and the Environment: using economic instruments*, HM Treasury, November 2002.

7.9 The impacts of climate change could be wide-ranging and affect many parts of society. Some of the possible impacts of climate change in the UK include increased weather variability causing damage to infrastructure and leading to transport disruption; reduced reliability of the energy supply; higher costs for building repairs and refurbishment; and increased flooding in many lowland areas due to more frequent river flooding and more severe storm surges.[2]

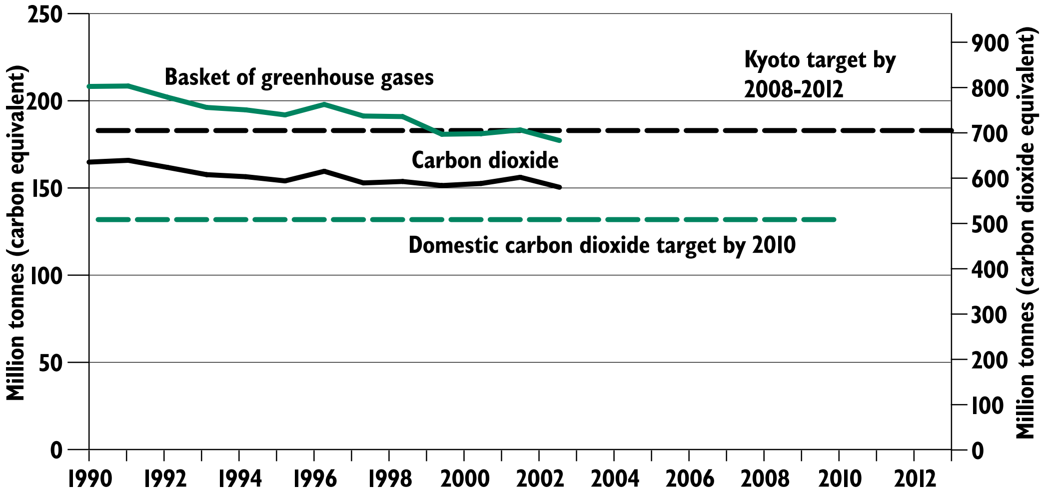
Climate change programme

7.10 The Government is committed to reducing emissions of the gases responsible for global warming. The Kyoto Protocol commits the UK to reduce its greenhouse gas emissions to, on average, 12.5 per cent below 1990 levels between 2008 and 2012. The Government also has a national goal to move towards a 20 per cent reduction in carbon dioxide emissions below 1990 levels by 2010. Chart 7.1 sets out progress against these goals. The climate change programme consists of measures designed to reduce carbon emissions across all sectors of the economy and will be reviewed in 2004.

The Energy White Paper

7.11 The Energy White Paper, published in February 2003, restates the Government's commitment to its climate change goals. It also sets out long-term strategies and shorter-term policies which aim to put the UK on the path to a 60 per cent reduction in greenhouse gas emissions from current levels by 2050 as recommended by the Royal Commission for Environmental Pollution. The Government's priorities are to strengthen renewables and energy efficiency.

Chart 7.1: UK emissions of greenhouse gases



Note: Estimates for 2002 are provisional.
Source: National Environmental Technology Centre and DEFRA.

7.12 UK data on the emissions of greenhouse gases show a clear downward trend. Between 1990 and 2001 greenhouse gas emissions fell by 12 per cent. Provisional data for 2002 show that UK emissions of greenhouse gases fell by between 14 and 15 percent between 1990 and 2002 and carbon dioxide emissions fell by 8.8 per cent during this period. Between 2000 and 2001 carbon dioxide emissions actually increased by 2.3 per cent, but decreased by 3.7 per cent between 2001 and 2002, based on provisional data for 2002.

[2] Full details available in the *UK Climate Change Impacts Programme* at www.ukcip.org.uk/scenarios.

Energy Products Directive

7.13 The Energy Products Directive (EPD) was formally adopted by the European Council of Ministers in October 2003. The Directive will come into force on 1 January 2004 and will provide a Community framework for taxation on energy products. It will increase the existing minimum rates of duty on hydrocarbon oils and introduce minimum rates of duty for the taxation of other energy products, including electricity, natural gas, coal and other solid fuels. Those Member States that do not currently tax these fuels, will be required to introduce such taxes. However, the minimum rates in the EPD will not affect the UK's oil duty rates, the CCL, or the UK's right to exempt domestic and charity non-business use of energy from the CCL.

Climate change levy

7.14 The CCL and its associated measures seek to encourage businesses to use energy more efficiently and to reduce emissions of carbon dioxide. The levy package is expected to reduce emissions by the equivalent of at least 5 million tonnes of carbon by 2010. The package is broadly revenue neutral for business, with CCL revenues recycled back to business through a 0.3 percentage point reduction in employer national insurance contributions (NICs) introduced at the same time as the levy, and support for energy-efficiency and low-carbon technologies.

CCL exemptions

7.15 In Budget 2002 the Government announced that, subject to state aid approval, it would introduce an exemption from CCL for electricity generated from coal mine methane sold via licensed electricity suppliers. Using coal mine methane to generate electricity delivers environmental gains and provides economic benefits to former coalfield areas. State aid clearance has been received and the exemption was introduced with effect from 1 November 2003.

Negotiated agreements

7.16 Budget 2003 announced that the Government would review the current eligibility criteria for climate change agreements (CCAs), under which energy-intensive sectors can obtain 80 per cent discounts from the CCL if they agree to increase their energy-efficiency and reduce emissions. Under the agreements 88 per cent of sites were certified as having met their first targets earlier this year. Eligibility to such agreements is currently related to the Pollution Prevention Control Regulations 2000, with the aim of protecting the competitiveness of UK industry. The Government believes that, in keeping with this original principle and with the EPD now agreed, there is scope to widen this eligibility while still providing strong incentives to encourage energy-efficiency. Following detailed discussion with industry, the Government has decided that, **subject to further consultation with energy-intensive sectors and state aid approval, it will extend the eligibility criteria for climate change agreements during 2004**. Therefore, in addition to the existing criteria, the Government will consider CCAs for sectors which meet a specific energy-intensity threshold, and will look to take account of any competitive distortions in those sectors. Further consultation with industry will take place ahead of Budget 2004 on the level at which the energy intensity threshold should be set, on competition issues, and on the practicalities, including the administrative burden of such a system.

Emissions trading

7.17 The UK Emissions Trading Scheme (ETS), the world's first economy-wide trading scheme, was launched in April 2002 and has made a very encouraging start. In the first year of the scheme around 600,000 allowances were traded and overall participants reduced emissions by 4.6 million tonnes of carbon. This was against a commitment to reduce emissions by 1.1 million tonnes of carbon a year by 2006. Companies participating in the scheme now face an economic cost for every tonne of carbon they emit, which ensures that environmental impact is taken into account in future financial and investment decisions. The ETS will also play an important role in helping to deliver the goals set out in the Energy White Paper and facilitating entry into the EU ETS.

7.18 The EU ETS is due to be introduced in 2005. The Government is working to develop a national allocation plan for the UK and has consulted with stakeholders from across the economy. Subject to further decisions about the plan, the Government will consult again shortly on details of the allocations to different sectors. In deciding these allocations, the Government will aim to ensure that the introduction of the EU ETS:

- is consistent with the UK's long-term emissions policy goals expressed in the Energy White Paper;
- is coherent with complementary measures which provide equivalent incentives across sectors to reduce emissions;
- is as simple as possible to operate for business – administration, compliance and transition costs should be kept to a minimum; and
- minimises impacts on international competitiveness and on fuel poverty.

7.19 The EU ETS will operate alongside a number of existing climate change policy instruments. To ensure the success of the EU ETS, the Government has considered how these policies should function together. One of the main tools of climate change abatement has been the use of CCAs, which tie reductions in the CCL to negotiated agreements, and which have already delivered substantial carbon savings. Taking account of this, the Government has decided to create a level playing field between CCAs and the EU ETS, and **will introduce the equivalent CCL discount for those installations in CCAs who would like to enter into the EU ETS instead, once the scheme is up and running**.

Investment in energy saving technologies

7.20 Enhanced capital allowances (ECAs) for investments in approved energy-saving technologies were introduced in 2001 and currently cover more than 6,000 approved products. Administration of the ECA scheme is managed by the Carbon Trust, an independent not-for-profit company funded principally from revenues recycled from the CCL.

7.21 In Budget 2003 the Government announced the addition of automatic monitoring and targeting equipment to the ECA scheme for energy-saving equipment. Further technologies were also added to the existing boiler, compressed air and refrigeration categories, effective from August 2003. The addition of these groups will be worth £5 million during their first full financial year. The Government believes that ECAs can be an effective method of helping business overcome financial barriers to installing energy-efficient technologies and continues to consider the case for additional technologies.

Renewable energy

7.22 The Government is committed to generating 10 per cent of electricity from renewable sources by 2010, subject to the costs being acceptable to the consumer, with the aspiration of doubling that percentage by 2020. The Renewables Obligation (RO) was introduced in April 2002 and requires energy suppliers to supply progressively higher proportions of energy from renewable sources each year to 2010. In December 2003, the Department for Trade and Industry (DTI) announced a five-year extension to the RO which will require suppliers to supply 15.4 per cent of power from renewable sources by 2015-16. In 2005-06 the Government will review progress and will elaborate a strategy for the remaining years to 2020. This will take account of the experience of carbon prices arising from the EU ETS and of the costs of renewable technologies. The Northern Ireland Office plans to introduce a Northern Ireland Renewables Obligation from April 2004.

Domestic energy efficiency

7.23 The Government consultation on specific economic instruments to promote household energy-efficiency closed in October 2003 and a summary of responses is published today. Measures under consideration included reducing VAT on energy-saving materials and energy-efficient products, capital allowances for businesses to lease energy-saving equipment to domestic households and registered social landlords, and a domestic business tax allowance.

7.24 As the consultation document made clear, the proposed measures on reduced rates of VAT for the purchase of energy-saving materials for DIY installation and energy-efficient products were subject to a successful outcome of the negotiations with EU partners on a review of EU rules governing reduced VAT rates. Although it remains the Government's objective to achieve a reduced rate of VAT, where it can effectively deliver improvements in energy-efficiency, including for the purchase of energy-saving materials for DIY installation, the future of these negotiations is uncertain. In the short term, these negotiations are unlikely to deliver an opportunity for VAT rates to be used to promote energy-efficiency, beyond the existing provisions. The proposed capital allowance for the leasing of energy-efficient equipment will be examined in the context of the review of corporation tax.

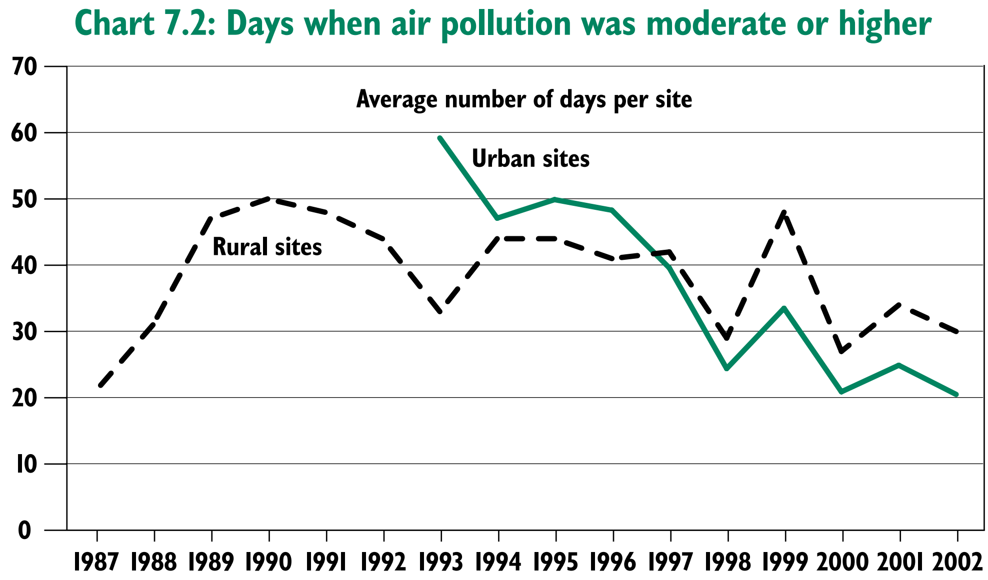
7.25 The Government agrees that there is a case for the use of economic instruments as part of a package of measures to promote energy-efficiency. Therefore, taking into account the responses to the consultation document, and in the light of the Corporation Tax Review and the negotiations with EU partners on VAT reduced rates, the Government will give further detailed consideration to measures to promote energy-efficiency, including the case for a domestic business tax allowance. A further announcement will be made in Budget 2004.

Air quality

7.26 The Government's policies on improving air quality are set out in the *Air Quality Strategy for England, Scotland, Wales and Northern Ireland* and its first addendum published in February 2003.[3] These strategies set health–based air quality standards for nine key pollutants and target dates for their achievement across the UK between 2003 and 2010.

7.27 As Chart 7.2 indicates, air quality in urban areas has improved significantly over the last decade, largely as a result of progressively tighter EU standards for new vehicles and fuels, supported by the use of economic instruments and the continuing reduction in total emissions from industry. To a certain degree, the level of UK air pollution is outside the control of the Government. Significant fluctuations in annual levels of air pollution can be caused by differences in weather conditions. Air pollution levels in rural areas can be particularly influenced by levels of ozone, which is a trans-boundary pollutant. The average number of days of moderate or poor air quality in urban areas of the UK has fallen from 59 days in 1993 to 20 days in 2002, and in rural areas from 50 days in 1990 to 30 days in 2002.

[3] Available at www.defra.gov.uk/environment/airquality.



Source: DEFRA, National Environment Technology Centre (NETCEN).

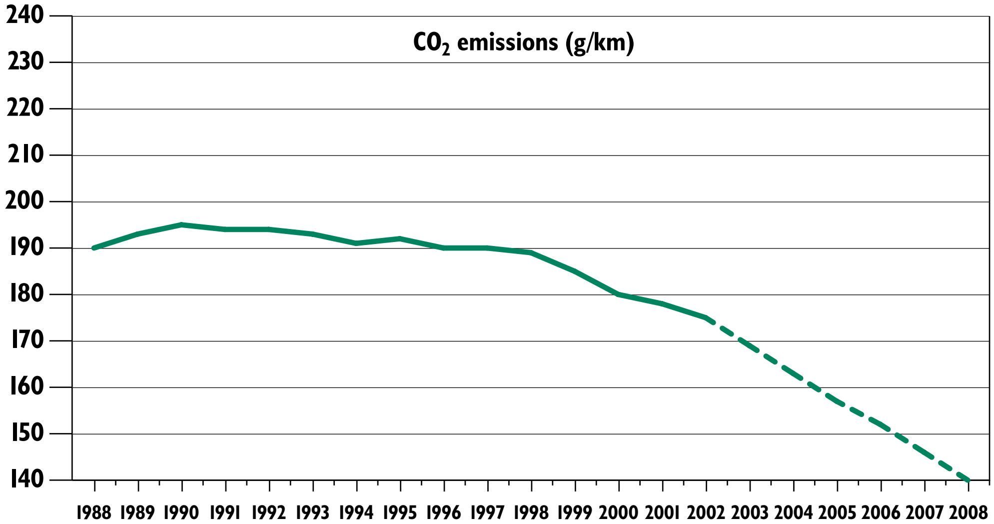
7.28 The UK is on course to meet the Government's air quality targets for the majority of pollutants. In 2002, targets had been met for benzene, carbon monoxide, lead, sulphur dioxide and 1,3-butadiene. However, despite major reductions, on the basis of current policy measures it is unlikely that the Government will meet its targets for nitrogen dioxide and particulates, particularly in some urban areas including parts of London. In order to tackle these pollution hot spots and achieve further general air quality improvements, the Government is currently reviewing the measures set out in the Air Quality Strategy and the Ten Year Plan for Transport.

TRANSPORT

7.29 A safe, clean and efficient transport system is crucial to sustaining economic growth, generating higher productivity and safeguarding the environment. Over recent decades, rising economic activity and incomes have increased the demand for personal travel and the transport of goods and services. The increase in road traffic has led to a major increase in congestion, which has also exacerbated the environmental impacts of transport. As described in Chapter 6, the Department for Transport (DfT) is currently considering priorities for reform, including on road congestion, which will help deliver environmental improvements as well as the economic benefits of a more efficient transport system.

7.30 The Government has taken a number of steps to advance its environmental objectives, encouraging take-up of the most efficient fuels and vehicles, and promoting the development of greener forms of transport and fuels in the future. Box 7.1 in this chapter sets out a proposed Alternative Fuels Framework that outlines the rationale for decisions on Government support for alternative fuels to meet environmental objectives. The Government's long-term goal is to support the switch to a low-carbon economy, including zero-emissions transport. Chart 7.3 shows how carbon dioxide emissions from new cars in the UK have fallen in recent years and are expected to fall further by 2008 in light of the voluntary agreement between the European Commission and car manufacturers, underpinned by environmentally-focused vehicle taxes.

Chart 7.3 Carbon dioxide emissions from new cars



Source: Data from 1995 to 2001 are based on DVLA monitoring. Data prior to 1995 are estimated from average new car fuel consumption figures. The petrol average new car consumption data are from Transport Statistics Great Britain. An equivalent diesel figure was calculated for 1994 at 22 per cent better than petrol fuel consumption. This figure was used for all previous years in this chart, in the absence of other data.

Fuel duties

7.31 In accordance with the Budget 2003 announcement, the Government made the delayed increase for the main road fuel duties on 1 October 2003. Future decisions on duty levels will continue to take into account all relevant economic, environmental and social factors.

Sulphur-free fuels

7.32 Sulphur-free fuels offer further environmental benefits over ultra-low sulphur fuels, delivering greater long-term reductions in carbon dioxide emissions when used in new engine technologies and further air quality improvements. As announced in Budget 2003, to bring forward the availability of this fuel, **the Government will introduce a duty differential for sulphur-free fuels of 0.5 pence per litre relative to the rates for ultra-low sulphur fuels from September 2004**.

Biofuels

7.33 The Government has already introduced a number of changes to encourage the growth of a successful biofuels industry in the UK. A biodiesel duty differential was introduced in July 2002, triggering sales which are now around two million litres per month from over 130 outlets in the UK. **In addition, Budget 2003 committed the Government to the introduction of a similar duty rate for bioethanol from January 2005**.

Box 7.1: Alternative Fuels Framework

The Government recognises the contribution that alternative fuels can make in delivering environmental objectives. This is reflected through the significant support that the Government has given to the sector over recent years.

With this framework, the Government goes further. The purpose of the framework is to ensure that policy continues to reflect the environmental benefits that alternative fuels can deliver and to establish a clear rationale for decisions on Government support. This approach is based on the principles set out in the Treasury document, *Tax and the Environment: Using Economic Instruments*, published alongside the 2002 Pre-Budget Report. The principal application of this framework is to policy on duty differentials for alternative fuels but the approach is equally relevant to decisions on the full range of potential economic instruments.

Statement of principles

- **Policy must be environmentally sustainable. Levels of support should reflect the full environmental impact of the fuel.**
- **Policy must be economically sustainable. The Government should not support an industry whose long-term survival is dependent on excessive levels of subsidy unjustified by environmental benefit.**
- **Policy must be socially sustainable. Support should reflect broader considerations of social impact and fairness.**
- **Policy must be affordable and provide value for money. Where fuels fulfil the criteria set, support will be given where it is both cost effective and affordable.**

The Importance of Certainty:

- **the Government recognises the importance of providing as much certainty as it can on duty differentials, to help provide the necessary stability, confidence and market conditions for investors. The Government will therefore commit to a rolling three-year period of certainty on the differentials in duty rates for alternative fuels.**

The Environmental Case:

- **the central priority will continue to be on environmental gains, with the emphasis being on quantified benefits that are based on the life-cycle carbon performance of the fuel. Recognising the comparatively high cost of carbon reduction in the transport sector, the Government will nevertheless seek to meet key environmental objectives in a cost-effective way; and**
- **the Government will take account of fuels that have additional environmental benefits by, for example, improving air quality and reducing waste.**

The Economic and Social Case:

- **the Government will only offer support beyond that justified by environmental benefit if there is clear evidence that this support will result in enhanced future benefit;**
- **in assessing the level and types of support available, the Government may also take into account other benefits to the economy arising from the use of alternative fuels; and**
- **where there is a direct link to Government priorities, and clear and well-established evidence of benefit.**

General Application:

- **This framework sets out principles which can be applied to all types of support for the take up of greener road fuels. Duty incentives alone can be a very blunt instrument, so where there are clear reasons for incentives to be more focused on specific objectives, the Government will also consider other means of support, such as capital incentives, grants or regulatory solutions which may be more suitable, better targeted and better value for money.**

7.34 In line with the principles set out in the Alternative Fuels Framework and consistent with the Government's commitments in previous Budgets, the Government today announces further measures to support investment in the biofuels sector, including:

- **a commitment to providing future market stability for alternative fuels,** with the Government committing to rolling three-year certainty on the differentials in duty rates on alternative fuels; and
- **a commitment to consider ways of focusing the duty regime on input taxation in addition to product-based taxation.** This would allow the duty regime to better incentivise more environmentally and economically efficient fuel manufacturing processes.

Road fuel gases

7.35 The duty on road fuel gases has not increased since Budget 2001, in line with the Government's commitment to freeze these duties until 2004 at the earliest. Budget 2003 announced a consultation on how best to ensure that future support for road fuel gases continues to reflect environmental and other policy objectives. Following this extensive consultation, the Government has decided that the environmental benefits offered by liquefied petroleum gas (LPG) no longer justify the level of duty differential it currently receives, while the long period of high duty support has allowed the necessary infrastructure to be developed. **The Government will gradually increase the duty rate for LPG over the next three years, setting duty differentials on a path towards a level commensurate with the fuel's environmental benefits. Consistent with the Government's commitment to give three-year certainty on duty differentials for alternative fuels, future differentials for the next three years will be announced in Budget 2004**.

7.36 The emissions evidence for natural gas (NG) vehicles suggests that they offer considerable additional environmental benefits over conventional fuels, particularly in terms of air quality. Given that conversions are focused on fleet vehicles, buses and HGVs, which are generally more polluting than other vehicles, there is a stronger case for maintaining a larger fuel differential reflecting the additional environmental benefits. **Therefore, consistent with the Government's commitment to give three-year certainty on duty differentials for alternative fuels, the Government has decided that the differentials for NG will be held constant for a further three years.**

Hydrogen **7.37** As announced in the Energy White Paper, the Government is currently undertaking an assessment of the overall energy implications of a hydrogen economy and large scale biomass-based fuels. A website is in place to provide information on progress and enable open access for comment and input into the assessment.[4] In addition, a two-year trial of three hydrogen buses will begin shortly. The buses benefit from support from the new vehicle technology fund and will operate as part of the London buses fleet.

Rebated oils **7.38** In Budget 2003 the Government announced it would consult producers, distributors and users of red diesel and fuel oil, as well as environmental groups, to establish whether preferential duty rates for rebated oils with a lower sulphur content would deliver worthwhile environmental benefits. In July 2003 the Government published a consultation document, *Duty Differentials for more Environmentally Friendly Rebated Oils*. Initial work done in this area suggests that there would be measurable environmental benefits from the introduction of low sulphur rebated oils in certain uses. **The Government therefore believes that it should introduce a modest duty differential in favour of red diesel with a sulphur content of less than 0.005 per cent and fuel oil with a sulphur content of less than 0.5 per cent. The level of this duty differential and any other conclusions from the consultation will be announced at Budget 2004**.

Vehicle excise duty **7.39** The Government has introduced a series of reforms to the vehicle excise duty (VED) system. These provide motorists with incentives to choose more environmentally-friendly vehicles and continue the shift towards taxing vehicle usage rather than ownership. The DfT has commissioned market research to find out the public perception of graduated VED as an environmental incentive to motorists. Together with company car taxation reform, the graduated VED system is designed to help drivers to choose cleaner vehicles. However, more work needs to be done to publicise the VED scheme and to influence consumer choices and the Government is now exploring how it can improve the effectiveness of the scheme.

Company car tax **7.40** Budget 2003 announced that the Inland Revenue would be conducting a comprehensive evaluation of the company car tax system, which was reformed in April 2002. The reform has resulted in fewer business miles being travelled and a shift to more fuel efficient cars, resulting in a significant reduction in carbon dioxide emissions from company cars. The reform has also saved business money through lower year-on-year administration costs. **The Government will analyse further the impact of the reform in making decisions about company car tax in future years**.

Company vans **7.41** Budget 2003 announced that the Government was reviewing the taxation system for company vans and would consult on options for reform, taking into account environmental benefits, fairness and modern working practices. The Government will announce the outcome of this review at Budget 2004.

Lorry road-user charging **7.42** Since the publication of *Lorry Road-User Charge – Progress Report Two* in May 2003, the Government has been working to refine the requirements of the charge. Discussions with the Road Haulage Forum and with other industry representatives have led to the development of technical proposals that better reflect operators' advice and experience. Developing technical requirements has helped refine understanding of the pathway to implementation, and this has been reinforced by consideration of the experiences of other countries. The Government intends to issue **a further progress report next year to update on the work to date and give more detail about plans for implementation**.

[4] Available on the DTI website at www.dti.gov.uk

Aviation **7.43** The Government recognises the significant contribution that aviation makes to the UK and global economy. Budget 2003 announced that the Government would be holding a series of discussions with key stakeholders following the publication of a discussion paper, *Aviation and the environment: using economic instruments*, which sets out the principles of the Government's approach in this area. These discussions have now been completed and a summary can be found on the DfT website. Details of how the Government intends to tackle the impacts of aviation will be announced in the Air Transport White Paper, due to be published shortly.

Box 7.2: Sustainable growth in aviation

The Government believes that a sustainable aviation industry must strike the necessary balance between promoting the clear economic benefits from aviation and ensuring that the environmental impacts of the industry are factored into behavioural incentives and long-term plans. The forthcoming Air Transport White Paper aims to establish a sustainable development path for the industry over the next 30 years, including the location of any new airport capacity. The growth in demand for aviation brings with it enormous benefits but also significant costs to the environment. By 2020, aviation is projected to be responsible for 10 to 12 per cent of UK carbon dioxide emissions, up from 5 per cent today. In addition to these global issues, there are also significant local environmental impacts such as local air pollutants like oxides of nitrogen and noise, which impact particularly on those communities located near airports.

Meeting these environmental challenges while delivering sustainable economic growth is one of the biggest tasks facing the industry. There are a number of ways to help the sector rise to this challenge. One of these is the use of economic instruments to encourage and reward behaviour that tackles environmental impacts. It is important that policy developments take account of the international nature of the industry, the need for international and long term solutions to global problems and the implications for the competitiveness of UK airlines.

IMPROVING WASTE MANAGEMENT

Waste strategy **7.44** Efficient use of resources and the effective management of waste are essential features of an environmentally-sustainable economy. The waste stream contains resources that can be re-used or recycled to deliver economic value, resulting in greater resource efficiency. Waste also has impacts on the environment both at a global level, due to emissions of greenhouse gases, and at the local level.

7.45 In response to the Cabinet Office Strategy Unit's report *Waste Not Want Not*, in May 2003 the Government set out its plans for a Sustainable Waste Management Programme. This focuses on improving waste minimisation, recycling and composting and researching new technologies for dealing with wastes which are not readily reduced, reused or recycled.

7.46 The Government commissioned an independent review of the existing literature on the evidence on the health and environmental effects of waste mangement options. The first of two stages of the work is currently being reviewed, with the aim of publishing the complete study in the spring. This review will inform the development of policy relating to waste management and debate by all interested parties, including local authorities. As the Government encourages a shift away from landfill through policies, such as significant increases to the standard rate of landfill tax and through the tradable landfill allowances following the passing of the Waste Emissions Trading Act (2003), it is continuing to expand its evidence-basis for the way waste from households and all sectors of the economy should be managed. This involves balancing environmental, health, economic and social considerations, and ensuring there is a strong incentive for individuals and business to minimise the waste they generate.

7.47 The most effective way of dealing with waste is ensuring that less is created in the first instance. One of the key outcomes of the World Summit on Sustainable Development, held in 2002, was a commitment to promote a ten-year framework in support of more sustainable patterns of consumption and production. In September 2003, the Government launched its framework which set out the economic and environmental case for tackling sustainable production and consumption and explained how the Government intends to meet its commitment. The Government's approach involves breaking the link between economic growth and environmental pollution, improving resource efficiency and examining the life-cycle of a product, through design, production, use and disposal, to help reduce its impact on the environment. The Government will examine using a variety of tools – including economic instruments, voluntary agreements, regulation and information campaigns – to work with business to achieve its objectives. The Government is also consulting on indicators which can measure the effectiveness of the planned actions and drive forward long-term improvements.

Landfill tax

7.48 The landfill tax encourages efforts to minimise the amount of waste generated and to develop more sustainable waste management techniques. It contributes to the achievement of the Government's waste strategy targets through the diversion of waste away from landfill. The standard tax rate is currently £14 per tonne. In line with the five-year escalator announced in 1999, this rate will increase to £15 per tonne on 1 April 2004. Thereafter, as announced in Budget 2003, the rate for an active tonne of waste will be increased by £3 per tonne in 2005-06, and by at least **£3 per tonne in the years thereafter to a medium- to long-term rate of £35 per tonne**. The Government will also be examining whether there would be benefits in extending simplified accounting to landfill tax.

Recycling landfill tax revenues to business

7.49 As stated in Budget 2003, increases in the standard rate of landfill tax will be introduced in a way that is revenue neutral to business as a whole and to local government. Since Budget 2003, the Government has consulted stakeholders and commissioned research to examine how revenue could be best recycled to help businesses tackle their waste management challenges.

7.50 The Government believes that there is a need for a range of waste management financing options and recognises that different financing options will work better in different circumstances. It proposes **a package of measures that will include grants and other financial support measures. The Government also believes that there is a need to extend the promotional and capacity building services to support a broader range of commercial and industrial sectors.** The Government does not think there is a strong case for recycling the increases in landfill tax revenue through any further tax cuts.

7.51 The Government is still considering the best delivery mechanisms for providing financial support through a package of measures. Stakeholders will be consulted on this in the run up to Budget 2004 and the next Spending Review.

Improving local waste management

7.52 Budget 2003 announced that the Waste Minimisation and Recycling Challenge Fund should be reformed into a local authority Waste Management Performance Fund in England, which will provide non-ringfenced incentives for local government to deliver a step-change in sustainable waste management performance. In August 2003 the Government announced that the new Fund will be introduced in 2005-06. In its first year, the Performance Fund will run in parallel with the Challenge Fund and will have £45 million available to reward good management performance, rising to £90 million in 2006-07. The Government will be consulting shortly on the detailed design of the Performance Fund, including options for the performance criteria against which rewards will be granted. The Government will in due course be announcing how the landfill tax increases from 2005-06 onwards will be made revenue neutral to local authorities.

Landfill tax credit scheme

7.53 The Government has improved the landfill tax credit scheme following consultation with stakeholders. Regulations have been expanded to cover projects that conserve or promote biodiversity in natural habitats, providing more support for species and habitats in the vicinity of landfill sites. The administration of the scheme has been streamlined, not only to reflect the smaller funding base but also to make it easier to manage. This will include a fast track application system for small grants. The changes will provide greater transparency and accountability, while adding effective project evaluation and evidence of value for money.

PROTECTING BRITAIN'S COUNTRYSIDE AND NATURAL RESOURCES

7.54 The Government's overall rural policy objective is to enhance opportunity and tackle social exclusion. It is committed to improving the productivity performance of the less well performing quartile of rural areas and to improving the accessibility of services for rural people.

Agriculture

7.55 Over 75 per cent of land in the UK is used for agricultural purposes, so the environmental impact of agricultural practice is an important determinant of the UK's environmental performance. Good agricultural practice can help preserve and improve the natural environment. However, agriculture is also the potential source of a range of environmental problems, including water pollution from the use of fertilisers and pesticides and the impact of methane and carbon dioxide emissions on climate change.

7.56 The Government believes that the reform of the Common Agricultural Policy (CAP), agreed in June 2003, could go some way to mitigating some negative environmental impacts associated with agriculture. Work is proceeding on the development of new agri-environment schemes under the Sustainable Food and Farming Strategy and pilots were launched in four areas in August 2003. However, the Government believes that it may be necessary to do more to tackle pressing environmental impacts.

Box 7.3: Reform of the Common Agricultural Policy

In June 2003, the EU Council of Agricultural Ministers agreed a reform package for the Common Agricultural Policy. The main elements of the reform package, which take effect from 2005, include:

- **decoupling – breaking the link between subsidies and production in order to reconnect farmers to their markets and reduce damaging environmental impacts;**
- **cross-compliance – to make subsidies dependent on meeting minimum environmental standards; and**
- **financial discipline – a mechanism will trigger action to reduce subsidies of CAP when expenditure looks in danger of exceeding agreed ceilings.**

7.57 Recent improvements in the biological and chemical quality of the UK's rivers are showing signs of levelling off and further action is needed to address the quality of the UK's rivers, lakes and groundwater. In particular, more action is required to address diffuse pollution from agriculture and other sources. The Government is taking forward the priorities set out in *Directing the Flow*,[5] published in November 2002. This emphasised the need for more integration of water policies with other policies, including land-use planning, tourism and regeneration. River basin management plans, to be developed under the EU Water Framework Directive, involving active participation of stakeholders, will be an important means of strengthening these links.

Diffuse water pollution

7.58 The Government has been considering the scope for using economic instruments to address the most pressing environmental issues associated with agriculture. The Department for the Environment, Food and Rural Affairs (DEFRA) published a discussion paper on tackling diffuse water pollution in April 2003. **The Government will be consulting formally on options to tackle diffuse water pollution in early 2004, including a consideration of the pros and cons of a role for economic instruments**.

7.59 The Government is committed to reducing the adverse environmental impacts of pesticide use. An industry voluntary initiative on measures to reduce the environmental damage caused by the agricultural use of pesticides was launched in April 2001. The Government values the work already completed by the signatories and will continue to press for more rapid progress. Provided that this voluntary initiative is fully implemented, the Government believes it should be the most effective way of reducing the environmental impact of pesticides and remains committed to this approach.

7.60 Signatories to the voluntary initiative expect that crop assurance schemes will soon require their members to register spray operators and recommend they develop crop protection management plans. This would be a step forward in increasing farmer uptake of the initiative. Work has also been taken forward, in consultation with stakeholders, on developing a national plan for pesticides. The Government is continuing to examine options for a tax or economic instrument should the voluntary initiative fail to deliver agreed objectives within a reasonable timescale.

[5] Available on the DEFRA website at www.defra.gov.uk

Water conservation

7.61 As announced in Budget 2003, the Government has introduced 100 per cent first-year enhanced capital allowances (ECA) for business investments in five groups of technologies that can reduce water use: flow controllers, metering and monitoring equipment, leak detection equipment, efficient toilets and efficient taps. The technology criteria list was published in July 2003, and the Technology Product List, which lists those products that are eligible for an ECA, was launched by DEFRA in November 2003.[6]

Sustainable land-use

7.62 The Government's approach to creating and maintaining sustainable communities is discussed in Chapter 3. The Government's strategy places key housing, planning and regeneration policies in the context of wider requirements for sustainable communities including employment, quality public services, transport, a safe and healthy local environment, and sound local government. The interim report of the Barker review of the factors affecting the elasticity of housing supply in the UK is published today and is discussed in Chapter 3.

Sustainable forestry

7.63 The Haskins Review, published in November 2003, recommended that forestry policy should be transferred from the Forestry Commission and brought within DEFRA's wider remit while its regulatory function should be closely aligned with the new Land Management Agency. DEFRA is considering how best to implement Lord Haskin's recommendations.

Aggregate extraction

Aggregates levy

7.64 The extraction of aggregates imposes a range of environmental costs. Introduced in April 2002, the aggregates levy seeks to incorporate these costs into the price of virgin aggregate and encourages the use of alternative materials, such as wastes from construction and demolition, that would otherwise be disposed of to landfill. It also promotes greater efficiency in the use of virgin aggregate and the development of alternative materials, such as waste tyres. In the light of independent research, the levy was set at a rate of £1.60 per tonne on virgin aggregate commercially exploited in the UK.

7.65 The Government continues to monitor the impact of the levy to ensure that it is achieving its objectives. There are early indications that extraction of virgin aggregate has decreased since the levy's introduction and that construction companies are using more construction and demolition waste rather than sending it to waste disposal sites. However, the Government is aware of concerns expressed by the aggregate and construction industries about the impact of the levy on localised markets. The Government will also be examining whether there would be benefits in extending simplified accounting to the aggregates levy.

7.66 The Government has examined with the aggregates industry and others a range of issues relating to the scope of the levy in order to clarify the liability of certain materials, protect revenue and ensure that the levy continues to fulfil its environmental objectives. **Following consultation with the industry in 2003, the Government has concluded that there is no case at present for an exemption from the levy for waste material arising from aggregate extraction**. However, in keeping with our established practice regarding the impact of environmental taxation, the Government is continuing to discuss the issue with industry.

[6] Further detail can be found under www.eca.gov.uk

Aggregates levy in Northern Ireland

7.67 Since Budget 2003, the Government and the aggregates and construction industries in Northern Ireland have worked hard to improve the analysis of the operation of the levy and the aggregates market, including an independent study *The assessment of the state of the construction aggregates sector in Northern Ireland*, that the Government commissioned and is publishing alongside the Pre-Budget Report.[7] The Government has also examined proposals for an extension to the current five year scheme which provides relief from the levy for aggregate used in processed products in Northern Ireland. Following discussions with stakeholders and the evidence from the study and subject to state aid approval, **the Government intends to extend the scope and length of the current relief for aggregates in Northern Ireland, providing that aggregates businesses in Northern Ireland that wish to benefit from the extended relief agree to implement environmental improvements to their operations**. The relief will continue to cover aggregate in processed products and be extended to cover virgin aggregate, coming into effect during 2004 and fixed at the current level of 80 per cent of the full rate until 31 March 2012. The environmental improvements that quarry operators will need to sign up to will be regularly monitored and reviewed and enforcement activity will be stepped up.

Sustainability Fund

7.68 DEFRA has completed a review of the operation of the Aggregates Levy Sustainability Fund. This concluded that there are strong economic arguments to support the continuation of the Fund as a targeted intervention to address the environmental costs of aggregates extraction. In its first year, the Fund distributed £29.3 million to help finance over 200 environment, heritage and access projects. **The Fund will therefore be continued for a further three years with the current level of funding, with a review to be carried out in the final year.** The existing bodies will be used for distributing the Fund for 2004-05 and the option of additional organisations for future years will be considered further.

ENVIRONMENTAL APPRAISAL OF POLICY MEASURES

7.69 The Government is committed to appraising the environmental impact of Budget measures and will continue to make available the methodology underpinning the figures presented in the appraisal tables. Table 7.1 shows how Budget measures sit alongside other policies as part of the Government's approach to the environmental elements of sustainable development. Table 7.2 sets out the environmental impact of measures introduced in recent Budgets which have a significant effect on the environment or which serve an environmental purpose. The Government aims to ensure that policy design, appraisal and evaluation take account of costs and benefits, the precautionary principle and the need to internalise costs by making the polluter pay.

7.70 To increase transparency and public reporting of key performance indicators, the environmental appraisal tables are now available on the Treasury website. The tables will be updated regularly to reflect ongoing monitoring of environmental indicators and further evaluation of specific schemes.

[7] Available on HM Customs and Excise website at www.hmce.gov.uk

Table 7.1: The Government's policy objectives and Budget measures

Policy objective	Sustainable development indicator[1] and recent trend data	Recent Government measures
Tackling climate change and improving air quality.	*Emissions of greenhouse gases* UK greenhouse gas emissions were between 14 and 15 per cent below 1990 levels in 2002.[2] *Days when air pollution is moderate or higher* Number of days with moderate or high air pollution decreased from 25 to 20 in urban areas and from 34 to 30 in rural areas between 2001 and 2002. *Road traffic* Between 1998 and 2002, total traffic volume rose by nearly 6 per cent, however, road traffic intensity (vehicle kilometres per GDP) fell by almost 4 per cent between 1998 and 2002.	Government measures • Climate Change Programme, DETR, November 2000. • UK Emissions Trading Scheme, DEFRA, August 2001. • Energy Efficiency Commitment, DEFRA, April 2002. • Renewables Obligation, DEFRA, April 2002. • National Air Quality Strategy, DETR, January 2000 and Addendum, DEFRA, February 2003. • Integrated Pollution, Prevention and Control Regime, DEFRA, 2002. • Ten Year Plan for Transport, DETR, July 2000, and Review, DfT, 2003. • Powering Future Vehicles, DfT et al, July 2002. Specific Budget measures • Climate change levy package. • Green Technology Challenge. • Reduced rate of VAT on the installation of energy saving materials. • Road fuel duty. • Reforms to car, lorry, van and motorcycle VED. • Company car tax and fuel scale charge reform, and authorised mileage allowance payments. • 100 per cent first-year allowances for cars with low carbon dioxide emissions, and hydrogen and natural gas refuelling infrastructure.
Improving waste management.	*Household waste and all waste arisings and management* Household waste increased from 22.5 million tonnes in 1996-7 to 25.6 million tonnes in 2001-2. However, over the same period the proportion of household waste being recycled increased from 7.5 per cent to 12.4 per cent.[3]	Government measures • Waste Strategy 2000, DETR, May 2000. • Waste Implementation Programme, DEFRA, 2002. • Waste Management Performance Fund. Specific Budget measures • Landfill tax and landfill tax credit scheme. • Sustainable waste delivery programme.
Regenerating Britain's towns and cities.	*New homes built on previously developed land* In 2002, 64 per cent of new housing was on previously developed land, increasing from around 54 per cent in the early 1990s.[4]	Government measures • Urban White Paper, DETR, November 2000. • Package of measures to tackle abandoned vehicles. Specific Budget measures • Capital allowances for flats over shops. • Tax relief for cleaning up contaminated land. • Stamp duty exemption for disadvantaged areas. • Reforms to the VAT treatment of conversion and renovation activity.
Protecting Britain's countryside and natural resources.	*Populations of wild birds* In 2000 the decline in farmland birds – the number of which has almost halved since 1977 – continued to level off. Woodland birds increased to their highest level since 1990. *Chemical river quality and biological river quality* By 2002, 94 per cent of rivers in England were of good or fair chemical quality. In England, 95 per cent of river lengths were of good or fair biological quality in 2002 compared with 89 per cent in 1990; 68 per cent were of good biological quality in 2002 compared with 60 per cent in 1990.	Government measures • Rural White Paper, DETR, November 2000. • Strategy for Sustainable Farming and Food, DEFRA, December 2002. Specific Budget measures • Aggregates levy and Aggregates Levy Sustainability Fund.

[1] *Achieving a Better Quality of Life, DEFRA January 2002 – latest data from www.sustainable-development.gov.uk*
[2] *The main six greenhouse gases are: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perflourocarbons, sulphur hexaflouride.*
[3] *Municipal Waste Management Survey, 2000-01, DEFRA. As the headline waste sustainable development indicator has not yet been updated this currently relates to the core indicator on household waste.*
[4] *The figure for 2002 is provisional.*

Table 7.2: The environmental impacts of Budget measures

Budget measure	Environmental impact[1]
Climate change levy package.	Savings of at least 5 MtC per year by 2010.[2]
Road fuel duty differentials.[3]	The shift to ULSP from ordinary unleaded is estimated to have reduced nitrogen oxide emissions by 1 per cent, carbon monoxide emissions by 4 per cent and emissions of volatile organic compounds by 1 per cent per year between 2001 and 2004. The shift to ULSD from ordinary diesel is estimated to have reduced emissions of particulates by 8 per cent and nitrogen oxides by up to 1 per cent per year between 2001 and 2004. The reduced rate for biodiesel could save up to 0.2 MtC per year by 2010.[4] The reduced rate for bioethanol could save a total of 0.5 MtC by 2010. The duty free differential for sulphur-free fuels will lead to a reduction in emissions of carbon dioxide and local air pollutants.
Reforms to car, lorry, van and motorcycle VED.	Reductions in emissions of carbon dioxide and local air pollutants.
Company car tax reform.	Estimated carbon dioxide emissions savings of 0.15 to 0.2 MtC in 2003. In the long run it is forecast that carbon dioxide savings will be between 0.5 and 1 MtC per year.[5]
Fuel scale charge reform.	Programme of increases over five years in the fuel scale charge between 1997/98 and 2002/03 is estimated to have reduced the number of drivers in receipt of free fuel by around 300,000.[5] It is expected that the programme has reduced carbon dioxide and local air pollutant emissions due to fewer private miles travelled where fuel has been paid for by drivers and not their employers. Restructuring the fuel scale charge in 2003 to relate it to carbon dioxide emissions and to include the same discounts and premiums as in the company car tax system will further reduce emissions of carbon dioxide and local air pollutants.
Authorised mileage allowance payments.	Introduction of statutory single rate from April 2002 is expected to lead to reductions in emissions of carbon dioxide and local air pollutants.
100 per cent first-year allowances for cars with low carbon dioxide emissions, and hydrogen and natural gas refuelling infrastructure.	Reductions in emissions of carbon dioxide and local air pollutants.
Air passenger duty (APD).	Reductions in emissions of carbon dioxide and local air pollutants.
Green Technology Challenge.	Reductions in energy and water use by business.
Capital allowances for flats over shops.	Bringing empty space over shops back into the residential market, helping to create greater urban diversity while reducing the pressure for new greenfield development.
Tax relief for cleaning up contaminated land.	Increases in the clean up of contaminated land.
Stamp duty exemption for disadvantaged areas.	Regeneration and improved functioning of property markets in Britain's most disadvantaged areas.
Reforms to the VAT treatment of conversion and renovation activity.	Reduced pressure on greenfield site development due to the better use of existing buildings.
Aggregates levy and Aggregates Levy Sustainability Fund.	Reductions in noise and vibration, dust and other emissions to air, visual intrusion, loss of amenity and damage to wildlife habitats.
Landfill tax.	Encourages waste producers and the waste management industry to switch away from landfill towards waste minimisation, re-use, and other waste management options.
Landfill tax credit scheme.	A scheme supporting local community and environmental projects in the vicinity of landfill sites.

[1] *These estimates are subject to a wide margin of error.*
[2] *Based on the DTI energy model. There are a number of difficulties involved in estimating the emissions savings from the individual components of the climate change levy, including the need to avoid double counting. Of the 5MtC (million tonnes of carbon) per year by 2010, the levy and exemptions account for 2.0 MtC, the negotiated agreements account for 2.5 MtC and energy efficiency measures account for 0.5 MtC. A related measure, the emissions trading scheme, involves 31 direct participants who have undertaken binding commitments to deliver emissions reductions of 1.1 MtC by 2006.*
[3] *Using NETCEN emissions models – further detail on the methodology used is provided in NETCEN's January 2000 report, UK Road Transport Emissions Projections. Between 1997 and 1999, the fuel duty escalator is forecast to have reduced emissions by 1 to 2.5 MtC per year by 2010. The reductions in fuel duty in Budget 2001 are estimated to have increased emissions by between 0.1 MtC and 0.2 MtC per year by 2010.*
[4] *DfT modelling.*
[5] *Based on Inland Revenue modelling.*

A THE ECONOMY

UK GDP growth has strengthened since early 2003. At the beginning of the year, significant global uncertainties weighed heavily on short-term prospects for the world economy. Global confidence and demand was dampened by geo-political tensions, volatility on international financial and exchange rate markets and general uncertainty regarding prospects for growth in major economies, in particular the euro area. It is inevitable that, as a highly open economy, the UK is substantively affected by global developments. Fragile business sentiment continued to affect investment expenditure, underlying external demand remained weak and household consumption also appeared to be constrained by global uncertainty. As a result, GDP growth in the first quarter of the year was significantly below trend.

Since early spring 2003, as geo-political uncertainties have receded, international growth prospects have improved considerably and are expected to strengthen further. Global financial markets have made up significant ground following sharp falls in 2002 and early 2003. US GDP growth has rebounded strongly with US business investment showing signs of recovery. In the UK, growth picked up strongly in the second and third quarters, as forecast in Budget 2003 and consistent with private business survey indicators in recent months.

This pick-up in activity is expected to be consolidated into 2004, broadly as envisaged in the Budget 2003 forecast, as some of the major uncertainties holding back the world economy recede and the global recovery gathers pace. Confidence in prospects for the UK economy has also been boosted by recent significant revisions to national accounts volume measures. These imply stronger trend output growth over the 1997 to 2001 period and more balanced growth than previously estimated, with consumption a little weaker and investment and net trade stronger.

The Pre-Budget Report economic assessment is that:

- **UK GDP is expected to grow by 2.1 per cent in 2003 and by 3 to 3½ per cent in both 2004 and 2005, in line with the Budget 2003 forecast. Growth is expected to fall back to its trend rate by early 2006 as slack in the economy is absorbed and output returns to its trend path. The forecast shows a continuing rebalancing of growth; and**
- **Consumer Prices Index (CPI) inflation is expected to rise slowly from early next year to reach its 2 per cent target in 2005 as the effects of recovery in the global economy and this year's depreciation of sterling feed through to higher import prices.**

Despite the positive outlook, risks remain for the UK economy. The uneven nature of the pick-up in global activity, the continued reliance on developments in the US, and the relatively disappointing performance of the euro area present a threat to the sustainability of recovery over the medium term. These factors also mean that global activity is vulnerable to the possibility of faltering US domestic demand in the short term. On the upside, given the relatively swift turnaround in activity since the spring, the present world recovery may have more momentum than currently expected.

INTRODUCTION[1,2]

A1 This annex discusses economic developments since Budget 2003 and provides updated forecasts for the UK and world economies in the period to 2006. It begins with an overview of developments and prospects in the world economy. It then outlines the Government's latest assessment of the UK economy, followed by a more detailed discussion of sectoral issues and risks.

THE WORLD ECONOMY

Table A1: The world economy

	Percentage changes on a year earlier unless otherwise stated				
		Forecast			
	2002	2003	2004	2005	2006
Major 7 countries[1]					
Real GDP	1½	2¼	3	2¾	2¾
Consumer price inflation[2]	1¾	1½	1½	1¾	1¾
Euro area					
Real GDP	¾	½	1¾	2¾	2½
World trade in goods and services	3½	4	7¾	8	7¼
UK export markets[3]	2	3¼	6¼	7¼	6¾

Source: EcoWin and HM Treasury.

[1] *G7: US, Japan, Germany, France, UK, Italy and Canada.*
[2] *Per cent, Q4.*
[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

Overview

A2 At the time of Budget 2003, economic activity in most major economies had slowed as geo-political uncertainties compounded existing vulnerabilities and led to significant falls in business and consumer confidence, increased volatility in financial markets and higher oil prices. As a result, the loss of momentum in global growth, which became apparent during autumn 2002, continued into early 2003. The Budget 2003 forecast assumed this would be a temporary slowing and, as expected, growth in several major economies has since strengthened as some key uncertainties have receded. Meanwhile, leading indicators – notably confidence measures and equity prices – have generally turned up across the G7.

A3 Growth in most G7 economies looks set to steadily improve during the course of 2004, though this acceleration is likely to be more pronounced in some economies than in others. Growth in the US appears to be increasing sharply and data from Japan suggest stronger growth than most forecasters expected. However, activity in parts of the euro area has been more subdued. During the first half of this year, euro area output stagnated. As a result, most forecasts for growth in the euro area have been revised down significantly since the spring.

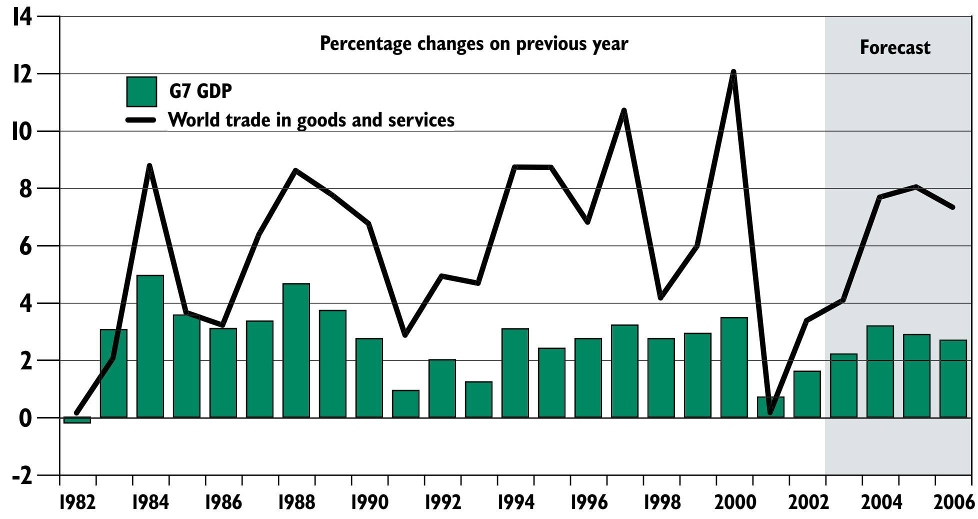
A4 Policy makers around the world have continued to support growth. US monetary policy has been loosened again since the spring and has been supported by a further easing in fiscal policy. Interest rates have also been lowered in the euro area.

[1]The UK forecast is consistent with national accounts and balance of payments statistics to the second quarter of 2003 released by the Office for National Statistics on 30 September 2003 and output, income and expenditure data for the third quarter released on 26 November 2003. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk) and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).
[2]The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

A5 Although some key uncertainties surrounding the global economy have diminished, significant risks still remain. In particular, imbalances between the world's major economies pose the risk of sudden, sharp movements in exchange rates. For example, further sharp falls in the value of the US dollar would pose a significant threat to regions where recovery is dependent on trade with the US. A further downside risk comes from labour markets, which have remained weak in a number of G7 economies. In some economies, activity might also be held back if balance sheet adjustment has further to run. Finally, ongoing security concerns and the continued threat from terrorism pose a risk of renewed volatility and nervousness in international financial markets and falls in consumer and business confidence.

A6 There are also a number of upside risks. Stockbuilding has generally remained modest by historical standards, and a turnaround in the inventory cycle could provide a powerful short-term stimulus to growth. In addition, there are clear signs that business investment is picking up in some major economies; and, in the past, recoveries in capital spending have often tended to accelerate faster than generally expected.

Chart A1: G7 GDP and world trade



G7 activity

A7 G7 GDP is forecast to grow by 2¼ per cent in 2003 and 3 per cent in 2004. This upward revision compared with the Budget 2003 forecast primarily reflects faster than expected recovery in the US, together with significant upward revisions to GDP in Japan during the first half of 2003. However, growth in the euro area is now forecast to be weaker than expected in Budget 2003, at ½ per cent in 2003 and 1¾ per cent in 2004.

A8 US growth slowed in the final quarter of 2002 and in early 2003 as heightened geo-political uncertainty hit confidence, depressing consumer spending and prompting businesses further to delay capital spending. Since then US GDP has accelerated sharply, with the third quarter recording the strongest quarterly growth since 1984. Much of the recent pick-up in activity reflects stronger household spending, partly in response to the latest fiscal package. However, business investment is also showing its first real signs of expansion since the recession in 2001. Many of the conditions for further increases in capital spending now seem to be in place. Stock markets have risen over 30 per cent since March, long-term interest rates are close to historical lows, corporate spreads have narrowed and profitability has increased by more than 30 per cent over the past year.

A9 Economic activity in the euro area remains weak, with growth this year expected to be just ½ per cent. Despite the pick-up in growth in the US and Japan, the further appreciation of the euro – which has now risen by around 20 per cent on a trade-weighted basis since the start of 2002 – hit net trade and acted as a drag on overall activity during the first half of the year. Meanwhile, private consumption has remained subdued, reflecting household concerns about the weak labour market, and investment has declined throughout the first three quarters of the year. In part, this reflects the unwinding of short-term factors that had supported capital spending in late 2002, such as reconstruction work following floods in Austria and Germany and investment incentives in Italy. Poor investment also reflects efforts to improve corporate balance sheets. In the third quarter, GDP growth picked up. Most of this improvement was the result of stronger exports, but business and consumer confidence have also increased in recent months and stock markets have risen markedly from their lows of early March, suggesting an improvement in domestic demand going forward. Therefore, the recovery is expected to continue during 2004, albeit with less momentum than had been projected at the time of Budget 2003.

A10 Since Budget 2003, GDP growth in Japan has significantly exceeded expectations. While this partly reflects recent data revisions, new data have also been stronger than expected. However, some of the recent acceleration in real GDP has been attributed to a more pronounced decline in the GDP deflator: nominal GDP in Japan has continued to fall over the past year. The latest Consensus forecast for GDP growth in Japan is 2.4 per cent in 2003, compared with 0.8 per cent at Budget time. Much of the recent acceleration in GDP in Japan is due to domestic demand, in particular business investment. This partly reflects successful restructuring by a number of large Japanese firms and is consistent with the improvements seen in confidence measures and corporate profitability, but it is also possible that the latest national accounts data are overstating this improvement. In particular, it is not easy to reconcile the recent strength of business investment with other indicators of capital spending. Going forward, domestic demand growth in Japan is expected to ease, although this should be partly offset by stronger demand from the external sector. With unemployment relatively high by historical standards and household income growth remaining weak, consumer spending is expected to remain subdued. Meanwhile business investment, which has played a key role in supporting growth so far during 2003, is expected to moderate as the impulse from recent restructuring and the associated increase in profits begins to wane.

Emerging markets and developing economies

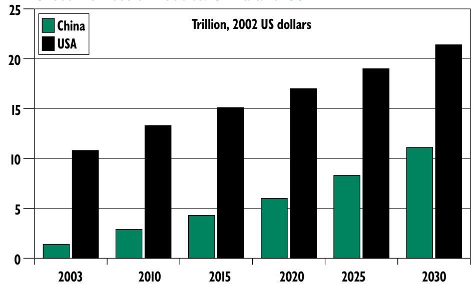
A11 Despite slower growth in the major world economies during late 2002 and early 2003, activity in emerging market economies has generally been resilient. While growth in parts of Asia slowed earlier in the year, this appears to have been a temporary response to shocks to confidence from heightened geo-political uncertainty and the outbreak of Severe Acute Respiratory Syndrome (SARS). More generally, activity in much of the region has remained robust, with China in particular providing a major driver for growth. In a number of Latin American economies the outlook suggests strengthening growth in 2004. Growth in sub-Saharan Africa remains subdued, though economic performance has been stronger in those countries where political stability has been achieved. Eastern European economies continue to be affected by the slow pace of growth in the euro area, although a number of smaller states have achieved sustained growth thanks to the positive impact of structural reforms and impending EU enlargement.

Box A1: The changing global economy

Rapid growth in a number of the world's emerging markets means that the geographical centre of gravity of the global economy is likely to change significantly over the coming decades. In particular, China is re-emerging as a global economic power. Valued at current market exchange rates China is already the sixth largest economy in the world, just behind the UK, and valued at purchasing power parities it is the second largest. Plausible projections of future growth over the coming decades suggest that China is set to rival the US in terms of the size of its economy, if not in per-capita income. Other countries are also forging ahead, notably India, Russia and in Eastern Europe. In short, the world's economic axis is gradually shifting eastwards.

Increasing prosperity among emerging economies will be a source of great wealth and opportunity for all. The advance of technology and continued progress in trade liberalisation will facilitate the reallocation of economic resources across the world, to benefit from comparative advantage and the international division of labour. Economies with high skill bases, such as the UK, will benefit from greater demand for higher value added goods and services as the spending power of emerging economies increases.

Gross Domestic Product: China and USA



Source: HM Treasury.

These structural adjustments in the global economy will also pose challenges. They underline the need for flexibility, particularly in labour markets, and for continual efforts to advance the skills of the workforce.

The changing shape of the global economy will have economic, social and political ramifications. There will be adjustments in the global supply, demand and hence prices of goods and services. The composition of demand for many products will evolve, reflecting the different tastes and preferences of consumers in emerging economies and the increasing influence of their culture on global society. Trading blocs will continue to evolve, and alternative currencies may be adopted as vehicles for trade and reserves. Global poverty reduction should be greatly expedited.

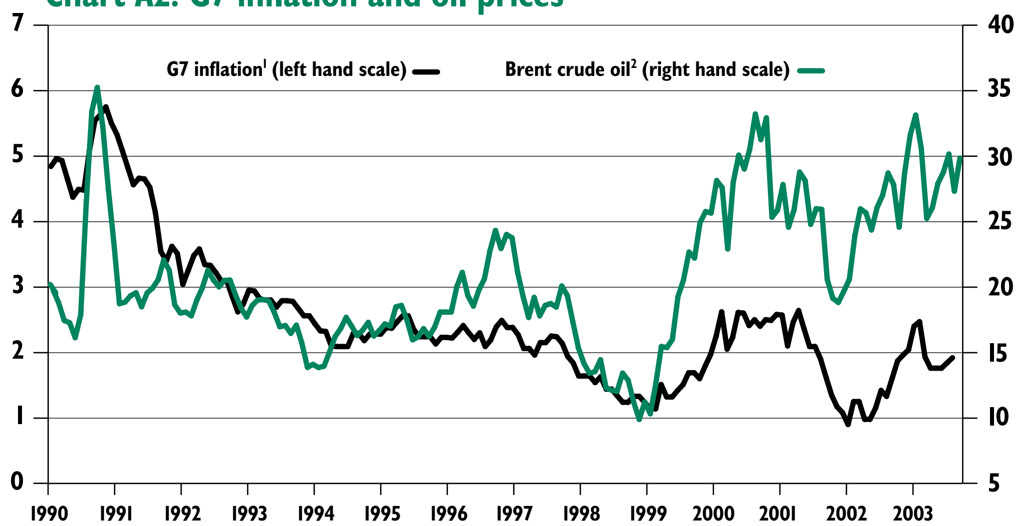
In the past the path of economic development has rarely been smooth. With rapid growth will come the risk of growing pains: inequality; ageing populations; booms and busts; and the political tensions that accompany great social shifts. As the importance of today's emerging economies continues to grow, so their challenges will become challenges for the whole world, reinforcing the need for co-operation in further developing the international financial architecture, and on issues such as the environment and the avoidance of protectionism, to ensure that progress is sustained.

A12 In general, those emerging economies with robust macroeconomic frameworks and sustainable exchange rate regimes appear to have coped better with the volatility in global financial markets during the early part of 2003.

World trade

A13 World trade growth slowed sharply during the second half of 2002, reflecting heightened geo-political uncertainty and slower growth in the world's major economies. Budget 2003 forecast this weakness to continue during early 2003 with a gradual acceleration taking hold in the second half of the year. Recent data suggests trade growth in early 2003 was even weaker than forecast, so while trade is still expected to accelerate during the remainder of the year, the forecast for 2003 as a whole is now lower than at Budget time. With the global recovery gaining momentum, world trade should continue to accelerate into 2004. However, although overall G7 growth is now expected to be stronger than previously forecast, the uneven nature of the recovery (discussed in Box A2) is likely to mean that world trade growth will be lower than projected in Budget 2003. In particular, the euro area accounts for a relatively large share of global trade, significantly greater than the US, and subdued activity in the euro area will tend to reduce overall world growth of exports and imports. This should be partly offset by trade in Asia, which is likely to continue to strengthen, supported by ongoing rapid economic growth in China. World trade is now expected to grow by 7¾ per cent in 2004, rising to 8 per cent in 2005 as the global recovery becomes more balanced.

Chart A2: G7 inflation and oil prices



[1] *Consumer price index, percentage change on a year earlier.*
[2] *US dollars per barrel.*
Source: EcoWin.

Oil and commodity prices

A14 Heightened geo-political uncertainty, together with strikes in Venezuela, led to significant volatility in oil markets in early 2003. After peaking at over $33 per barrel in March, prices fell to around $24-26 per barrel as some key uncertainties receded. Prices edged up again during the summer to reflect the low level of global stocks, increased seasonal demand and stronger economic growth. Early autumn saw a gradual decline in prices, reflecting the seasonal fall in gasoline demand from the US, until an announcement of a cut in production targets by OPEC when Brent prices rose to above $30 per barrel. Current prices remain around $29 per barrel. Markets expect oil prices to moderate over the medium term in response to growing non-OPEC supply and increased production in Iraq, but given the current tightness in inventories further increases cannot be ruled out. Non-oil commodity prices were dampened in early 2003 by relatively weak demand due to low growth in global industrial production and trade. Since then prices have begun to rise again underpinned by a pick-up in demand, especially from Asia. This is expected to continue as the global recovery gathers momentum.

G7 inflation

A15 With output levels below potential in most major economies, inflationary pressures have remained subdued. G7 inflation rose around the turn of the year as a result of movements in oil prices but, as expected at Budget time, edged back down during the first half of 2003. As the global recovery gathers pace, spare capacity should be reduced and commodity prices are likely to rise, easing downward pressure on inflation.

Forecast issues and risks

A16 Some key downside risks have receded since the time of Budget 2003, and this has been accompanied by a sharper than expected recovery, especially in the US. However, other downside risks remain. There are still significant imbalances in the global economy which pose the threat of sudden, sharp movements in exchange rates. These highlight the urgent need for policy makers to push ahead with the structural reforms that will ensure a broad-based and sustainable recovery over the medium term (see Box A2). In the short term, imbalances may also lead to greater calls for protectionist measures in some economies which, if accommodated, would pose a major threat to global development. It is therefore essential that the WTO Doha Development Agenda negotiations are re-launched as soon as possible (see Box 5.5).

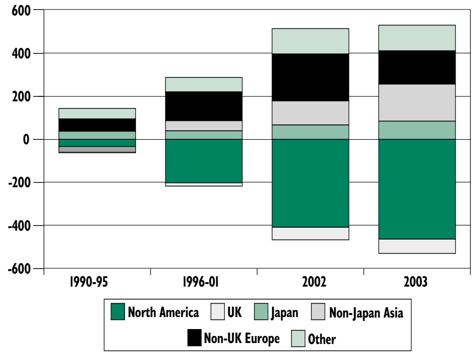
A17 A further downside risk comes from the potential rebuilding of balance sheets. Significant progress has been made in rebuilding household and corporate balance sheets across several major economies since the recession of 2001. However, this process may not be complete. Further balance sheet adjustment might entail significantly weaker spending by households or the business sector and could undermine the recovery. This is particularly a risk for the household sector when combined with weak labour markets. Finally, the ongoing threat of terrorism and continued concern over security pose the risk of renewed nervousness in financial markets and falls in consumer and business confidence.

A18 There are also significant upside risks to G7 growth. In particular, business inventories remain close to historically low levels, and a period of significant stock building could provide a powerful short-term stimulus to growth and trade. The G7 forecast also assumes only a relatively modest acceleration in capital spending when compared with previous recoveries. However, with internal and external financing conditions remaining stimulative in most major economies, investment may bounce back more sharply than forecast.

Box A2: Global imbalances

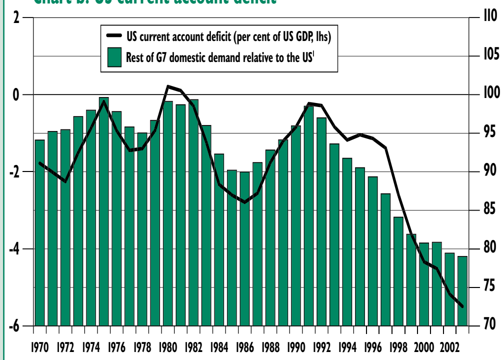
While some major short-term risks have diminished since the time of the Budget, policy makers around the world need to refocus attention on enhancing the medium-term sustainability of the global recovery. Perhaps the clearest threat to that recovery is that it remains uneven across the world's major economies. While differences in growth rates among the G7 economies are not new, the cumulative impact of these over time has in part led to unprecedented global net trade imbalances (Chart a).

Chart a: Global current account position (billion US dollars, 2000 prices)



Source: OECD.

Chart b: US current account deficit



[1] Ratio of Rest of G7 domestic demand to US domestic demand. 1980Q3 = 100.
Source: OECD.

Such imbalances are unlikely to be sustainable over the medium term, raising the question of how they might unwind. The risk is that they will be resolved by large and sudden movements in major exchange rates. A sharp fall in the value of the US dollar would have significant implications for growth in those economies that are dependent on US trade, and might also hit US domestic demand by pushing up long-term interest rates and reducing household purchasing power.

A more benign unwinding of these imbalances could only occur against the backdrop of more balanced global growth. As Chart b illustrates, stronger domestic demand outside of the US is the key ingredient to this. This highlights the need for policy makers in all major economies to push ahead with the reforms needed to increase growth rates. For example, in Europe further sustained progress on wide-ranging economic reforms is necessary to enhance long-run growth potential and increase resilience to shocks. In particular, delivering high and stable levels of growth and employment demands even greater flexibility in European labour, product and capital markets. In Japan the Government must push ahead with its agenda for financial sector reform, while in Emerging Asia the momentum of structural reform must be maintained to sustain domestic demand growth.

UK ECONOMY

Trend growth

A19 Data revisions since Budget 2003 provide new information and point to a higher than previously thought trend rate of output growth over the past few years, but for the Pre-Budget Report the existing 2¾ per cent trend rate projection is retained.

A20 Substantial upward revisions to measured UK GDP data were introduced by the Office for National Statistics (ONS) in Blue Book 2003, and are discussed in detail in the next section. These revisions have been driven by new information from surveys and by methodological improvements, including the annual chain-linking of the national accounts. In particular, non-oil gross value added (GVA) growth was revised up in all years from 1996 to 2001. This has the effect of boosting the estimated trend rate of growth between the adjudged on-trend points in the first half of 1997 and the third quarter of 2001.

A21 Over this period, the Blue Book 2003 data yield an annual trend rate of output growth of 2.9 per cent, revised up from the previous estimate of 2.6 per cent at the time of Budget 2003. There have been no significant revisions over the same period to outturns for the trend growth rates of average hours worked or employment, so the increase in the trend rate of output growth is captured almost entirely in the productivity growth component. Therefore, the estimated growth rate of underlying trend output per hour between 1997 and 2001 has increased to 2.7 per cent, 0.3 percentage points higher than at Budget 2003.

A22 A mechanical application of the Treasury's trend growth methodology would project forward this trend productivity increase which, with other trend growth components unchanged, would raise the trend output growth projection well above the existing 2¾ per cent neutral assumption. This would imply a negative output gap in mid-2003 well in excess of the 1½ per cent gap estimated on the basis of the 2¾ per cent trend growth assumption. However, evidence and judgement suggest that a current negative output gap much wider than 1½ per cent of GDP would be implausible:

- it would be surprising for such a wide gap to have opened up since late 2001 without any rise in the unemployment rate – which has been flat at just over 5 per cent – even allowing for lags between output and employment and businesses hoarding labour in the expectation that the slowdown in activity would be short-lived;
- nevertheless it may be that the sustainable rate of unemployment has continued to fall significantly since 2001, to well below the actual rate. This would be broadly consistent with the fall in private sector average earnings growth over the same period and various other economic indicators, such as the CBI and BCC surveys, which also point to slack in the economy at present. However, it is difficult to believe that these indicators point to a larger negative output gap than implied by the 2¾ per cent trend growth assumption;
- there is little evidence of the degree of downward pressure on inflation that might be expected if there were a large negative output gap;

- GDP data for latest quarters are more prone to upward revision than those for the more distant past,[3] imparting a possible bias towards overstating the absolute size of current output gaps if estimates are derived from the difference between mechanical projection of past trends and the latest quarter's data. This is part of the uncertainty surrounding output gap estimates, which is why projections of the public finances are stress-tested against the risk that the current output gap may be less negative (or more positive) than the central estimate; and

- uncertainty about underlying trends is compounded as the economy moves further away from its latest on-trend point. It has been two years or so since the last on-trend point in the third quarter of 2001. Therefore, trend growth projections must be cautious and guard against the risk that what happened in the economy more than two years ago is becoming a less reliable guide to current developments.

A23 Table A2 shows the contributions from the various components of trend output growth over the 1997 to 2001 period, and the decomposition of the 2¾ per cent trend growth projection assumed at Budget time. Data revisions prior to the third quarter of 2001, when the economy is judged last to have been on trend, and outturns for more recent quarters, raise a number of issues bearing on the components of the trend growth projection:

- the implication that trend output growth between 1997 and 2001 was more productivity rich than previously estimated raises the possibility of stronger trend productivity growth over the current cycle than projected at Budget time. However, compositional changes in employment perhaps tend to point in the opposite direction. For example, the increasing share of public sector employment in the economy over the past few years may have slightly depressed measured whole economy productivity growth,[4] though any such effect is unlikely to be large enough to be discernible. Moreover, actual growth in output per hour since 2001 has averaged below 2 per cent, but this weakness could wholly reflect cyclical factors;

- average hours worked have come down by ¾ per cent a year on average since the third quarter of 2001, though they have been flat since late 2002. At the current stage in the cycle it is difficult to judge whether this pattern primarily reflects cyclical or structural factors. However, it is possible that the trend fall in average hours worked over the current cycle could be more than the 0.1 per cent a year assumed in the Budget 2002 and Budget 2003 projections: past evidence suggests that the pro-cyclical response of average hours worked has typically been significantly weaker than the actual fall observed since 2001;

- the working-age employment rate has grown at an annualised rate of 0.2 per cent since the third quarter of 2001, in line with the trend projection first introduced in Budget 2002. However, the possibility that the sustainable rate of unemployment has carried on falling significantly over the past couple of years suggests the trend employment rate over the cycle may turn out to exceed the projection; and

[3] The ONS (*Revisions to quarterly GDP growth*, L.Akritidis, Economic Trends, No.594, May 2003) quoted an average upward revision to four-quarter GDP growth compared to initial estimates of approximately 3/4 percentage points between the first quarter of 1993 and the final quarter of 1999, with the total revision taking several years to come through.

[4] As explained in the Budget 2002 Trend Growth paper (*Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002).

- the working-age population has grown at an annualised rate of 0.5 per cent since the third quarter of 2001, in line with the 2002 Pre-Budget Report and Budget 2003 projections. Following recently released revisions to ONS mid-year population estimates, the Government Actuary's Department (GAD) will publish new 2002-based population projections on 18 December. The assumptions GAD will apply for these projections have already been published, and preliminary indications are that they point to growth in the population of working age averaging ½ per cent a year until 2006, slowing for demographic reasons to ¼ per cent for 2007 and 2008. However, the net inward migration assumption of 130,000 a year is almost 30,000 below latest estimates of the average for the past five years, 1998 to 2002, when outturns have varied between about 140,000 and 170,000. This suggests upside potential to the projection.

A24 After weighing up all the considerations relating to the estimated current output gap and the components of the trend growth projection, and continuing to take a cautious approach to productivity prospects, the existing 2¾ per cent trend output growth projection is retained as the neutral judgement. However, the data revisions further increase confidence that the 2¾ per cent assumption is consistent with the economy's potential. A deliberately cautious trend growth assumption ¼ percentage point below the neutral view continues to be used for the purposes of projecting the public finances.

Table A2: Contributions to trend output growth[1]

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[2, 3]		Trend average hours worked[3]	Trend employment rate[3]	Population of working age[4]	**Trend output**
	Underlying (1)	Actual (2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1	2.22	2.05	–0.10	0.33	0.24	**2.54**
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	2.14	1.96	–0.37	0.36	0.66	**2.63**
Budget 2003	2.35	2.14	–0.47	0.43	0.50	**2.61**
PBR 2003	2.65	2.44	–0.47	0.42	0.54	**2.94**
Projection[5]						
2001Q3 to 2006Q4						
Budget 2002	2.1	2.0	–0.1	0.2	0.6	**2¾**
Budget 2003	2.35	2.25	–0.1	0.2	0.5	**2¾**
PBR 2003[6]	2.35	2.25	–0.1	0.2	0.5	**2¾**

[1] *Treasury analysis based on the judgement that 1986Q2, 1997H1, and 2001Q3 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components going forward. Columns (2)+(3)+(4)+(5)=(6). Full data definitions and sources are set out in Annex A of 'Trend Growth: Recent Developments and Prospects', HM Treasury, April 2002.*

[2] *The underlying trend rate is the actual trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant. Column (1)=column (2) + (1-a) column (4), where a is the ratio of new to average worker productivity levels. The figuring is consistent with this ratio being of the order of 50 per cent, informed by econometric evidence and LFS data on relative entry wages.*

[3] *The decomposition makes allowances for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that hours lag output by just one quarter, though this lag is hard to support by econometric evidence, not least because quarterly LFS data only extend as far back as 1992Q2. Hours worked and the employment rate are measured on a working-age basis.*

[4] *UK household basis.*

[5] *Neutral case assumptions for trend from 2001Q3.*

[6] *Underlying the mid-points of the GDP forecast growth ranges from 2003Q4.*

Overview of recent developments and prospects

Table A3: Summary of forecast[1]

		Forecast			
	2002	2003	2004	2005	2006
GDP growth (per cent)	1¾	2	3 to 3½	3 to 3½	2½ to 3
CPI inflation (per cent, Q4)	1½	1½	1¾	2	2

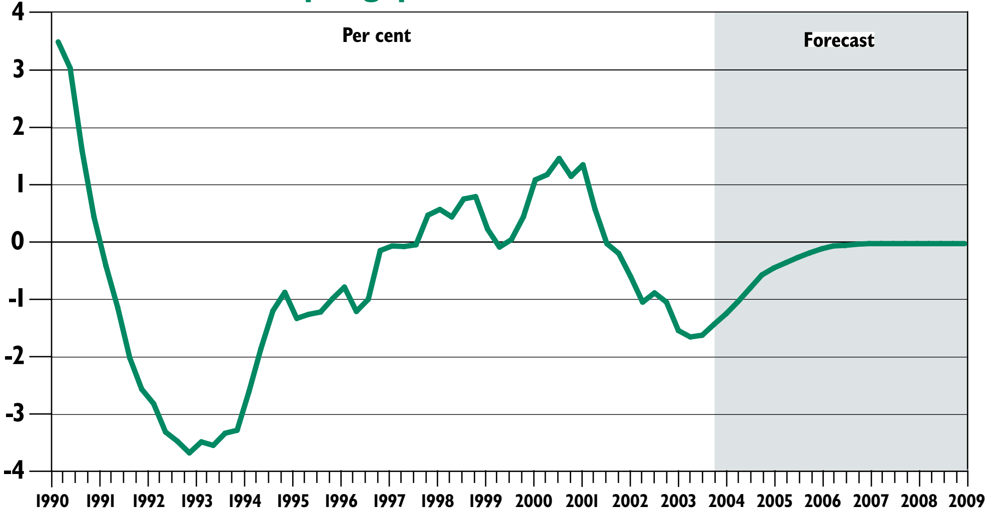
[1] *See footnote 3 to Table A9 for explanation of forecast ranges*

A25 The extensive revisions to UK GDP data introduced by the ONS in Blue Book 2003 have mainly affected real volume measures, with only small changes to nominal data. While some of the effects have worked in opposing directions, the overall effect is that measured GDP growth since the mid-1990s is now stronger and relatively more balanced between expenditure components than previously estimated. In particular, household consumption growth is now estimated to have grown more slowly over the recent past, with business investment and net trade both stronger. These revisions are discussed more fully in Box A3.

A26 In recent years, the domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well in a challenging global economic environment. Strong economic fundamentals and proactive monetary policy action have supported private consumption, and fiscal policy has also supported demand, with sound public finances allowing counter-cyclical action through the operation of the automatic stabilisers. With inflation on the RPIX measure having remained close to its symmetric 2½ per cent target and few inflationary pressures on the horizon, the independent Monetary Policy Committee of the Bank of England reduced interest rates by a further 25 basis points on 10 July, the second cut of the year and the ninth since the beginning of 2001. This took base rates to 3½ per cent, their lowest level for 50 years. Fiscal policy has continued to complement monetary policy in helping to offset the effects on the UK of a weak international economy.

A27 In the circumstances, UK GDP has held up well, though it has grown at below trend rates. UK GDP rose by 2.1 per cent in 2001 and by 1.7 per cent in 2002. In the first half of 2003, the UK economy was affected by uncertainty surrounding the conflict in Iraq, high oil prices and volatility on financial and exchange rate markets, which compounded an already fragile global environment and undermined confidence in all major economies. Faced with these challenging international conditions, UK companies further postponed decisions on new investment expenditure in the first quarter. Sluggish external demand continued to restrain underlying UK export growth in early 2003, with export demand from EU markets – which account for over half of UK trade – particularly weak. Moreover, consumer confidence appears to have been dented by global geo-political tensions in the early months of the year. As a result, UK GDP growth in the first quarter of 2003 remained below trend, at 0.2 per cent, down from 0.5 per cent in the final quarter of last year and the weakest quarter-on-quarter increase for just under 11 years.

Chart A3: The output gap[1]



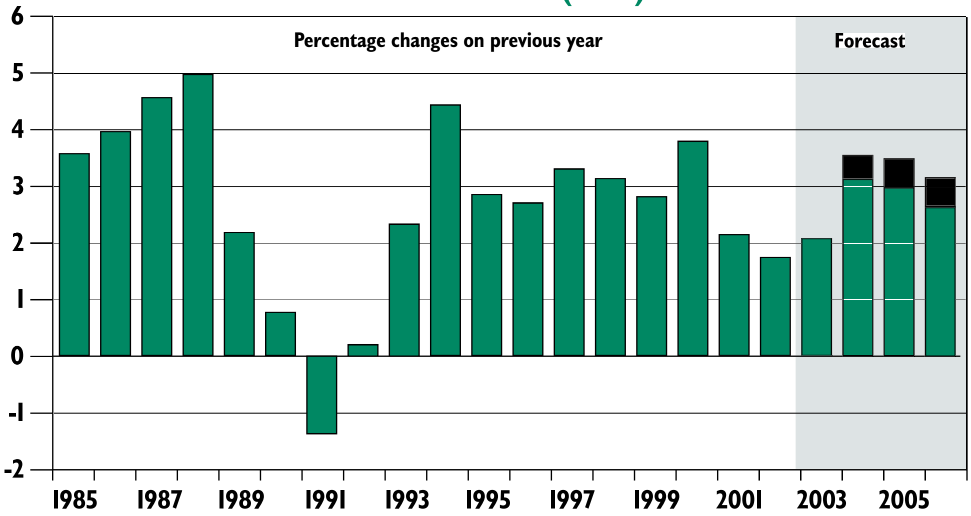
[1] *Actual output less trend output as a percent of trend output (non-oil basis).*

A28 UK demand and activity have strengthened as geo-political uncertainties have receded. Against a steadily improving global background, financial markets have more than made up for losses incurred during the first quarter of 2003, though they remain significantly below the peaks of 1999 and 2000. The FTSE 100 Index has risen by over 30 per cent since its trough in March, while overseas financial markets have seen similar gains. Many forward-looking survey and confidence measures have also improved considerably in recent months. While the MPC pre-emptively increased interest rates by 25 basis points on 6 November, this still leaves base rates close to 40 year lows, and no higher than at the time of Budget 2003. GDP grew by 0.6 per cent in the second quarter and by 0.7 per cent in the third quarter of the year, more or less in line with the Budget forecast, to stand 2.0 per cent higher than a year earlier.

A29 Royal Bank of Scotland Purchasing Managers Indices for the regions and devolved countries suggest the pick-up in demand and output has been relatively widespread across the UK, with all 12 regions recording increased business activity in the three months to November.

A30 The UK economy has continued to perform well compared with most of its major competitors. UK GDP growth in the first three quarters of 2003 outpaced that in Germany, France and the euro area as a whole, continuing the trend of recent years. UK GDP growth has now been above that in the euro area for nine of the past 11 quarters.

Chart A4: Gross Domestic Product (GDP)[1]



[1] *Shaded areas on bars represent forecast ranges.*

A31 The size of the estimated negative output gap in the third quarter of 2003 – around 1½ per cent of GDP on the assumption of 2¾ per cent trend output growth – is the same as the forecast made at Budget time, despite data revisions for 2002. So the forecast path for GDP is also broadly unchanged, with the economy building on recent positive developments and accelerating through into 2004. GDP is now expected to grow by 2.1 per cent in 2003 as a whole, within the lower half of the Budget 2003 forecast range. In both 2004 and 2005, GDP is forecast to grow by 3 to 3½ per cent. Growth is expected to fall back to its trend rate by early 2006 as slack in the economy is taken up and output returns to its trend level. Relative to recent years, the forecast implies more balanced growth.

A32 CPI inflation, which the Pre-Budget Report confirms as the operational target for monetary policy to apply from now on, is forecast to remain a little below target in 2004 as existing slack in the economy continues to dampen domestically generated pricing pressures. However, inflation is expected to return to target from 2005 as the combined effects of the recent depreciation of sterling and the strengthening recovery in the world economy feed through to higher import prices.

Box A3: Revisions to the UK national accounts

The extensive revisions to UK national accounts real volume measures introduced by the Office for National Statistics in Blue Book 2003 not only raised estimated GDP growth since the mid-1990s but also affected all of the main expenditure components.

Annual growth of private household consumption between 2000 and 2002 now averages 3¾ per cent – around 0.5 percentage points lower than previously estimated. This mainly reflects the introduction of annual chain-linking and the implied re-weighting of indices to reflect more contemporary prices and expenditure patterns.

Business investment was stronger in recent years than previously estimated. In the second quarter of 2003, business investment stood 4¼ per cent below its peak in the final quarter of 2000, compared with a decline of 11¼ per cent on the basis of pre-Blue Book 2003 data. The recent decline in business investment expenditure is now also judged to have been shallower than in the downturns of the early 1980s and 1990s. Upward revisions to investment figures reflect the inclusion of new information and also updated price weights. Given sharp falls in prices of ICT equipment in recent years, the weight of these items in investment spending has been reduced, mitigating their drag on total investment during the recent global economic slowdown. Revisions to trade data mainly reflect upward revisions to import price indices and adjustments for the effects of VAT missing trader intra-Community (MTIC) fraud – see Box A7. The revised data indicate net trade exerted a less negative drag on growth between 1998 and 2000, with changes to exports and imports offsetting each other in 2001. In 2002, there is a larger drag from net trade as a result of the scale of MTIC fraud.

These revisions show that growth has been relatively more balanced than previously estimated.

Demand

A33 Global uncertainties in the first quarter of 2003 appear to have temporarily dented household expenditure. As a result, household consumption in the first quarter of the year recorded a marginal fall, only its second quarterly decline in the past eight years. Since then, as geo-political uncertainties have receded, consumer confidence has recovered to above its long-run average, supported by continued strong labour market outcomes, further house price gains and the recovery in equity prices. Private consumption growth has consequently resumed, increasing by 0.7 per cent in the second quarter and by 0.8 per cent in the third. Retail sales have also picked up, after having been close to flat over the first few months of the year, growing 1.5 per cent in the three months to October.

A34 Against a backdrop of low inflation, a strong labour market and a pick-up in GDP growth, household real disposable income growth should strengthen, and so consumption should continue to grow relatively robustly over the forecast horizon. Nevertheless, underlying consumption growth is expected to remain below rates seen since the mid-1990s as a result of moderating house price inflation and slower rises in households' wealth, together with a diminishing appetite for borrowing as consumers adjust to relatively high levels of debt. However, this outlook is particularly prone to both upside risks in the short term and downside risks more generally.

Table A4: Contributions to GDP[1] growth[2,3]

	Percentage points, unless otherwise stated				
		Forecast			
	2002	2003	2004	2005	2006
Private consumption	2¼	1¾	1¾	1¾	1¾
Business investment	–½	0	¼	¾	½
Government	½	1	1	¾	¾
Change in inventories	–¼	0	¼	0	0
Net trade	–1½	–½	–¼	0	0
GDP growth, per cent	**1¾**	**2**	**3¼**	**3¼**	**2¾**

[1] *Fixed base volumes*

[2] *Components may not sum to total due to rounding and omission of private residential investment, the transfer costs of land and existing buildings and the statistical discrepancy.*

[3] *Based on central case. For the purpose of public finance projections, forecasts are based on the bottom of the forecast GDP range.*

A35 Real government spending on current goods and services, as measured in the national accounts, has accelerated a lot less than nominal spending over the recent past, but measurement difficulties mean that the real measure is almost certainly highly misleading (see Box A4). Following growth of 3¼ per cent in 2003, the forecast assumes that growth in real government consumption slows to about 2½ per cent a year. This implies less of a slowdown in real than in nominal spending, given that growth in nominal government consumption is projected to slow from around 10½ per cent this year to around 6 per cent.

A36 Business investment has shown tentative signs of strengthening since the spring, as the effects of uncertainties have receded. In the year to the third quarter of 2003, business investment rose marginally – the first positive annual growth since the end of 2001. At the same time, strong growth in government investment has continued to support overall capital expenditure, with general government capital spending in the year to the third quarter up around 10 per cent on a year earlier.

A37 With corporate profitability having risen over the past year and company balance sheets far healthier than during the late 1990s' ICT boom, businesses are well positioned to step up investment as the global recovery gathers pace into 2004. Business investment is forecast to rise by ¾ per cent in 2003 as a whole, accelerating to between 3 to 3½ per cent in 2004 and to 5½ to 6¼ per cent the year after.

A38 Substantial upward revisions to imports from the EU from 1999 onwards have recently been introduced into the UK trade statistics. These revisions reflect initial adjustments for the impact of VAT missing trader intra-Community (MTIC) fraud, which for at least the past four years had led to a significant under-recording of UK imports from the EU, an issue discussed in more detail in Box A7.

A39 Interpreting trade data has been further complicated by technical problems in the recording of goods exports. Goods exports volumes have been erratic, but appear to have fallen a little further since the start of the year. Most of the recent weakness of exports has been due to trade with the EU, partly as a result of HM Customs and Excise closing down businesses involved in MTIC fraud, but also reflecting disappointing growth in the euro area over the first half of 2003. In recent months, goods export volumes to the EU have been at their lowest level for around four years. However, recent trade figures are still likely to be prone to revisions.

A40 Looking ahead, exports are expected to pick up into 2004 as momentum in the global economy gathers pace and as the lagged effects of the weakening in sterling against the euro over the past year feed through. At the same time, stronger business investment and a continued recovery in manufacturing output are expected to underpin stronger import growth.

Output

A41 Manufacturing output has increased over the past year and the latest data show it has now registered three consecutive quarters of positive growth. While global uncertainties meant growth was marginal between the final quarter of 2002 and the first quarter of 2003, manufacturing output rose 0.5 per cent in the second quarter of the year, growing at a faster rate than the service sector for only the second time in the past two and a half years. Manufacturing output rose gradually in the third quarter, although production was possibly affected by the exceptionally hot weather in August. October saw a particularly sharp pick up of 1 per cent on the month: abstracting from the period around the Golden Jubilee in 2002, this is the fastest increase since August 2001. Aggregate manufacturing output does, however, continue to mask divergences within the sector, with seven of the 14 main industries seeing growth between the second and third quarters of this year and five seeing further declines.

A42 Some parts of the high-technology electrical and optical equipment sector appear to have seen output bottom out, with ICT production having increased from lows in the second half of last year. However, the impact of the global recovery in ICT on UK high-technology businesses is unclear: computers and semiconductors production have both increased since the end of last year, but output of mobile phones has continued to contract, with production having declined by two thirds since the onset of the global economic slowdown in 2001. In Scotland, where the global downturn had a particularly severe impact due to the concentration of ICT businesses based in 'Silicon Glen', high-technology production has yet to pick-up following sharp falls in 2001 and 2002.

A43 Many survey indicators suggest that manufacturing activity has picked-up further, in line with recent official output data. For example, the CIPS manufacturing survey for November showed new orders rising at their fastest pace for almost four years with firms reporting a relatively marked acceleration in export demand. The November CBI monthly trends survey also reported order books improving.

A44 The British Chambers of Commerce survey for the third quarter showed manufacturers' confidence regarding future profitability and turnover improving in seven of the 12 UK countries and regions. Manufacturers in the South East and North East were the most optimistic, while confidence amongst firms in Scotland, Wales, Northern Ireland and the North West remained considerably below the national average.

A45 The pick-up in business investment, allied with improving prospects for world trade, are expected to underpin a strengthening of manufacturing output into next year and 2005, building on recent signs of a turnaround in the sector. Following growth of ¼ per cent this year, manufacturing output is forecast to rise by 1¾ to 2¼ per cent in both 2004 and 2005, consistent with its long-run performance.

A46 Construction output grew by 2.5 per cent between the second and third quarters of 2003. This followed particularly sharp growth of over 4 per cent in the second quarter, the fastest quarterly increase for almost 16 years. Construction activity has benefited from strong growth in public investment in recent years as the Government's spending plans have come on stream. Other evidence suggests the commercial sector has played an increasingly important role in boosting total construction demand in recent months.

Box A4: Measuring real government output

Budget 2002 announced significant increases in government spending over the next few years. The composition of this growth between increases in real output and prices has important implications for evaluating the Government's drive to improve public services.

The non-market nature of most government services means that measuring government output (or real consumption) and productivity is not straightforward. Traditionally real government consumption has been measured by real inputs, ruling out productivity improvements. However, in recent years the ONS has been developing a direct volume approach to measuring government output. In principle this allows for productivity change, conforming with recommended international best practice, but the existing volume measures, at their current stage of development, have considerable drawbacks in practice. In particular, satisfactory methods have yet to be found to take account of changes in the quality of services provided; and the relevance and coverage of the indicators offer ample scope for further advance.

The approach used to measure educational output illustrates some of the issues. The basic output indicator used is the total number of pupil years of teaching, on the grounds that pupils consume lessons. This means that for a given number of pupils, extra education spending will not feed through at all to recorded output. Instead it will show up one-for-one in a higher rise in the implied deflator. It will not capture service improvements such as reduced class sizes or the delivery of better quality teaching. Whereas extra spending need not necessarily be expected, at least in the short term, to raise teacher productivity, in so far as it leads to better educational standards it should add value and so raise real output. But under the existing method of measurement it cannot.

Over 60 per cent of government output is now measured using direct volume indicators, including health and education services which together constitute around half of government output. Over the past few years, nominal current spending on health and education has accelerated relatively strongly. Yet there has been relatively weak growth in measured real output in these services, with a strong pick-up in the implied deflator. For example, in the second and third quarters of 2003, nominal government consumption was up about 11 $^{3}/_{4}$ per cent on a year earlier, split into measured real growth of just around 4 per cent and an increase in the implied deflator of almost 7 $^{1}/_{2}$ per cent – well in excess of the rate of input cost inflation.

Measurement practices may well explain this, and mean that the measures in question are underscoring real growth and conveying misleading policy signals. In any case, it is appropriate at present to raise the priority accorded to further improving measurement, because stronger growth in government spending aimed at delivering tangible public service improvements sharpens the focus on performance indicators and policy evaluation. The National Statistician announced on 4 December 2003 that Sir Tony Atkinson had been asked to undertake a review of the future development of measures of government output, productivity and associated price indices so as to advance methodologies. A preliminary report will be produced by July 2004 and a final report by January 2005.

A47 Service sector output growth weakened considerably in the first half of 2003. Following growth of 0.9 per cent in the final quarter of 2002, the private services sector registered growth of 0.4 per cent in the first quarter of this year and output remained flat in the second quarter. This temporary weakness appeared partly to reflect the effects of global uncertainty, and the conflict in Iraq in particular, on certain service industries. A reluctance to make overseas trips during the period of the conflict triggered a sharp fall in air travel between the end of 2002 and mid-2003, with hotels and restaurants output remaining virtually flat in the first quarter.

A48 More recently, the service sector has rebounded as global uncertainties have diminished. Private sector services output rose by 0.8 per cent between the second and third quarters. Moreover, business survey evidence points to this pattern being consolidated going forward. In particular, the CIPS Reports on services have suggested a marked pick-up in the sector since the summer, with business activity growing at its fastest rate for almost six and a half years in November and business expectations regarding the near-term outlook signaling further robust growth in coming months.

A49 The BCC third quarter survey also showed confidence regarding future turnover and profitability among service sector firms rising above their long-run averages. However, the regional picture remains mixed. Confidence in Scotland and the North West remains significantly below the national average, with Wales and the East Midlands among the more optimistic regions. Service sector confidence generally remains above that in manufacturing, with the exception of the South East.

A50 The regional distribution of private sector rates of capacity utilisation over the past year, as measured by the BCC survey, suggests that it tends to be high when unemployment rates are low, as might be expected if regional variations in sustainable unemployment rates were relatively limited. Unemployment rates were lowest in the South West and South East, and highest in Greater London and the North East, but capacity utilisation rates in these regions tended to accord with the negative relationship with unemployment. The main outliers to the relationship are Yorkshire and Humberside and particularly Scotland, where utilisation rates were higher than unemployment rates might have suggested, and the Eastern region, where both unemployment and capacity utilisation rates were relatively low. This perhaps tends to suggest that, compared to other regions, there may be supply-side factors making it relatively easier to sustain low unemployment in the Eastern region and relatively more difficult in Yorkshire and Humberside and Scotland.

A51 In February 2003, the Chancellor asked Christopher Allsopp to undertake a wide-ranging review of the informational and statistical requirements for monetary and wider economic policymaking, including to support the Government's objective of promoting economic growth in all regions. The Review team's First Report, described in Box A5, concentrates on regional statistics and is being published today. The Government welcomes the report and looks forward to discussing the proposals with the Review team, the National Statistician and others.

Box A5: The Allsopp Review: Regional information

As part of his review, Christopher Allsopp was asked to produce an assessment of the regional information and statistical framework needed to support the Government's objective of promoting economic growth in all regions and reducing the persistent gap in growth rates between the regions.

Christopher Allsopp's First Report proposes bringing regional accounts more into the national accounts framework and improved, more timely GVA estimates based on production data.

Many of the First Report's recommendations concern the processes required to provide adequate regional and sub-regional data, including expansion of a number of key surveys. The recommendations include:

- **a better quality and more timely measure of real regional Gross Value Added;**
- **expanding the range of microeconomic and sub-regional data already available;**
- **an Office for National Statistics (ONS) or Government Statistical Service (GSS) presence in the English regions, to complement that which already exists in Scotland, Wales and Northern Ireland; and**
- **greater access for the ONS to administrative data held within government, which could improve both regional and national data, while offering important savings in the compliance burden on business.**

The labour market

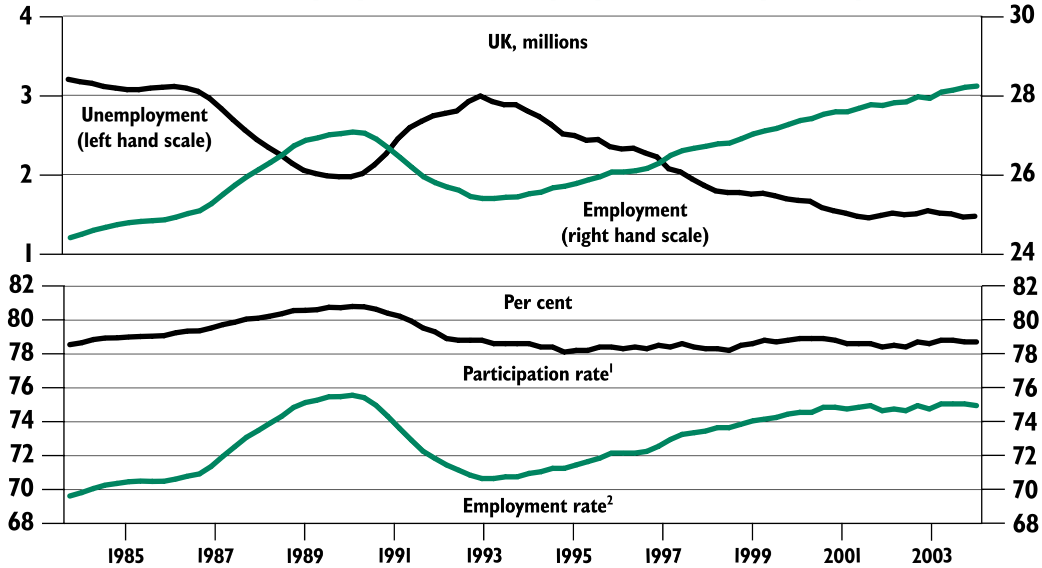
A52 The UK labour market has remained resilient to shocks from global economic developments. The employment rate is close to record highs and unemployment rates have remained stable. The performance of the UK labour market provides evidence that the Government's supply-side reforms are creating a more dynamic and flexible labour market in the UK. The resilience of the UK labour market contrasts with many other industrialised countries where unemployment has risen.

A53 The unemployment rate, on the International Labour Organisation (ILO) definition, trended gently downwards over the year to the third quarter of 2003, while remaining broadly flat over the past two years or so. At 5.0 per cent, it remains the lowest among the G7 economies. Claimant count unemployment has also nudged down in recent months, following short-lived increases in the earlier months of the year. It has been below one million for over two and a half years, and is now at its lowest level since 1975. In October, the claimant rate stood at just 3.0 per cent.

A54 Growth in the working-age population – which rose by an estimated 180,000, or 0.5 per cent, in the year to the third quarter – has been more than absorbed by growth in employment. However, with unemployment down by 70,000 in the year to the third quarter, working-age inactivity has been little changed over the past year, though the rate edged down. In the third quarter, employment was about 310,000 up on a year earlier. This brought the employment level to a new record high of over 28 million, and the employment rate to 74.6 per cent, up a little on a year earlier and exceeding most analysts' expectations at the time of Budget 2003.

A55 Most regions and countries of the UK have seen a continuation of rising employment and falling unemployment over the past year. However, there have been regional variations. All regions bar the North East, East Midlands and West Midlands have seen increases in employment in the year to the third quarter of 2003; and three regions – London, the North East and the East – have seen rises in unemployment. These rises have been very modest and associated with increasing numbers of economically active people. London saw unemployment rise 8,000 over this period, possibly due to the downturn in financial services, though overall employment in the capital rose markedly. The dispersion of unemployment rates between regions and countries of the UK also remains narrow compared with the experience in the 1980s and 1990s.

Chart A5: LFS employment, unemployment and participation



[1] *Percentage of the working-age population who are economically active (i.e. employed or unemployed).*
[2] *Percentage of the working-age population in employment.*

A56 Of the 310,000 – or 1.1 per cent – rise in total employment in the year to the third quarter of 2003, over two-thirds was accounted for by full-time self-employment, with its share rising significantly. This implies a larger increase in private than public sector employment. However, the number of full-time employees fell slightly on the year, with the corresponding decline in share virtually mirroring the rise in the share of full-time self-employment. This left the share of overall full-time employment in total employment little changed on the year, whereas over the previous year it had fallen sharply. Most of the rise in full-time self-employment appears to have been concentrated in the banking, finance and insurance sector mainly in London and the South East, perhaps reflecting the establishment of new businesses by individuals made redundant by City financial institutions, and in construction, reflecting ongoing buoyancy in this sector nationwide.

A57 Rising public sector employment has been a key feature of recent labour market developments, as the Government's spending commitments aimed at improving key public services come on stream. Public sector jobs increased by 86,000 in the year to mid-2002, with the majority of gains in the health sector. Since then jobs in public administration, education and health (which mainly comprise public sector employment) have increased on average by around 45,000 a quarter, compared to around 25,000 a quarter over the previous year. With self-employment accounting for most of the growth in total employment over the past year or so, and total employees in the third quarter of 2003 little changed on a year earlier, rising public sector employment seems to have been accompanied by falls in private sector employees over this period, notably in manufacturing.

A58 Over the year to summer 2002, average weekly hours worked declined sharply as firms responded flexibly to global uncertainty by adjusting hours rather than employment. This contrasts with many other countries where employment took more of the strain of global uncertainties. Since then average weekly hours worked have been relatively flat, but some cyclical upturn is expected as businesses respond to strengthening demand.

A59 Productivity growth slowed in 2001 and 2002 as companies chose to retain workers during the recent period of international weakness when output growth eased back in the face of weak external demand. However, it has shown some signs of cyclical recovery more recently. Unit wage costs have continued their downward trend in recent months, rising just 1.2 per cent in the year to the second quarter of 2003, the lowest rate of growth for over seven years.

A60 Whole economy average earnings growth has remained well within sustainable limits over the past two years, notably falling from around 3¾ per cent in the summer and autumn of last year to around 3 per cent in spring this year before edging up in more recent months. There remains a divergence between growth in public and private sector pay. Average earnings growth (including bonuses) this year has been running at about 3 per cent in the private sector and in excess of 5 per cent in the public sector, where recent rates have been temporarily boosted by pay rises in health, social work and public administration having been awarded at a different time to last year. Over the first three quarters of 2003 whole economy average earnings were 3.4 per cent up on a year earlier, compared to the independent average forecast prevailing at the time of Budget 2003 of 4.0 per cent growth for the year as a whole. The recent behaviour of earnings growth, as well as average hours worked, appears to reflect a flexible response to the cooling in output and demand growth as the world economy weakened, thereby supporting employment.

THE UK FORECAST IN DETAIL

Inflation

A61 The Pre-Budget Report confirms that the operational target for monetary policy to apply from now on will be defined in terms of Consumer Prices Index (CPI) inflation, instead of RPIX inflation. Underlying inflation remains firmly in check. Since the inception of the present monetary policy framework in May 1997, inflation has been kept close to target and within a narrow band, with RPIX inflation averaging 2.4 per cent over this period. In October 2003, RPIX stood at 2.7 per cent. CPI inflation stood at 1.4 per cent, among the lowest in the EU.

A62 There have been a number of influences on inflation outturns in recent months. Shallower discounting of clothing and footwear prices in the summer sales, coupled with subsequently stronger price recoveries, made an upward contribution to annual inflation in August, and the unusually hot and dry summer in the UK and mainland Europe adversely affected supplies of many fresh vegetables. However, the cost of foreign package holidays has fallen significantly this year, especially to European destinations, possibly reflecting the effects of geo-political uncertainties. Petrol prices have been more stable in recent months following previous increases in oil prices through 2002 and into 2003.

A63 Divergences between the rates of goods and services price inflation have narrowed in recent months. Goods prices in the retail prices basket stood 0.6 per cent higher in October than a year earlier. At the same time, service sector price inflation has moderated, with price rises for leisure and recreational services especially having eased back over the past year or so.

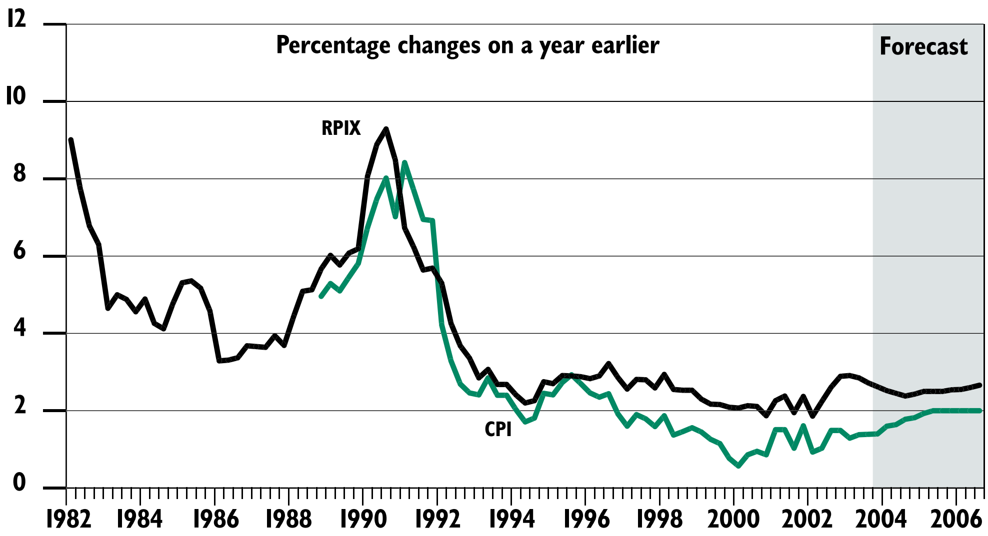
A64 Since spring 2003, moderation in the underlying growth of house prices has generally made a downward contribution to RPIX inflation, as measured through the housing depreciation component. The wedge between RPIX and CPI inflation arising from housing components has consequently narrowed, and was at its smallest for almost a year in October.

A65 On the basis of the Halifax house price index, annual rates of house price growth have almost halved since their peak in October 2002, and the Nationwide and ODPM measures corroborate this picture. However, monthly house price growth has picked up since earlier in the year, and the housing market has maintained more momentum than many were expecting. National house price indices continue to mask relatively significant dispersion in house price inflation among the regions and countries of the UK. House price valuations in the northern regions and the Midlands have tended to see increases above those in the UK as a whole over the past year, while those in London and the South East have risen relatively modestly. As a result, Halifax estimates that the gap in the level of house prices between the north and south narrowed by around £8,000 in the year to the third quarter of 2003.

A66 Inflation prospects are likely to reflect the balance of opposing influences. Existing slack in the economy, built up during the recent world slowdown, is expected to exert further downward pressure on domestically generated inflation through 2004 and into 2005. However, working in the reverse direction, the lagged effects of the recent depreciation of sterling are expected to result in higher import price inflation over the forecast horizon. In addition, the further pick-up in the pace of global recovery is also expected to lift import prices in 2004 and 2005. CPI inflation is therefore forecast to rise slowly from early next year to settle at its 2 per cent target by the second half of 2005.

A67 The difference between CPI and RPIX inflation is expected to narrow markedly from 1.3 percentage points in October 2003 to ½ percentage point two years ahead, the typical forecast horizon for monetary policy purposes. Thereafter, the differential is expected to remain broadly stable, rising slightly above ½ percentage point in future years. With CPI inflation expected to remain at its target level of 2 per cent, RPIX inflation is expected to rise slightly above 2½ per cent depending on a range of economic factors, and rounds up to 2¾ per cent in this Pre-Budget Report forecast. The ONS is expected to take into account any internationally agreed future changes in the measurement of inflation.

Chart A6: CPI and RPIX[1]



[1] *Outturns until 2003Q3; forecasts for every second quarter from 2003Q4 to 2006Q4.*

The household sector

A68 As a result of the recent revisions to the UK national accounts, GDP growth since the mid-1990s has been less consumption rich than previously estimated, reflecting a combination of downward revisions to private consumption growth and upward revisions to GDP growth. Between 1995 and 2002, data available at the time of Budget 2003 showed real private consumption and real GDP up by almost 33 and 20 per cent respectively, whereas the revised data show corresponding estimates of just over 30 and 21 per cent. However, in nominal terms the latest data confirm a much narrower gap between private consumption and GDP growth which was also evident in the previous data, with private consumption up 50¾ per cent and GDP up 45¼ per cent over this period, and the share of private consumption in GDP at current prices up from about 64 to 66 per cent. Therefore, the nominal data indicate that growth in private consumption has been more sustainable than the real data suggest, reflecting a decline in the relative price of consumption goods and services. Revisions have also lowered estimated growth in real private consumption in 2003, which is now put at 2.5 per cent over the year to the second quarter, almost 1 percentage point lower than previously estimated.

Table A5: Household sector[1] expenditure and income

	Percentage changes on previous year, unless otherwise stated				
		Forecast			
	2002	2003	2004	2005	2006
Household consumption[2]	3½	2½	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
Real household disposable income	1½	2	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
Saving ratio (level, per cent)	5¼	4¾	4¾	4¾	4¾

[1] *Including non-profit institutions serving households.*
[2] *Chained volume measures.*

A69 Geo-political uncertainties and volatility on financial markets appear to have temporarily dented private consumption growth in the initial months of 2003. Consumer confidence dipped below its long-run average in February and March. The lagged effects of falls in net household wealth in 2002, arising from declining equity prices, may also have influenced consumer spending this year. In the first quarter, household consumption fell 0.2 per cent, its first decline since 1995, and retail sales, which comprise around 40 per cent of household consumption, also declined.

A70 Since early spring, consumer confidence has returned to above its long-run average as geo-political uncertainties have receded, equity prices have recovered and signs of a strengthening world economy have emerged. Underlying growth of retail sales has also strengthened, with volumes increasing 1.5 per cent in the three months to October compared with the previous three months, though it remains below rates seen for much of 2001 and 2002.

A71 While underlying consumption growth appears to have eased since the second half of 2002, it has continued to outpace increases in disposable income, thereby contributing to continued strong growth in demand for personal borrowing since Budget 2003. Low interest rates and further gains in house price valuations have helped maintain a benign borrowing environment for households. The recovery in equity prices since the spring and the corresponding boost to households' financial wealth, may also have enhanced confidence for taking on additional debt (see Box A6).

Box A6: Household balance sheets

Household borrowing rose by 14 per cent in the year to the third quarter of 2003. This was driven mainly by a strong rise in mortgage lending, which accounts for over 80 per cent of the stock of household debt. As illustrated in Chart a, the ratio of household debt to income reached a new peak of over 130 per cent in the second quarter of 2003.

However, any assessment of household finances needs to consider households' asset positions alongside levels of debt. The recent rise in household borrowing has been heavily influenced by developments in the housing market. While the strong rise in house prices over recent years has led to increased borrowing by home buyers, it has also significantly boosted the value of housing wealth, as can be seen in Chart a. The value of households' total net wealth has increased by over 50 per cent since the beginning of 1997, with sharp growth in housing wealth more than offsetting the effects of the weakening in global equity prices between 2000 and early 2003. As a result, the ratio of household debt to total wealth has remained stable. Moreover, while mortgage equity withdrawal has increased, households have simultaneously been building up their holdings of money and deposits. Mortgage equity withdrawal has not caught up with recent rises in house prices in the sense that untapped equity in the housing stock has continued to rise, presently standing at over 75 per cent of total housing wealth.

Chart a: Household debt and housing wealth as a percent of disposable income

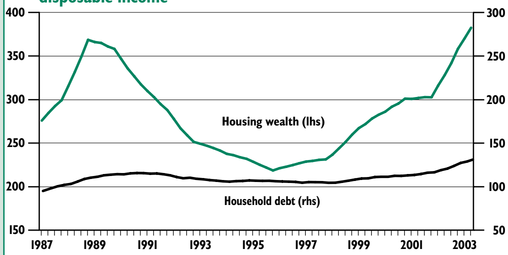
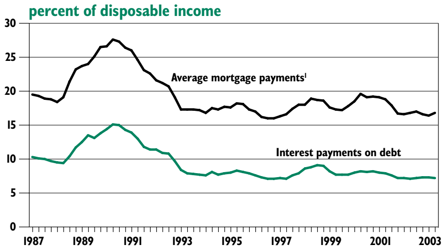


Chart b: Household interest and mortgage payments as a percent of disposable income



[1] Average mortgage repayments for those taking out a mortgage for house purchase in the specified quarter.

A key difference between the current position of households' balance sheets and conditions in the late 1980s is that interest rates are currently close to their lowest level for fifty years. Chart b shows that low interest rates have kept the proportion of household income taken in interest payments low by historical standards. Similarly, the average mortgage payment as a percent of income is also low.

Household borrowing inevitably poses risks to the forecast. However, economic stability based on low inflation, low interest rates and high levels of employment should ensure that existing levels of debt are sustainable. Widespread household defaults have in the past occurred only in the face of a significant rises in both interest rates and unemployment. Evidence from the last recession in the early 1990s suggests that growth in borrowing slowed from 1989 when households started to retrench as interest rates rose to around 15 per cent and interest payments reached 15 per cent of disposable income.[a] Interest payments currently account for 7.2 per cent of disposable income, significantly below early 1990s' levels, and so the prospect of an uncomfortably sharp retrenchment in household borrowing remains low.

[a] This figure does not take into account the impact of Mortgage Interest Relief at Source, which subsidised borrowing costs.

A72 Household consumption is forecast to continue growing at around recent rates. With personal debt at historically high levels, consumers' appetite for further increases in borrowing is likely to recede, and more moderate increases in house prices are expected to rein back mortgage equity withdrawal. Thus despite stronger growth of disposable incomes than of late, as the output gap closes, consumption growth over the forecast horizon is expected to be weaker than experienced since the mid-1990s. Private consumption is now forecast to increase by 2½ per cent this year and by between 2¼ to 2¾ per cent in 2004 and 2005, with the saving ratio stabilising.

Companies and investment

A73 The latest national accounts revisions show that business investment has been stronger in recent years than previously estimated. This partly reflects relative declines in the prices of many investment goods – and ICT goods in particular (see Box A3). The ratio of current price business investment expenditure to GDP has shown little trend over the past twenty years or so. Thus, while the relative price of business investment has trended downwards, real business investment has, on average, tended to grow faster than GDP over this period.

Table A6: Gross fixed capital formation

	Percentage changes on previous year				
		Forecast			
	2002	**2003**	**2004**	**2005**	**2006**
Whole economy[1]	1¾	2¼	6 to 6½	5½ to 6	4 to 4¾
of which:					
Business[2,3]	–3½	¾	3 to 3½	5½ to 6¼	4½ to 5¼
Private dwellings[3]	19¼	4½	3¾ to 4	3¾ to 4¼	1½ to 2
General government[3,4]	7¾	15½	30	9¼	6¾

[1] *Includes costs associated with the transfer of ownership of land and existing buildings.*

[2] *Private sector and public corporations' (except National Health Service Trusts) non-residential investment. Includes investment under the Private Finance Initiative.*

[3] *Excludes purchases less sales of land and existing buildings.*

[4] *Includes National Health Service Trusts.*

A74 However, despite the effects of recent revisions, business investment remained subdued in the early stages of the year, as forecast in Budget 2003. Uncertainty surrounding the situation in Iraq, financial market volatility and other ongoing risks compounded the effects of an already fragile global economy and discouraged companies from bringing investment projects back on stream. Business investment remained broadly flat between the final quarter of 2002 and the first quarter of 2003, coinciding with the peak of global uncertainty surrounding the situation in Iraq. Relatively sharp declines on global equity markets in the early months of 2003, combined with remaining doubts about the momentum of the world recovery, are also likely to have constrained investment demand.

A75 More recently, there have been tentative signs that a gradual business investment recovery is underway. In the year to the third quarter of 2003, it recorded its first – albeit marginal – positive annual growth rate since the end of 2001. Imports of capital goods appear to have flattened out during the summer months, while production of capital equipment has seen a modest rise over the past year or so.

A76 However, in the past business investment has tended to lag GDP growth and a more substantial turnaround in companies' capital expenditure has yet to make itself evident. With the exception of corporate expenditure on vehicles, investment in machinery and equipment has remained subdued, while being partially offset by buoyant spending on buildings and structures. Nominal expenditure on computer hardware and software has also fallen a little further this year although, given declining prices for ICT goods, this may well mask growth in real terms. Investment by manufacturing firms remains low, reflecting the degree of spare capacity accumulated during the protracted period of global weakness.

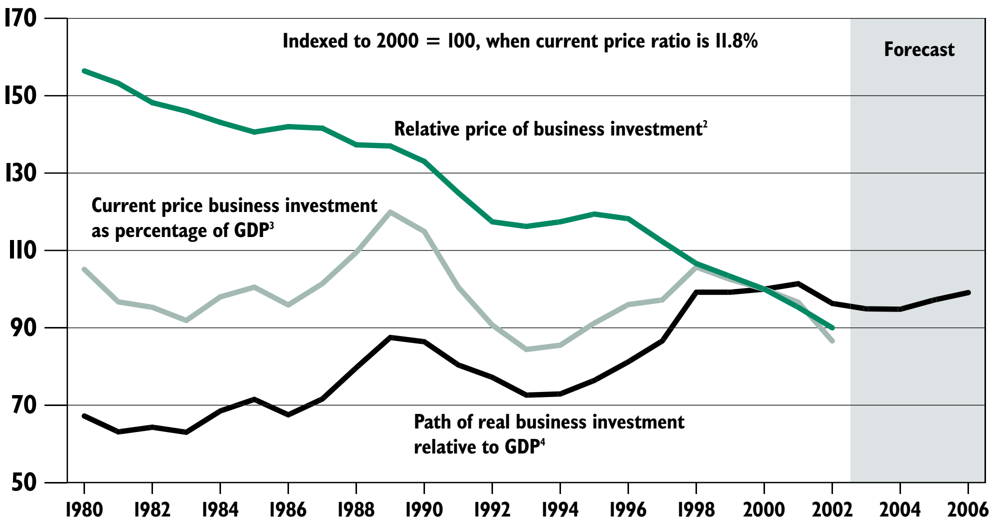
A77 Nonetheless, recent business survey indicators suggest that spare capacity in some of the regions and countries of the UK which were most exposed to the global slowdown is lower than in many other parts of the country. This tentatively indicates that investment in these areas may also have suffered disproportionately from weak external demand in recent years. Broadly consistent with the underlying picture from official data, the latest BCC survey suggests a gradual strengthening in investment intentions across most UK regions and countries into the third quarter, with particularly pronounced improvements in the West Midlands, the North West and South West.

A78 The July 2003 CBI Industrial Trends Survey showed the proportion of manufacturing companies citing demand uncertainty as a factor holding back investment at its highest since the aftermath of the 11 September 2001 tragedies. The proportion of companies emphasising uncertainty as the key factor in limiting investment expenditure fell back in the October 2003 CBI survey, though it remained slightly above its long-run average. Evidence from the survey suggests that uncertainty about demand continues to be the main constraint on investment in nearly all regions and countries of the UK, despite a number of key global uncertainties having receded. Only firms in the South West judge inadequate net return to be a more significant factor undermining the appetite of businesses to invest.

A79 Nonetheless, despite some lingering uncertainties, the UK corporate sector has shown positive signs of strengthening since the spring. Company profitability has improved in recent months. Manufacturers' rates of return have risen for four consecutive quarters, possibly reflecting the effects of the decline in the value of sterling on profit margins. Rates of return in the service sector also picked up over the second quarter. Company balance sheets have continued to improve, offering a solid foundation for raising capital expenditure going forward. Moreover, private non-financial corporations have now been net lenders for a year: net lending by private non-financial corporations was £3½ billion in the second quarter of 2003.

A80 The BCC third quarter survey showed indicators of confidence regarding future profitability among both manufacturing and service sector firms rising above their long-run averages. However, the regional picture remains mixed. Confidence in Scotland, Wales and the North West remains significantly below the national average, with Yorkshire and Humberside and the East Midlands among the more optimistic regions. Service sector confidence generally remains above that in manufacturing, with the exception of the South East.

Chart A7: Business investment[1]



[1] Business investment includes investment by public corporations (except National Health Trusts) and investment under the Private Finance Initiative.
[2] Ratio of implied business investment deflator to GDP deflator.
[3] Ratio of business investment to GDP in current prices.
[4] Ratio of business investment to GDP in chained volume measures.

A81 Investment expenditure is expected to gather further momentum into 2004 and 2005. Following growth of ¾ per cent this year, business investment is forecast to rise by 3 to 3½ per cent in 2004 and 5½ to 6¼ per cent in 2005. A gathering pace of recovery in the world economy is expected to be the main impetus for increased investment. Recoveries in equity valuations should also support the pick-up in business investment, while the fall-back in sterling against the euro, which may allow for the rebuilding of export margins, could act as an additional spur over the forecast horizon.

A82 With government investment expected to continue growing strongly as a result of the Government's spending plans, whole economy fixed capital formation is expected to grow significantly faster than private consumption and GDP in all forecast years.

Trade and the balance of payments

Table A7: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices[1]			Goods and services balance
	Exports	Imports	Exports	Imports	Terms of trade[2]	
2002	–1	3¾	1¼	–2	2½	–31¼
Forecast						
2003	–1½	½	1	–¼	1¼	–33
2004	5¼ to 5¾	5¼ to 5¾	2	1¼	¾	–33
2005	7 to 7½	5¾ to 6¼	3¼	3	¼	–31½
2006	6¼ to 6¾	5¾ to 6¼	3	2¾	0	–32½

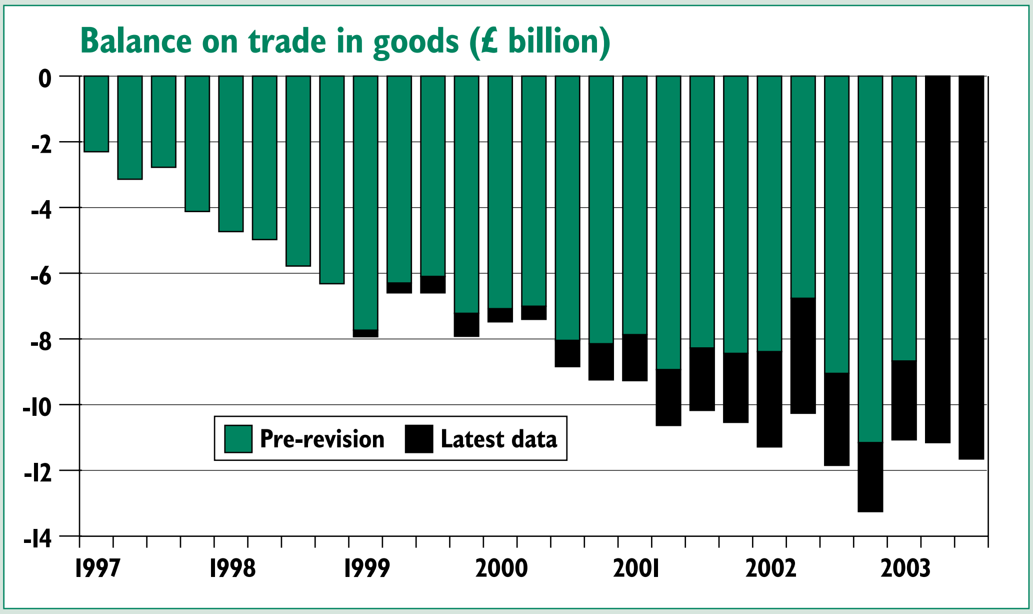
[1] Average value indices.
[2] Ratio of export to import prices.

A83 There have been large revisions to official trade data since Budget 2003 (see Box A3). Box A7 discusses the substantial upward revisions to imports from the EU and the trade deficit from 1999 onwards to correct for under-recording owing to VAT missing trader intra-Community (MTIC) fraud. Other revisions, in particular to import price indices, have generally reduced estimates of goods import volumes growth in recent years. MTIC fraud has also affected UK goods export volumes.

Box A7: Missing trader intra-Community fraud

In July 2003, the ONS introduced substantial upward revisions from 1999 onwards to imports from the EU, and hence the estimated UK trade deficit, to adjust for initial estimates of the impact of VAT missing trader intra-Community fraud (MTIC). This fraud had, for at least the past four years, led to UK imports from the EU being significantly under-recorded, though the revisions had only a very modest impact on measured GDP growth. Essentially, fraudsters have not been declaring their imports from the EU, and then have been selling them on at VAT inclusive prices and going missing without paying the VAT over to HM Customs and Excise. The fraud is not exclusive to the UK: it can be perpetrated between any two or more Member States because these VAT arrangements apply throughout the EU.

The fraud had been growing for several years to a peak in 2002, when imports from the EU were under-recorded by over £11 billion, equivalent to 1 per cent of GDP. This adds directly to the trade deficit, which is now estimated to have been 3 per cent of GDP in 2002 compared to 2 per cent previously.



Over the past year or so, HM Customs and Excise made significant progress in tackling this fraud and several firms have ceased operations. This has resulted in a sharp drop in illicit exports and imports of mobile phones and computer components (the commodities of choice for the fraudsters) which has depressed overall UK trade growth over the past year. For example, in the first three quarters of 2003 exports volumes fell by 2¾ per cent on a year earlier, whereas excluding fraud-related exports volumes grew by 1¼ per cent.

The ONS estimates that as a result of the fraud alone, real GDP growth in 2000 and 2001 would have been revised down by 0 to 0.2 percentage points each year. Estimates of real GDP growth from the beginning of 2002 have not been affected by the import revisions as they are measured primarily by output data. These fraud-related GDP revisions were introduced as part of the 2003 Blue Book dataset published in September 2003, but they were more than offset by other revisions which raised real GDP growth over 1997 to 2000.

A84 Interpreting trade data over more recent months is also complicated by problems arising from the introduction of a new system of recording exports by HM Customs and Excise. While these problems appear now to have been resolved, it is still possible that recent data may be less reliable than usual.

A85 Despite signs that the world economy has turned the corner and even after allowing for the effects of MTIC fraud, underlying export volumes have remained weak. Fraud-adjusted goods export volumes rose by less than ¼ per cent between the second and third quarters of this year, although they stood 1¾ per cent higher than a year earlier. Over the past year, volumes to the EU have been far weaker than those to non-EU markets, which appears consistent with the pattern of global GDP growth. In the third quarter, goods export volumes to the EU were at their lowest for four years. While export volumes to non-EU countries have been more erratic than usual, they have shown some signs of recovery: in the third quarter of 2003, they were 6½ per cent higher than a year earlier and up 15½ per cent compared with their recent trough in the final quarter of last year.

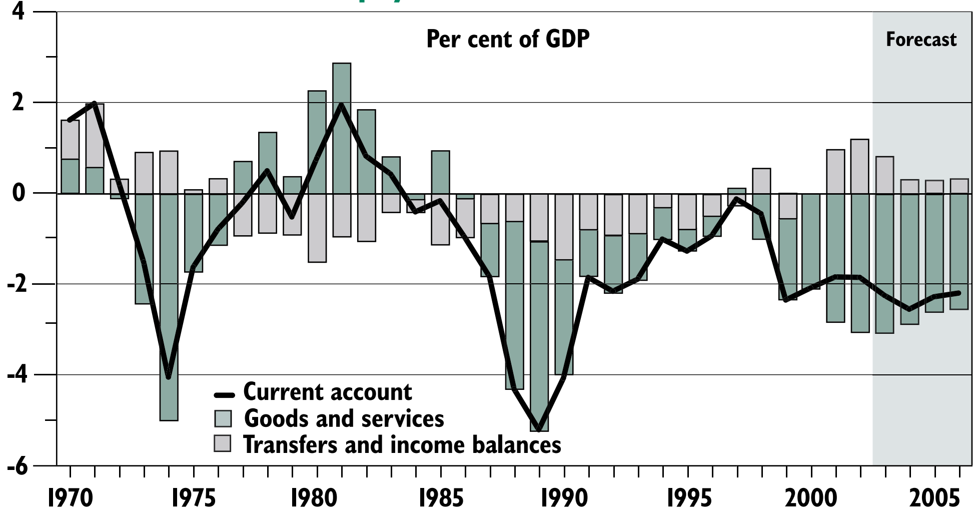
A86 Survey evidence has generally corroborated this picture of weak export demand over recent months, with the CBI July Regional Trends Survey showing the export orders balances in half the regions of the UK below their long-run averages. Scottish Executive data suggest Scottish manufactured exports continued to decline in the first quarter of the year, though at a slower rate than in previous quarters. High-technology electrical and instrumental engineering goods account for around 40 per cent of total Scottish manufactured exports. Scottish exports of these goods have declined by almost 60 per cent since the onset of the global slowdown in 2001.

A87 In recent years, services exports have generally proved more resilient than goods exports to the challenges of a weak global economy. Indeed, trade in services was in record surplus in 2002. However, uncertainties in early 2003 dented external demand for UK services. In particular, security concerns during the conflict in Iraq significantly discouraged overseas travellers to the UK, and visitor numbers from North America fell 14 per cent in the year to the second quarter of 2003. General economic uncertainty and volatility on financial markets also appear to have adversely affected demand for business and financial services earlier in the year. Despite some evidence of a pick-up in the value of service exports since the first quarter, they remain significantly down compared with the pattern of recent years. With the exception of the third quarter of 2001, when the events of September 11 had their most direct effect on overseas travel and payouts from UK-based insurance institutions, the surplus on services trade stood at its lowest for over seven years in the second quarter.

A88 The current account deficit over the first half of 2003 was broadly unchanged on a year earlier, although there was a sharp widening between the first and second quarters. A large surplus on investment income has continued partly to offset the trade deficit within the current account. In 2002, the UK had a record surplus on investment income of over £21 billion, while in the first six months of this year the income surplus was also up on a year earlier. A number of factors have maintained sizeable income surpluses over the recent past. Overseas investments by UK oil operators benefited from a period of relatively high world oil prices. The global downturn in financial services since 2000 has affected the UK's financial services industry, reducing profits earned by overseas banks and institutions with bases in the UK. While long-term structural factors should underpin income surpluses going forward, the forecast entails a moderation relative to recent years.

A89 Compared with last year, the UK trade deficit is expected to remain broadly flat in 2003 as a whole. The trade deficit is then expected to widen slightly over the forecast horizon, as UK import growth picks up around the same time as export growth, in response to strengthening business investment and brightening conditions in the manufacturing sector. Relative to GDP, the current account deficit is expected to remain modest compared to historical peaks, stabilising at around 2¼ per cent of GDP by the end of the forecast horizon.

Chart A8: Balance of payments current account



Independent forecasts

A90 Until recently, independent forecasters had generally been revising down their projections for UK GDP growth in 2003, but have lately upgraded their forecasts. The average of *new* growth forecasts in November was 2 per cent, consistent with the Pre-Budget Report estimate. The average of independent forecasts for 2004, at 2.6 per cent, remains below the Pre-Budget Report range, but is slightly higher than at the time of Budget 2003. Moreover, a number of prominent forecasters, including the European Commission and OECD, have recently revised up their projections for growth in 2004, with their forecasts now only a little below the Pre-Budget Report range. Indeed, almost two thirds of those included in the Treasury's Comparison of Independent Forecasts who have issued new projections since September have revised up their estimates of growth for 2004.

Table A8: Pre-Budget Report and independent[1] forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2003			2004		
		Independent			Independent	
	Pre-Budget Report	Average	Range	Pre-Budget Report	Average	Range
Gross domestic product	2	1.9	1.6 to 2.2	3 to 3½	2.6	0.3 to 3.5
RPIX (Q4)	2¾	2.7	2.2 to 2.9	2½	2.4	1.7 to 3.3
Current account (£ billion)	–24¼	–22.2	–39.3 to –8.0	–29½	–23.5	–43.9 to –5.0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts', November 2003.*

Forecast risks

A91 Downside risks to the forecast have diminished since Budget 2003. Nonetheless, if realised, the risks to the global forecast would clearly affect the UK's prospects. In particular, sharp movements in exchange rates or further balance sheet adjustment in certain key economies would threaten UK external demand and confidence. However, upside risks to the global outlook raise the possibility of a sharper upturn in UK economic growth going forward.

A92 In the UK, a sharp weakening of the housing market and a corresponding adjustment in prices would be likely to have an adverse effect on consumption expenditure. Similarly, an unexpectedly sharp retrenchment in household borrowing would also undermine growth in consumer spending. On the upside, momentum in consumer spending and house prices in the short term could continue to exceed expectations, though this would tend to increase the medium-term downside risks.

A93 At the present time, the improvement in UK business investment remains tentative, and investment could be subject to further unexpected weakness if business confidence is subjected to further shocks. Nonetheless, the business investment forecast carries upside risks. In past upturns, business investment has accelerated sharply and proved stronger than expected once GDP growth has picked up, and again the recovery in business investment could surprise in this direction over the forecast horizon.

Table A9: Summary of economic prospects[1, 2, 3]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast[4]				Average errors from past forecasts[5]
	2002	2003	2004	2005	2006	
Output at chained volume measures						
Gross domestic product (GDP)	1¾	2	3 to 3½	3 to 3½	2½ to 3	¾
Manufacturing output	–3½	¼	1¾ to 2¼	1¾ to 2¼	1¾ to 2¼	1¾
Expenditure components of GDP at chained volume measures[6]						
Domestic demand	3	2½	3¼ to 3¾	2¾ to 3¼	2¾ to 3¼	¾
Household consumption[7]	3½	2½	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾	1
General government consumption	2½	3¼	2½	2½	2½	1¼
Fixed investment	1¾	2¼	6 to 6½	5½ to 6	4 to 4¾	1½
Change in inventories[8]	–¼	0	¼	0	0 to ¼	¼
Exports of goods and services	–1	–1½	5¼ to 5¾	7 to 7½	6¼ to 6¾	2¼
Imports of goods and services	3¾	½	5¼ to 5¾	5¾ to 6¼	5¾ to 6¼	2
Balance of payments current account						
£ billion	–19	–24¼	–29½	–28	–28¼	7¼
per cent of GDP	–1¾	–2¼	–2½	–2¼	–2¼	¾
Inflation						
CPI (Q4)	1½	1½	1¾	2	2	–
RPIX (Q4)	2½	2¾	2½	2½	2¾	¼
Producer output prices (Q4)[9]	1	1½	2¼	2	2	1¼
GDP deflator at market prices	3¼	3	2½	2½	2¾	1
Money GDP at market prices						
£ billion	1044	1096	1158 to 1164	1222 to 1234	1287 to 1306	10
percentage change	5	5	5½ to 6	5½ to 6	5¼ to 5¾	¾

[1] *The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2003, released by the Office for National Statistics on 30 September 2003, and output, income and expenditure data for the third quarter released on 26 November 2003.*

[2] *All growth rates in tables throughout this annex are rounded to the nearest ¼ percentage point.*

[3] *As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral 2¾ per cent assumption for the trend rate of output growth. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of 2½ per cent a year trend growth used as the basis for projecting the public finances.*

[4] *The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

[5] *Average absolute errors for year-ahead projections made in autumn forecasts over the past ten years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2004.*

[6] *Further detail on the expenditure components of GDP is given in Table A10.*

[7] *Includes households and non-profit institutions serving households.*

[8] *Contribution to GDP growth, percentage points.*

[9] *Excluding excise duties.*

Table A10: Gross domestic product and its components

		£ billion chained volume measures at market prices, seasonally adjusted									
		Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
2002		669.0	185.2	170.0	1.5	1025.9	271.2	1297.1	310.2	1.5	988.3
2003		685.3	191.2	174.0	0.7	1051.4	267.3	1318.6	311.4	1.5	1008.7
2004		701.2 to 704.7	195.8	184.4 to 185.3	3.3 to 4.3	1084.7 to 1090.0	281.4 to 282.7	1366.0 to 1372.7	327.5 to 329.1	1.5	1040.1 to 1045.2
2005		717.9 to 724.9	200.5	194.3 to 196.3	2.0 to 4.0	1114.7 to 1125.6	300.9 to 303.8	1415.6 to 1429.5	346.1 to 349.5	1.5	1071.0 to 1081.5
2006		734.0 to 744.8	205.3	202.4 to 205.3	2.3 to 5.4	1144.0 to 1160.8	319.4 to 324.1	1463.3 to 1484.9	365.8 to 371.2	1.5	1099.1 to 1115.3
2002	1st half	331.4	92.7	83.8	0.7	508.7	136.4	645.1	154.4	0.7	491.3
	2nd half	337.6	92.5	86.2	0.8	517.2	134.8	652.0	155.8	0.8	497.1
2003	1st half	340.3 to 340.3	95.3	86.5 to 86.5	–0.5 to –0.5	521.8 to 521.8	133.7 to 133.7	655.5 to 655.5	155.6 to 155.6	0.8	500.7 to 500.7
	2nd half	344.8 to 345.2	95.9	87.5 to 87.6	1.2 to 1.3	529.4 to 529.9	133.5 to 133.6	662.9 to 663.6	155.8 to 155.9	0.8	507.9 to 508.4
2004	1st half	348.5 to 349.7	97.0	90.9 to 91.2	1.7 to 2.1	538.1 to 540.1	138.3 to 138.8	676.3 to 678.8	161.3 to 161.8	0.8	515.8 to 517.7
	2nd half	352.8 to 354.9	98.8	93.5 to 94.1	1.6 to 2.2	546.6 to 549.9	143.1 to 144.0	689.7 to 693.9	166.3 to 167.3	0.8	524.2 to 527.4
2005	1st half	357.0 to 360.0	99.2	96.0 to 96.8	1.4 to 2.3	553.6 to 558.4	148.2 to 149.5	701.8 to 707.8	170.7 to 172.1	0.8	531.9 to 536.4
	2nd half	360.9 to 364.9	101.3	98.3 to 99.4	0.6 to 1.8	561.1 to 567.3	152.7 to 154.4	713.8 to 721.7	175.5 to 177.4	0.8	539.1 to 545.0
2006	1st half	364.9 to 369.9	101.8	100.3 to 101.7	1.4 to 2.8	568.5 to 576.2	157.3 to 159.4	725.8 to 735.6	180.4 to 182.8	0.8	546.2 to 553.6
	2nd half	369.0 to 374.9	103.5	102.0 to 103.7	0.9 to 2.6	575.5 to 584.7	162.0 to 164.6	737.5 to 749.3	185.4 to 188.4	0.8	552.9 to 561.7
		Percentage changes on previous year[4,5]									
2002		3½	2½	1¾	–¼	3	–1	2	3¾	¼	1¾
2003		2½	3¼	2¼	0	2½	–1½	1¾	½	0	2
2004		2¼ to 2¾	2½	6 to 6½	¼	3¼ to 3¾	5¼ to 5¾	3½ to 4	5¼ to 5¾	0	3 to 3½
2005		2¼ to 2¾	2½	5½ to 6	0	2¾ to 3¼	7 to 7½	3¾ to 4¼	5¾ to 6¼	0	3 to 3½
2006		2¼ to 2¾	2½	4 to 4¾	0 to ¼	2¾ to 3¼	6¼ to 6¾	3¼ to 4	5¾ to 6¼	0	2½ to 3

[1] *Includes households and non-profit institutions serving households.*

[2] *Also includes acquisitions less disposals of valuables.*

[3] *Expenditure adjustment.*

[4] *For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.*

[5] *Growth ranges for GDP components do not necessarily sum to the ½ percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

B

THE PUBLIC FINANCES

The interim projections for the public finances in this Pre-Budget Report show that the Government is on track to meet its strict fiscal rules over the economic cycle:

- **the average current budget since the start of the current economic cycle in 1999-2000 shows an annual surplus of around 0.2 per cent of GDP, equivalent to a margin or surplus in this cycle of £14 billion, meaning the Government is on track to meet the golden rule on the basis of cautious assumptions. The cyclically-adjusted current budget in the cautious case returns close to balance by the end of the projection period; and**
- **public sector net debt is projected to be low and stable over the next five years, stabilising at 35½ per cent of GDP and well below the 40 per cent ceiling set in the sustainable investment rule.**

This report and the UK's annual Convergence Programme also show that the projections in this Pre-Budget Report are fully consistent with a prudent interpretation of the Stability and Growth Pact, which takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment.

The 2003 *End of year fiscal report* is published alongside this Pre-Budget Report. The report underlines the Government's commitment to transparency in fiscal policy by providing detailed retrospective information on the state of the public finances in 2001-02 and 2002-03.

INTRODUCTION

B1 Chapter 2 describes the Government's fiscal policy framework and shows how the projections of the public finances presented in this Pre-Budget Report are consistent with the fiscal rules. This annex explains the fiscal projections in more detail. It includes:

- five-year projections of the current budget and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule respectively;
- projections of public sector net borrowing, the fiscal aggregate relevant to assessing the impact of fiscal policy on the economy;
- projections of the cyclically-adjusted fiscal balances; and
- detailed analysis of the outlook for government receipts and expenditure.

B2 The fiscal projections continue to be based on deliberately cautious key assumptions audited by the National Audit Office (NAO).

B3 As described in Chapter 2, an *End of year fiscal report* is published alongside this Pre-Budget Report. The report underlines the Government's commitment to transparency in fiscal policy by providing detailed retrospective information on the state of the public finances in 2001-02 and 2002-03, including their performance against the fiscal rules and against published forecasts and plans. The information set out in the 2003 *End of year fiscal report* supplements the historical and provisional outturn data published in this annex.

B4 The Pre-Budget Report updates the projections of the public finances contained in Budget 2003 to take account of subsequent developments in both the public finances and the world and UK economies. The projections represent an interim forecast update and are not necessarily the outcome the Government is seeking.

MEETING THE FISCAL RULES

B5 Table B1 shows five-year projections for the current budget and public sector net debt, the key aggregates for assessing the performance against the golden rule and the sustainable investment rule respectively. Outturns and projections of other important measures of the public finances, including net investment and net borrowing, are also shown.

Table B1: Summary of public sector finances

	Per cent of GDP							
	Outturns		Estimate	Projections				
	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Fairness and prudence								
Surplus on current budget	0.9	–1.1	–1.7	–0.7	–0.4	0.0	0.3	0.6
Average surplus since 1999-2000	1.7	1.0	0.4	0.3	0.2	0.1	0.2	0.2
Cyclically-adjusted surplus on current budget	0.6	–0.6	–0.8	–0.1	–0.1	0.0	0.3	0.6
Long-term sustainability								
Public sector net debt[1]	30.2	30.9	32.8	33.8	34.6	35.1	35.4	35.5
Core debt[1]	31.1	31.2	32.2	32.6	33.2	33.7	34.1	34.3
Net worth[2]	24.9	24.3	21.5	19.4	16.2	16.0	14.8	14.4
Primary balance	1.7	–0.5	–1.7	–0.9	–0.7	–0.4	–0.3	–0.1
Economic impact								
Net investment	0.9	1.0	1.6	1.9	2.0	2.1	2.2	2.2
Public sector net borrowing (PSNB)	0.1	2.1	3.4	2.6	2.4	2.1	1.9	1.7
Cyclically-adjusted PSNB	0.3	1.6	2.4	2.0	2.2	2.0	1.9	1.7
Financing								
Central government net cash requirement	0.3	2.1	3.6	2.8	2.6	2.5	2.1	1.8
Public sector net cash requirement	0.3	2.1	3.6	2.6	2.3	2.2	1.8	1.6
European commitments								
Treaty deficit[3]	0.0	2.1	3.3	2.6	2.4	2.1	2.0	1.8
Cyclically-adjusted Treaty deficit[3]	0.3	1.5	2.4	2.0	2.2	2.1	2.0	1.8
Treaty debt ratio[4]	37.9	37.9	39.3	40.2	40.8	41.1	41.4	41.5
Memo: Output gap	0.0	–1.1	–1.4	–0.7	–0.2	0.0	0.0	0.0

[1] *Debt at end March; GDP centred on end March.*
[2] *Net worth at end December; GDP centred on end December.*
[3] *General government net borrowing on a Maastricht basis.*
[4] *General government gross debt measures on a Maastricht basis.*

B6 As explained in Chapter 2, the Government's provisional view is that the current economic cycle started in 1999-2000. Based on the assumptions used in these projections, the economy will next return to trend levels, ending the current cycle, in 2005-06.

The golden rule

B7 The projections show that the Government is on track to meet the golden rule, on the basis of cautious assumptions, with an average annual surplus on the current budget over the whole cycle of around 0.2 per cent of GDP, equivalent to a margin or surplus in this cycle of £14 billion. On this basis, and based on cautious assumptions, the Government is on track to meet the golden rule. If the economic cycle were to have started in 1997-98, the average surplus on the current budget up to 2005-06 would be over 0.2 per cent of GDP. The cyclically-adjusted surplus, which allows underlying or structural trends in the indicators to be seen more clearly by removing the estimated effects of the economic cycle, shows a deficit from 2002-03 to 2005-06, but is close to balance in 2004-05 and 2005-06 before returning to balance in 2006-07.

B8 The economy is projected to return to trend by early 2006. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2008-09 is 0.1 per cent of GDP. At this early stage and based on cautious assumptions, the Government is therefore on track to continue to meet the golden rule after the end of this cycle.

The sustainable investment rule

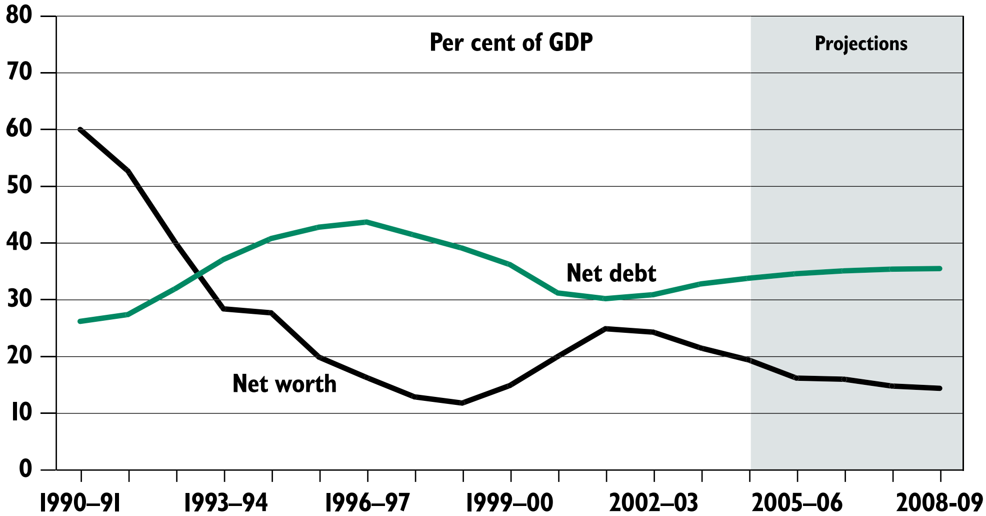
B9 The sustainable investment rule is also comfortably met over the economic cycle. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and expenditure taken by the Government, including the decision to use the proceeds from the auction of spectrum licences to repay debt, reduced debt to around 30 per cent of GDP by the end of 2001-02. It is now projected to grow slowly, as the Government borrows modestly to fund increased investment in public services, stabilising at 35½ per cent at the end of the projected period – £64 billion below the 40 per cent level. The projections for core debt, which exclude the estimated impact of the economic cycle, increase more slowly to around 34 per cent of GDP.

Net worth

B10 Net worth is the approximate stock counterpart of the current budget balance. Declines of net worth are expected for the remainder of the projection period from the high level of 24.9 per cent of GDP in 2001-02. At present, net worth is not used as a key indicator of the public finances, mainly as a result of the difficulties involved in accurately measuring many government assets and liabilities.

B11 Chart B1 shows public sector net debt and net worth as a per cent of GDP from 1990-91 to 2008-09.

Chart B1: Public sector net debt and net worth



Net investment

B12 As a result of decisions taken in the 2002 Spending Review, public sector net investment is projected to rise steadily to 2¼ per cent of GDP in 2008-09. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being held at a stable and prudent level, well below 40 per cent of GDP.

Net borrowing

B13 This increase in net investment, together with the new projections for the current budget, mean that public sector net borrowing is expected to increase to a maximum of around 3½per cent of GDP in 2003-04 before falling to around 1¾ per cent of GDP in 2008-09. Cyclically-adjusted net borrowing is below 2½ per cent of GDP in every year.

Financing

B14 The central government net cash requirement was 2.1 per cent of GDP in 2002-03. It is projected to increase in 2003-04 before decreasing to 1.8 per cent of GDP in 2008-09, mirroring the profile of net borrowing.

European commitments

B15 Table B1 shows the Treaty measures of debt and deficit used for the purposes of the Excessive Deficit Procedure – Article 104 of the Treaty. The public finance projections set out in this Pre-Budget Report and the UK's annual Convergence Programme are consistent with the Government's prudent interpretation of the Stability and Growth Pact, as described in Chapter 2.

CHANGES TO THE FISCAL BALANCES

B16 Table B2 compares the latest estimates for the main fiscal balances with those in Budget 2003.

Table B2: Fiscal balances compared with Budget 2003

	Outturn[1]	Estimate[2]		Projections		
	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Surplus on current budget (£ billion)						
Budget 2003	–11.7	–8.4	–1	2	6	9
Effect of non-discretionary changes to:						
Receipts[3]	–0.5	–5.5	–4	–4	–3	–1
Current expenditure[4]	0.4	–2.9	–2	–2	–3	–3
Effect of discretionary changes	0.0	–2.5	–1	–1	0	0
PBR 2003	**–11.8**	**–19.3**	**–8**	**–5**	**0**	**4**
Net borrowing (£ billion)						
Budget 2003	24.0	27.3	24	23	22	22
Effect of changes in current surplus	0.1	10.9	7	7	6	4
Effect of changes in net investment	–1.5	–0.9	0	0	0	0
PBR 2003	**22.5**	**37.4**	**31**	**30**	**27**	**27**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2003	–0.5	0.2	0.5	0.4	0.4	0.6
PBR 2003	**–0.6**	**–0.8**	**–0.1**	**–0.1**	**0.0**	**0.3**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2003	1.7	1.5	1.5	1.7	1.7	1.6
PBR 2003	**1.6**	**2.4**	**2.0**	**2.2**	**2.0**	**1.9**
Net debt (per cent of GDP)						
Budget 2003	30.9	32.2	32.7	33.2	33.5	33.8
PBR 2003	**30.9**	**32.8**	**33.8**	**34.6**	**35.1**	**35.4**

[1] *The 2002–03 figures were estimates in Budget 2003.*
[2] *The 2003–04 figures were projections in Budget 2003.*
[3] *Further details given in table B8.*
[4] *Includes depreciation.*

B17 The revisions to the public sector current budget in this Pre-Budget Report are partly due to changes to the forecast of public sector receipts, which have been reduced in all years. As explained in Chapter 2 and Annex A, this reduction is mainly due to changes in the composition of GDP. In particular, lower than expected growth in wages and salaries has reduced receipts from income tax and social security contributions.

B18 The discretionary changes of £2½ billion made in 2003-04 reflect the carying forward of the £2 billion unallocated special reserve into 2003-04 and the addition of a further £500 million. A further £300 million is being added in 2004-05 as a prudent allowance against continuing commitments. This will ensure that the Government is able to meet its international commitments in Iraq and elsewhere in the war against terrorism. The discretionary changes for 2004-05 onwards also reflect other measures announced in the Pre-Budget Report, notably the increases to the child element of Child Tax Credit, and measures to protect tax revenues (see Table B4).

B19 Overall, the current budget has been revised from a deficit of £8.4 billion to a deficit of £19.3 billion in 2003-04, and from a deficit of £1 billion to a deficit of £8 billion in 2004-05. In later years, the change in the forecast for current budget since Budget 2003 decreases, with the current budget going into balance or surplus from 2006-07 onwards. However, the tough decisions on taxation and spending taken by the Government over the course of the last Parliament to reduce debt to low and stable levels, means that even after these revisions and based on cautious assumptions, the Government remains on track to meet its strict fiscal rules.

B20 Net borrowing has been revised up since the Budget, from £27.3 billion to £37.4 billion in 2003-04 and from £24 billion to £31 billion in 2004-05 before stabilising around £27 billion at the end of the projection period. The changes in net borrowing since Budget 2003 are largely due to the changes in the current budget, as described above.

FORECAST DIFFERENCES AND RISKS

B21 The fiscal balances represent the difference between large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. Over the past ten years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been around 1 per cent of GDP. These tend to grow as the forecast horizon lengthens. A full account of differences between the projections made in Budget 2001 and Budget 2002 and the subsequent outturns is provided in the 2003 *End of year fiscal report*.

B22 As explained in Annex A, UK demand and activity have strengthened since early 2003 as geo-political uncertainties have receded. Global financial markets have made up considerable ground following sharp falls in 2002 and early 2003 and US GDP growth has rebounded strongly. In the UK, growth picked up strongly in the second and third quarters. The pick-up in activity is expected to be consolidated into 2004.

B23 However, there are also risks to the economic outlook. The uneven nature of the pick-up in global activity, the continued reliance on developments in the US and the relatively disappointing performance of the euro area, present a threat to the sustainability of this recovery over the medium term. These factors also mean that global activity is vulnerable to the possibility of faltering US domestic demand in the short term. On the upside, given the relatively swift turnaround in activity since the spring, the present world recovery may be stronger than currently expected.

B24 Short-term forecasts of the public finances are critically dependent on the path of the economy, as most tax revenues and some public expenditure – notably social security – vary directly with the economic cycle. Earlier work[1] (confirmed by more recent analysis in the 2003 *End of year fiscal report*, see Box B1 below) suggested that if GDP growth were one percentage point higher or lower than assumed over the coming year, net borrowing might be lower or higher by 0.4 per cent of GDP in the first year and by a further 0.3 per cent of GDP the following year. These figures are now closer to 0.5 and 0.2 per cent respectively, as the introduction of the corporation tax instalment system has reduced the lag between profits and tax receipts. However, not all cycles will conform exactly to these parameters, notably because the estimates are based on historical data (since which time both the state of the economy and the tax regime have changed) and because cycles differ in respects other than magnitude.

Box B1: Public Finances and the Cycle

The economic cycle has significant short-term effects on the public finances. This means it is important to distinguish between cyclical and underlying or 'structural' effects in the public finances. UK experience suggests that serious mistakes can occur if purely cyclical improvements are treated as if they were structural, or if a structural deterioration is interpreted as cyclical. The *Code for fiscal stability*[a] requires the Government to publish estimates of the cyclically-adjusted balances.

Annex A in the 2003 *End of year fiscal report*, published alongside this Pre-Budget Report, examines the relationship between the economic cycle and the public finances. It confirms the results of previous Treasury analysis and supports the current coefficients used to calculate cyclically-adjusted fiscal aggregates. The Treasury's ready reckoners for calculating cyclically-adjusted estimates of key fiscal indicators are shown below.

Cyclically-Adjusted (CA) Fiscal Aggregate		Fiscal Aggregate		Output Gap		Output Gap (–1)
CA net borrowing	=	net borrowing	+	0.50	+	0.20
CA current budget	=	current budget	–	0.50	–	0.20

Overall a 1 per cent increase in output relative to trend is estimated to reduce the ratio of public sector net borrowing to GDP by just under ¾ of a percentage point[b] after two years, while increasing the ratio of the surplus on the current budget to GDP by just under ¾ of a percentage point.

These estimates are approximate and are simplified representations of the true dynamic impact of the cycle on the public finances. They are subject to margins of error since estimates of the output gap are based upon a stylised cycle. In practice, every cycle is different and so will be its effect on the public finances.

[a] HM Treasury, November 1998

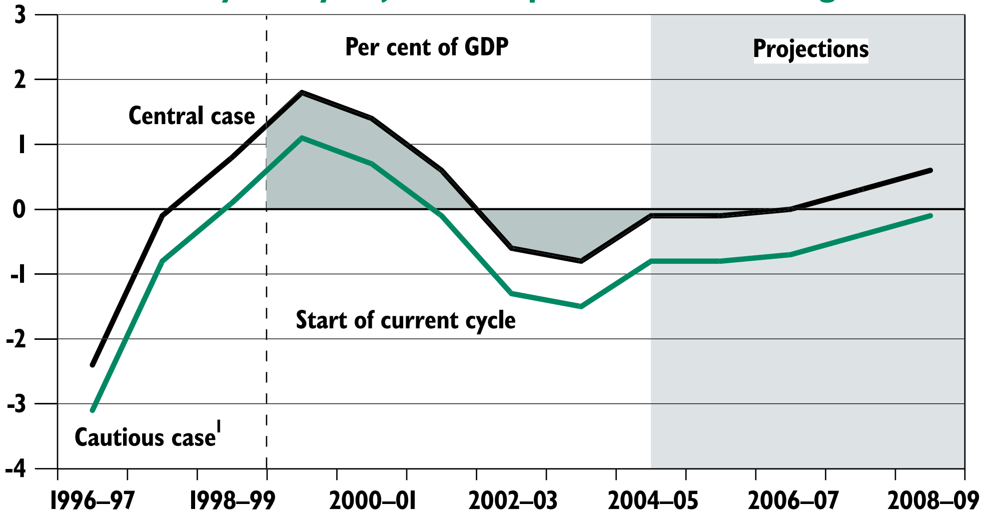
[b] The same applies to the ratio of public sector net cash requirement, as financial transactions are not expected to be cyclical, and also to the Maastricht definition of deficit.

[1] *Fiscal policy: public finances and the cycle*, HM Treasury, March 1999.

B25 Projected differences in short-term growth forecasts may have only a temporary effect on public finances. For a given path of trend output, higher or lower growth in the short term will be followed by lower or higher growth later on, and the public finances may be little affected on average over the cycle.

B26 However, changes in the estimated cyclical position of the economy in relation to its trend – the output gap – will have a permanent effect on prospects. For this reason, the Government has remained vigilant to the uncertainties inherent in forecasting the public finances and created a margin against unexpected events through the use of cautious, audited assumptions and in the cautious case. Combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, the Government can now draw on this margin to safeguard the increase in investment in priority public services, fully meet the UK's international commitments and allow the automatic stabilisers to work in full, while remaining on track to meet the fiscal rules.

Chart B2: Cyclically-adjusted surplus on current budget



[1] Cautious case assumes trend output one percentage point lower in relation to actual output than in the central case.

ASSUMPTIONS

B27 The fiscal projections are based on the following assumptions:

- the economy follows the path in Annex A. In the interests of caution, the fiscal projections continue to be based on the deliberately prudent and cautious assumption of trend output growth of $2\frac{1}{2}$ per cent a year up to 2006-07, $\frac{1}{4}$ percentage point lower than the Government's neutral view. The Government's neutral view of trend output growth is reduced to $2\frac{1}{2}$ per cent in 2007-08 and 2008-09, and so, to maintain a cautious approach, an assumption of $2\frac{1}{4}$ per cent is used in the public finance projections, still $\frac{1}{4}$ percentage point lower than the Government's neutral view;

- there are no tax changes beyond those announced since Budget 2003 or in this Pre-Budget Report (see Table B4), and the indexation of rates and allowances. Consistent with the *Code for fiscal stability*, the forecast does not take account of measures proposed in this Pre-Budget Report for consultation or other proposals where final decisions have yet to be taken;

- firm Departmental Expenditure Limits (DEL) as set out in the 2002 Spending Review up to 2005-06, but adjusted for the impact of policy decisions and DEL/AME reclassifications;

- total Annually Managed Expenditure (AME) programmes through to 2005-06 have been reviewed. The total has been adjusted for DEL/AME reclassifications, for the estimated costs of spending measures announced in this Pre-Budget Report or before (see Table B4) and where necessary to cover changes in the forecasts of individual components;

- prior to setting overall spending limits for the 2004 Spending Review period at the time of the next Budget, the assumed cash growth rates for DEL in 2006-07 and 2007-08 remain the same as set out in Budget 2003. Other current spending in AME is forecast to grow at $1\frac{3}{4}$ per cent in real terms in line with its recent trend, and net investment is forecast to increase to an assumption of $2\frac{1}{4}$ per cent of GDP in 2007-08, while remaining consistent with the sustainable investment rule;

- current spending in DEL and AME in 2008-09 is assumed to grow at the same rates as in 2007-08. Net investment remains at $2\frac{1}{4}$ per cent of GDP; and

- as in Budget 2003, the spending projections include additional amounts to allow for the five-year health settlement of difference between planned health growth and health's long term average growth of 3.6 per cent.

Table B3: Economic assumptions for the public finance projections

	Percentage changes on previous year						
	Outturn	Estimate	Projections				
	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Output (GDP)	1¾	2¼	3¼	2¾	2½	2¼	2¼
Prices							
CPI	1¼	1¼	1¾	2	2	2	2
GDP deflator	3¼	2¾	2½	2½	2¾	2¾	2¾
RPI[1] (September)	1½	3	3½	3	2½	2¾	2¾
Rossi[2] (September)	1¼	2	2	2¼	2¼	2¼	2¼
Money GDP[3] (£ billion)	1055	1111	1174	1238	1304	1369	1436

[1] *Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year.*

[2] *RPI excluding housing costs, used for uprating certain social security benefits.*

[3] *Not seasonally adjusted.*

B28 The key assumptions underlying the fiscal projections are audited by the NAO under the three-year rolling review process. Details of all the audited assumptions are given in Box B2.

B29 For this Pre-Budget Report, the Comptroller and Auditor General has audited the assumption relating to equity prices. While the assumption was an imprecise one over the last three years, the Comptroller and Auditor General concluded that it remains a sensible and transparent rule for forecasting purposes. In addition, following the change in the measure of inflation used in the inflation target, the Government has revised the assumption on the consistency of price indicators used to project the public finances, and this has also been audited. The assumption was deemed to be reasonable. The Comptroller and Auditor General also audited the assumption for projecting VAT receipts, and found that it had been less cautious than evidence at the time of making the assumption had suggested it would be. The Comptroller and Auditor General will complete the audit of the assumption at the time of Budget 2004, after considering the additional analysis being undertaken by HM Customs and Excise, following the recent data revisions to UK national accounts. In the meantime, the existing assumption has been used for the projections in this Pre-Budget Report, an approach that the Comptroller and Auditor General considers a cautious response.[2]

B30 The Government launched a comprehensive strategy for tackling VAT fraud, avoidance and non-compliance in the 2002 Pre-Budget Report. This strategy is being extended further, as described in Chapter 5, and consistent with previous practice the VAT ratio assumption takes account of the direct and preventive effects, but not the deterrent effects, and has been audited by the Comptroller and Auditor General who concluded that a reasonable and cautious approach had been adopted in the assumptions underlying the projected extra yield. In line with the cautious approach to the public finances, the Government has included an additional £185 million in 2004-05, rising to £315 million in 2006-07 in the public finance projections from the extension of the strategy.

[2] *Audit of Assumptions for the 2003 Pre-Budget Report*, National Audit Office, December 2003 (HC 35).

Box B2: Key assumptions audited by the NAO

• Privatisation proceeds[1,6,11]	Credit is taken only for proceeds from sales that have been announced.
• Trend GDP growth[1,6,9]	$2\frac{1}{2}$ per cent a year to 2006-07 and $2\frac{1}{4}$ per cent in 2007-08 and 2008-09.
• UK claimant unemployment[1,4,7,9]	Rising slowly to 0.95 million in 2005-06, from recent levels of 0.93 million, consistent with the average of independent forecasts.
• Interest rates[1,6,7,11]	3-month market rates change in line with market expectations (as of 27 November).
• Equity prices[2,7,12]	FTSE All-Share index rises from 2154 (close 27 November) in line with money GDP.
• VAT[2,7,10,12]	Ratio of underlying VAT to consumption falls by 0.05 percentage points a year. Only the direct and preventative effects of the anti-fraud VAT strategy are included in the projections.
• Consistency of price indices[2,7,12]	Projections of price indices used to project the public finances are consistent with CPI.
• Composition of GDP[3,8]	Shares of labour income and profits in national income are broadly constant in the medium term.
• Funding[3,8]	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
• Oil prices[5,10]	\$24.9 a barrel in 2004, the average of independent forecasts, and then constant in real terms.
• Tobacco[6,10,11]	The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For the 2003 Pre-Budget Report, a share of 18 per cent has been used in all forecast years.
• Inland Revenue compliance and enforcement package[11]	Only direct and some preventive effects are allowed for.

[1] Audit of Assumptions for the July 1997 Budget Projections, 19 June 1997 (HC3693).
[2] Audit of Assumptions for the Pre-Budget Report, 25 November 1997 (HC361).
[3] Audit of Assumptions for the Budget, 19 March 1998 (HC616).
[4] Audit of the Unemployment Assumption for the March 1999 Budget Projections, 9 March 1999 (HC294).
[5] Audit of the Oil Price Assumption for the Pre-Budget Report, November 1999 (HC873).
[6] Audit of Assumptions for the March 2000 Budget, 21 March 2000 (HC348).
[7] Audit of Assumptions for the Pre-Budget 2000 Report, 8 November 2000 (HC959).
[8] Audit of Assumptions for the March 2001 Budget, 7 March 2001 (HC304).
[9] Audit of Assumptions for the April 2002 Budget, 17 April 2002 (HC760).
[10] Audit of Assumptions for the 2002 Pre-Budget Report, 27 November 2002 (HC109).
[11] Audit of Assumptions for Budget 2003, 9 April 2003 (HC627).
[12] Audit of Assumptions for the 2003 Pre-Budget Report, 10 December 2003 (HC35).

PRE-BUDGET REPORT POLICY DECISIONS

B31 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all firm decisions announced in the Pre-Budget Report or since Budget 2003, including the special reserve allocation in DEL, increases to the Child Tax Credit and measures to protect tax revenues. The fiscal impact of these measures is set out in Table B4.

B32 In line with the conventions in previous Pre-Budget Reports, expenditure measures in AME for future years have been added to total AME, and the 2003-04 and 2004-05 special reserve allocations have been added to total DEL.

B33 The projections do not take account of measures proposed in the Pre-Budget Report where final decisions have yet to be taken prior to Budget 2004, these include:

- the introduction of a scheme allowing local authorities to retain a proportion of increases in local business rates revenues;
- the introduction of a half penny per litre duty differential to the rates for sulphur-free fuels relative to the rates for ultra-low sulphur fuels from 1 September 2004;
- the levy to be charged to pension schemes in respect of the Pensions Protection Fund;
- the introduction of the Graduate Contributions Scheme which will allow graduates to pay back their university tuition fees once they are earning; and
- measures to simplify the taxation of pensions.

B34 The measures in Table B4 that either close tax loopholes or tackle tax fraud represent the estimated direct Exchequer effect of the measure on existing levels of avoidance or fraud activity. Further details explaining the conventions used in Table B4 can be found in Appendix A2 of the Financial Statement and Budget Report 2003.

Table B4: Estimated costs of Pre-Budget Report policy decisions and others announced since Budget 2003[1]

	(+ve is an Exchequer yield)			£ million
	2003–04	2004–05	2005–06	2006–07
Raising productivity in an enterprise economy				
Improvements to the VAT flat-rate scheme	0	–10	–25	–30
Improvements to R&D tax credit schemes	0	–15	–25	–25
Capital allowances: increases in the thresholds defining SMEs	0	–100	–170	–125
Corporation tax reform: extension of relief for management expenses	0	–20	–35	–25
Corporation tax reform: transfer pricing and thin capitalisation	0	25	40	25
Interest and royalties directive	0	*	*	5
Increasing employment opportunity for all				
Housing benefit: social sector Pathfinders	0	0	–15	–30
Building a fairer society				
Child Tax Credit: increase above earnings commitment	0	–885	–925	–955
Employer supported childcare	0	0	–20	–25
Working Tax Credit for first time parents	0	–10	–10	–10
State pension: deferral; lump sum and increments	0	0	–10	–25
Modernising National Savings and Investments	0	0	5	5
VAT: cultural bodies	–20	–25	–25	–20
Protecting tax revenues				
Foreign earnings deduction for seafarers (FED)	0	20	50	40
Reform of the Construction Industry Scheme (CIS)	0	20	40	80
Modernising the taxation of trusts	0	40	105	100
VAT: abusive grouping	0	50	70	65
VAT: partial exemption special methods	0	50	55	50
VAT: assignment of bad debts	5	20	20	20
Tackling alcohol fraud	0	5	10	175
Total Pre-Budget Report measures	**–15**	**–835**	**–865**	**–705**
Additional Pre-Budget Report policy decisions				
Total special reserve allocation	–2500	–300	0	0
TOTAL POLICY DECISIONS	**–2515**	**–1135**	**–865**	**–705**
Extension of the VAT strategy[2]	–5	165	210	290
TOTAL DISCRETIONARY MEASURES	**–2520**	**–970**	**–655**	**–415**

* *Negligible*

[1] *Costings shown relative to an indexed base.*

[2] *Net of additional resources allocated to HM Customs and Excise.*

FISCAL AGGREGATES

B35 Tables B5 and B6 provide more detail on the projections for the current and capital budgets.

Table B5: Current and capital budgets

	£billion						
	Outturn	**Estimate**			**Projections**		
	2002–03	**2003–04**	**2004–05**	**2005–06**	**2006–07**	**2007–08**	**2008–09**
Current budget							
Current receipts	396.5	422.8	456	489	520	550	580
Current expenditure	394.0	427.3	449	478	503	528	553
Depreciation	14.4	14.8	16	16	17	18	19
Surplus on current budget	**–11.8**	**–19.3**	**–8**	**–5**	**0**	**4**	**8**
Capital budget							
Gross investment	29.7	36.6	42	45	48	53	55
Less asset sales	–4.7	–3.8	–4	–4	–4	–4	–4
Less depreciation	–14.4	–14.8	–16	–16	–17	–18	–19
Net investment	10.7	18.0	23	25	27	31	32
Net borrowing	**22.5**	**37.4**	**31**	**30**	**27**	**27**	**24**
Public sector net debt – end year	**334.1**	**374.8**	**408**	**439**	**468**	**497**	**522**
Memos:							
Treaty deficit[1]	21.8	37.1	31	30	28	28	26
Treaty debt[2]	399.8	436.8	472	505	536	567	596

[1] *General government net borrowing on a Maastricht basis.*
[2] *General government gross debt on a Maastricht basis.*

Table B6: Current and capital budgets

	Per cent of GDP						
	Outturn	**Estimate**			**Projections**		
	2002–03	**2003–04**	**2004–05**	**2005–06**	**2006–07**	**2007–08**	**2008–09**
Current budget							
Current receipts	37.6	38.1	38.9	39.5	39.9	40.2	40.4
Current expenditure	37.3	38.5	38.2	38.6	38.5	38.6	38.5
Depreciation	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Surplus on current budget	**–1.1**	**–1.7**	**–0.7**	**–0.4**	**0.0**	**0.3**	**0.6**
Capital budget							
Gross investment	2.8	3.3	3.6	3.7	3.7	3.8	3.8
Less asset sales	–0.4	–0.3	–0.3	–0.3	–0.3	–0.3	–0.3
Less depreciation	–1.4	–1.3	–1.3	–1.3	–1.3	–1.3	–1.3
Net investment	1.0	1.6	1.9	2.0	2.1	2.2	2.2
Net borrowing	**2.1**	**3.4**	**2.6**	**2.4**	**2.1**	**1.9**	**1.7**
Public sector net debt – end year	**30.9**	**32.8**	**33.8**	**34.6**	**35.1**	**35.4**	**35.5**
Memos:							
Treaty deficit[1]	2.1	3.3	2.6	2.4	2.1	2.0	1.8
Treaty debt ratio[2]	37.9	39.3	40.2	40.8	41.1	41.4	41.5

[1] *General government net borrowing on a Maastricht basis.*
[2] *General government gross debt on a Maastricht basis.*

B36 Following a deficit of 3 per cent of GDP in 1996-97, current budget surpluses of more than 2 per cent were recorded in 1999-2000 and 2000-01 and of around 1 per cent of GDP in 2001-02. These surpluses have allowed Government to use fiscal policy to support monetary policy during the recent economic slowdown, and as a result the current budget is now in deficit. However, as the economy moves back to trend, the current budget moves back towards balance, and by the end of the projection period is in surplus by more than $^1/_2$ per cent of GDP.

B37 The current budget surplus is equal to public sector receipts minus public sector current expenditure and depreciation. Underlying the projections of the current budget up to 2005-06 are steady increases in the ratio of public sector receipts. The current expenditure projections are based on decisions made in and since the Spending Review 2002, including this Pre-Budget Report. By 2005-06, when the current cycle ends under the assumptions used in these projections, the accumulated total surplus over the economic cycle will be £4$^1/_2$ billion. If the economic cycle were to have started in 1997-98, the accumulated total surplus would be £13$^1/_2$ billion.

B38 Table B5 also shows that net investment is projected to increase from £18 billion in 2003-04 to £32 billion in 2008-09, as the Government seeks to rectify historical under-investment in public infrastructure. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, as debt is being held at less than 36 per cent of GDP throughout the projection period, well within the 40 per cent limit set by the sustainable investment rule.

RECEIPTS

B39 This section looks in detail at the projections for public sector tax receipts. It begins by looking at the main determinants of changes in the overall projections since Budget 2003, before looking in detail at changes in the projections of individual tax receipts. Finally, it provides updated forecasts for the tax-GDP ratios.

Changes in total receipts since Budget 2003

B40 Forecasts of public sector current receipts have been revised down in all years since Budget 2003. Table B7 breaks down the causes of these revisions between economic determinants audited by the NAO, changes to the components of GDP, and other factors.

Table B7: Changes in current receipts since Budget 2003

	£ billion				
	Estimate	Projections			
	2003–04	2004–05	2005–06	2006–07	2007–08
Effect on receipts of non-discretionary changes in:					
Economic determinants audited by the NAO[1] *of which:*	½	1½	2	2	2½
Equity price assumption	½	1	1½	1½	1½
GDP components	–4	–5½	–5½	–5	–4
of which:					
Wages & salaries	–3½	–4	–4	–3½	–3
Consumers' expenditure	–½	–½	–1	–1	–½
Other	–2	–½	–1	0	1
Total before discretionary changes	**–5½**	**–4½**	**–4½**	**–2½**	**–½**
Discretionary changes	0	0	0	½	½
Total change	**–5½**	**–4**	**–4**	**–2**	**0**

[1] *Excludes the higher than expected VAT receipts, which is included in other changes. Also excludes extension to VAT strategy which is included in discretionary changes.*

Economic determinants audited by the NAO

B41 Changes in economic determinants audited by the NAO have increased public sector receipts by between £1½ billion and £2½ billion per year from 2004-05 onwards. This is largely a result of higher equity prices, which increase receipts from stamp duty, capital taxes, and corporation tax from life assurance companies. The NAO audited assumption on equity prices used in Budget 2003 meant that the projections only assumed equity prices would rise in line with money GDP from a starting level of 1778. However, since the Budget equity prices have actually risen by around 20 per cent.

GDP components

B42 Offsetting the positive impact of the economic determinants audited by the NAO are changes to the composition of GDP. As explained in paragraph B45, growth in wages and salaries in 2003 has been lower than projected, reducing revenues from income tax and NIC by around £3½ billion in 2003-04 and in future years. Lower than expected growth in consumers' expenditure has also had a negative impact on VAT and excise revenues, although as explained in paragraph B53, despite this lower growth, VAT revenues in the first half of 2003-04 have been substantially above the levels projected in Budget 2003, partly reflecting caution in the NAO audited assumptions used to forecast VAT revenues.

Other factors **B43** The remaining differences in the forecast of receipts can be explained by various factors including lower than expected levels of housing transactions, the reclassification of business rates paid by local authorities and lower than expected oil production. As explained in paragraph B57, the reclassification of business rates paid by local authorities, which reduces receipts by around £1 billion per year, has no impact on the current budget or net borrowing as it is offset by an equivalent reduction in public expenditure.

Tax-by-tax analysis

B44 Table B8 shows the changes to the projections of individual taxes since Budget 2003. Table B9 contains updated projections for the main components of public sector receipts for 2002-03, 2003-04 and 2004-05, while B10 looks in more detail at changes in receipts between 2002-03 and 2003-04.

Table B8: Changes in current receipts by tax since Budget 2003

		£ billion	
	2002–03	**2003–04**	**2004–05**
Income tax (gross of tax credits)	–0.7	–3.3	–3.1
Social security contributions	0.3	–1.9	–2.1
Non–North Sea corporation tax[1]	–0.1	–1.6	–2.0
Less tax credits[2]	0.0	0.0	0.5
North Sea revenues	–0.1	0.0	–1.4
Capital taxes[3]	–0.1	–0.1	0.4
Stamp duty	0.0	–0.4	0.2
Value added tax	–0.1	2.4	2.1
Excise duties[4]	0.0	–0.1	1.1
Other taxes and royalties[5]	0.0	0.6	–0.1
Net taxes and social security contributions	**–0.7**	**–4.3**	**–4.4**
Other receipts and accounting adjustments	0.2	–1.2	0.2
Current receipts	**–0.5**	**–5.5**	**–4.2**

[1] *Gross of enhanced and payable tax credits.*
[2] *Includes enhanced company tax credits that offset tax liability.*
[3] *Capital gains tax and inheritance tax.*
[4] *Fuel, alcohol and tobacco duties.*
[5] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*

Table B9: Current receipts

	£ billion		
	Outturn 2002–03	Estimate 2003–04	Projection 2004–05
Inland Revenue			
Income tax (gross of tax credits)	112.6	118.8	128.3
Social security contributions	64.7	72.6	78.4
Corporation tax[1]	29.6	29.4	34.6
Tax credits[2]	–3.4	–4.6	–3.9
Petroleum revenue tax	1.0	1.4	1.0
Capital gains tax	1.6	1.0	1.4
Inheritance tax	2.4	2.5	2.8
Stamp duties	7.5	7.5	9.3
Total Inland Revenue (net of tax credits)	**216.0**	**228.6**	**252.0**
Customs and Excise			
Value added tax	63.5	69.0	72.2
Fuel duties	22.1	22.9	24.8
Tobacco duties	8.1	8.0	8.2
Spirits duties	2.3	2.4	2.4
Wine duties	1.9	1.9	2.0
Beer and cider duties	3.1	3.2	3.4
Betting and gaming duties	1.3	1.3	1.3
Air passenger duty	0.8	0.8	0.9
Insurance premium tax	2.1	2.3	2.5
Landfill tax	0.5	0.6	0.6
Climate change levy	0.8	0.8	0.8
Aggregates levy	0.2	0.3	0.3
Customs duties and levies	1.9	1.9	1.9
Total Customs and Excise	**108.7**	**115.5**	**121.3**
Vehicle excise duties	4.6	4.9	5.2
Oil royalties	0.4	0.0	0.0
Business rates[3]	18.5	18.7	18.9
Council tax	16.7	18.4	19.9
Other taxes and royalties[4]	10.9	12.5	13.2
Net taxes and social security contributions[5]	**375.8**	**398.6**	**430.5**
Accruals adjustments on taxes	–0.1	2.8	1.0
Less own resources contribution to European Communities (EC) budget	–4.4	–4.5	–4.0
Less PC corporation tax payments	–0.1	–0.1	–0.1
Tax credits adjustment[6]	1.1	0.5	0.5
Interest and dividends	4.5	4.1	4.9
Other receipts[7]	19.8	21.4	23.3
Current receipts	**396.5**	**422.8**	**456.2**
Memo:			
North Sea revenues[8]	4.9	4.7	3.7

[1] *Gross of enhanced and payable tax credits.*
[2] *Includes enhanced company tax credits that offset tax liability.*
[3] *Includes district council rates in Northern Ireland paid by business.*
[4] *Includes VAT refunds and money paid into the National Lottery Distribution Fund.*
[5] *Includes VAT and 'traditional own resources' contributions to EC budget.*
[6] *Tax credits which are scored as negative tax in the calculation of NTSSC but expenditure in the national accounts.*
[7] *Includes gross operating surplus and rent; net of oil royalties and business rate payments by Local Authorites.*
[8] *Consists of North Sea coporation tax, petroleum revenue tax and royalties.*

Table B10: Net taxes and social security contributions 2003–04

	£ billion			Percentage change on 2002–03		
	Outturn[1] Apr–Oct	Estimate Nov–Mar	2003–04	Outturn[1] Apr–Oct	Estimate Nov–Mar	Full year
Inland Revenue						
Income tax and capital gains tax[2]	62.6	53.2	115.7	4.0	4.4	4.2
Social security contributions	40.7	31.9	72.6	9.0	16.7	12.3
Corporation tax[2]	19.3	9.6	28.9	–3.4	3.1	–1.3
Petroleum revenue tax	0.8	0.6	1.4	34.6	50.4	40.9
Inheritance tax	1.5	1.0	2.5	2.2	6.6	4.0
Stamp duties	4.4	3.2	7.5	–6.6	9.7	–0.4
Total Inland Revenue (net of tax credits)	**129.2**	**99.4**	**228.6**	**4.0**	**8.3**	**5.9**
Customs and Excise						
Value added tax	40.9	28.2	69.0	8.3	9.6	8.8
Fuel duties	13.3	9.6	22.9	2.4	4.5	3.3
Tobacco duties	4.8	3.2	8.0	–2.1	1.4	–0.7
Alcohol duties	4.3	3.2	7.5	3.7	2.4	3.1
Other Customs duties and levies	4.6	3.5	8.1	3.2	4.4	3.7
Total Customs and Excise	**67.9**	**47.6**	**115.5**	**5.6**	**7.1**	**6.2**
Vehicle excise duties	2.9	1.9	4.9	6.3	6.3	6.3
Business rates	13.2	5.4	18.7	0.9	1.8	1.1
Council tax	12.5	5.9	18.4	10.8	9.2	10.3
Other taxes and royalties	7.1	5.3	12.4	8.7	11.5	9.9
Net taxes and social security contributions	**232.9**	**165.6**	**398.6**	**4.8**	**7.8**	**6.1**

[1] *Provisional.*

[2] *Net of tax credits scored as negative tax in net taxes and social security contributions.*

Income tax and social security contributions

B45 Income tax receipts and social security contributions in 2003-04 are expected to be around £5 billion lower than forecast in Budget 2003. Most of this is the result of lower than expected growth of wages and salaries, which also reduces receipts in future years. As in Budget 2003, the average tax rate on income tax is assumed to recover over the forecast period, as financial company profits recover and corresponding bonuses, which are largely paid by higher-rate tax payers, increase. This bonus effect has less effect on national insurance contributions.

Non-North Sea corporation tax

B46 Non-North Sea corporation tax receipts in 2003-04 are estimated to be around £1½ billion below the Budget projection. This fall is largely due to lower than expected growth in company profits which also reduces receipts in future years. This is partly offset by higher tax receipts from life assurance companies as a result of higher equity prices.

B47 Table B10 shows that total corporation tax receipts (including North Sea corporation tax) in April to October 2003 were 3.4 per cent lower than in the corresponding months of 2002-03 but for the remainder of 2003-04 are expected to be 3.1 per cent higher. The comparison for the April to October period is affected by the final stage of the transition to quarterly instalment payments under which large companies had to make balancing payments in 2002 but not in 2003.

Tax credits **B48** Although the estimates of tax credits that are scored as negative tax in 2003-04 has not changed since the Budget, forecasts for future years have been revised downwards, which increases receipts by around £½ billion per year. This is largely a result of Inland Revenue updating their estimates of the negative tax share of total tax credits. However, the changes in these shares have no overall impact on the fiscal aggregates as they are offset by equal and opposite changes to expenditure, which are discussed in more detail in paragraph B70.

North Sea revenues **B49** North Sea revenues in 2003-04 are estimated to be broadly in line with the Budget projection. However, receipts from 2004-05 onwards are expected to be around £1 to 1½ billion lower, largely a result of lower oil production forecasts, and lower oil prices, as audited by the NAO.

Capital gains and inheritance tax **B50** Although equity prices are much higher than projected in Budget 2003, receipts from capital taxes in 2003-04 are expected to be marginally lower than the Budget projection. This is largely because capital gains tax receipts in 2003-04 are based on gains realised in 2002-03, and are unaffected by recent movements in equity prices. The full impact of higher equity prices and house prices does not feed into capital tax receipts until 2004-05.

Stamp duties **B51** Receipts from stamp duties from April to October in 2003-04 were 6.6 per cent lower than during the same period in 2002-03. This is mainly as a result of lower than expected levels of land and property transactions, which were 20 per cent down on the previous year. However, from the second half of 2003-04, this effect should be offset by the impact of higher equity and house prices.

VAT receipts **B52** Despite lower than expected growth in consumers' expenditure, VAT receipts in the first seven months of 2003-04 were much higher than expected. As a result, the full year projection has been revised up by around 2½ billion. This estimate cautiously makes an allowance of around £320m for the specific risk posed by claims arising from a European Court of Justice Judgment in relation to the three-year cap on repayments. This sum is in addition to around £40m paid from receipts in the 2002-03 financial year.

B53 It is not yet possible to assess fully the reasons for the higher than expected VAT receipts, although it may reflect caution in the assumptions used to forecast VAT revenues, namely that the underlying VAT to consumers' expenditure falls by 0.05 percentage points a year, and that only the direct and preventive, but not deterrent effects, of the VAT strategy announced in the 2002 Pre-Budget Report were included in the forecast.

B54 The forecast of VAT revenues from 2004-05 onwards continues to be governed by the assumptions described above, and has been revised upwards in all years.

Excise duties **B55** Excise duties in 2003-04 are estimated to be around £0.1 billion lower than forecast in the Budget. The upward revision to excise duties from 2004-05 onwards reflects upward revisions to the RPI forecast, (which increases forecast duty rates), a downward revision of the oil price forecast, and the introduction of an improved fuel duty model, developed in response to forecasting experience described in the 2003 *End of year fiscal report*.

Other receipts

B56 The upward revision to other taxes and royalties in 2003-04 largely reflects higher than expected VAT refunds for the year-to-date. These also score as public expenditure and therefore have no impact on net borrowing. Accruals adjustments in 2003-04 have been revised down by around £0.9 billion. This is mainly a result of lower accruals adjustments for income tax and NIC.

B57 In the Blue Book 2003, the Office for National Statistics (ONS) introduced changes in the definition of public sector current receipts so they no longer included business rates paid by local authorities. This change reduces receipts by around £1 billion and is included in the other receipts line. It is matched by a corresponding reduction in local authority expenditure, such that there is no overall impact on the fiscal aggregates.

Tax-GDP ratio

B58 Table B11 shows projections of receipts from major taxes as a per cent of GDP, and Table B12 sets out current and previous projections of the overall tax-GDP ratio.

B59 The tax-GDP ratio is expected to rise slightly in 2003-04, largely as a result of the NICs rate increase that came into effect on April 2003. The increase in the ratio from 2004-05 onwards is largely driven by the following factors:

- normal fiscal drag;
- the recovery of financial company profits; and
- strong growth in tax receipts such as VAT refunds which have no overall impact on fiscal aggregates.

Table B11: Current receipts as a proportion of GDP

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Income tax (gross of tax credits)	10.7	10.7	10.9	11.1	11.3	11.5	11.6
Social security contributions	6.1	6.5	6.7	6.7	6.7	6.8	6.8
Non-North Sea corporation tax[1]	2.5	2.3	2.7	3.0	3.1	3.2	3.2
Tax credits[2]	–0.3	–0.4	–0.3	–0.3	–0.3	–0.3	–0.3
North Sea revenues[3]	0.5	0.4	0.3	0.3	0.3	0.3	0.2
Value added tax	6.0	6.2	6.1	6.1	6.1	6.1	6.1
Excise duties[4]	3.6	3.5	3.5	3.4	3.4	3.3	3.2
Other taxes and royalties[5]	6.6	6.6	6.7	6.9	7.0	7.1	7.2
Net taxes and social security contributions[6]	**35.6**	**35.9**	**36.7**	**37.3**	**37.7**	**38.0**	**38.2**
Accruals adjustments on taxes	0.0	0.2	0.2	0.1	0.1	0.1	0.1
Less EC transfers	–0.4	–0.4	–0.3	–0.3	–0.3	–0.3	–0.3
Tax credits[7]	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other receipts[8]	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Current receipts	**37.6**	**38.1**	**38.9**	**39.5**	**39.9**	**40.2**	**40.4**

[1] *Gross of enhanced and payable tax credits.*
[2] *Tax credits scored as negative tax in net taxes and social security contributions.*
[3] *Includes oil royalties, petroleum revenue tax and North Sea corporation tax.*
[4] *Fuel. alcohol and tobacco duties.*
[5] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*
[6] *Includes VAT and 'own resources' contributions to EC budget. Cash basis.*
[7] *Tax credits scored as negative tax in net taxes and social security contributions but expenditure in the national accounts.*
[8] *Mainly gross operating surplus and rent, excluding oil royalties. Net of Local Authority business rate payments.*

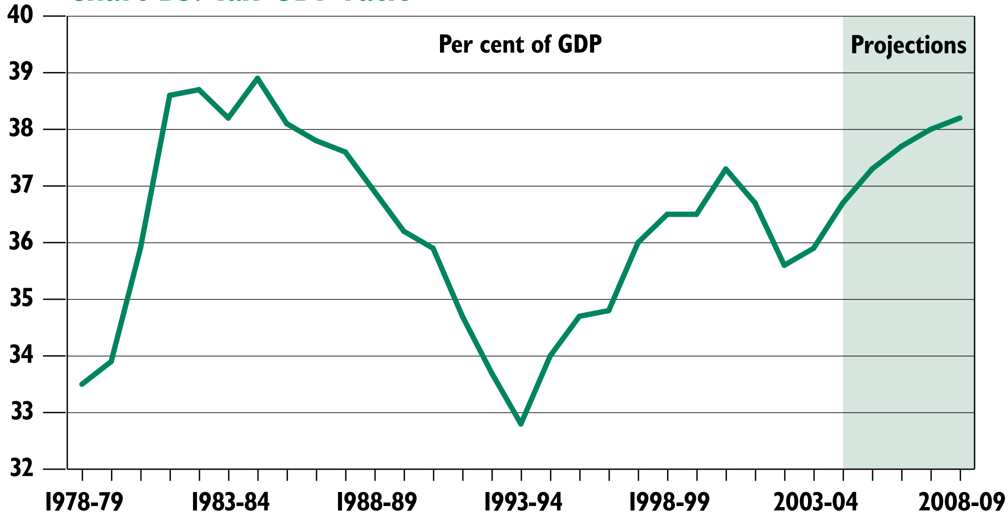
Table B12: Net taxes and social security contributions[1]

	Per cent of GDP						
	Outturn[2]	Estimate[3]	Projections				
	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Budget 2003	35.6	36.3	37.1	37.6	37.9	38.2	
PBR 2003	**35.6**	**35.9**	**36.7**	**37.3**	**37.7**	**38.0**	**38.2**

[1] Cash basis. Uses OECD definition of negative tax tax credits.
[2] The 2002–03 figures were estimates in Budget 2003.
[3] The 2003–04 figures were projections in Budget 2003.

B60 Chart B3 shows the tax-GDP ratio from 1978-79 to 2008-09.

Chart B3: Tax-GDP ratio[1]



[1] Net taxes and social security contributions as defined in Table B12.

PUBLIC EXPENDITURE

B61 Table B13 shows projections for public expenditure up to 2005-06, the last year covered by the 2002 Spending Review. The projections cover the whole of the public sector, using the national accounts aggregate Total Managed Expenditure (TME). TME is split into Departmental Expenditure Limits (DEL) – firm three year limits for departments' programme expenditure – and Annually Managed Expenditure (AME) – expenditure that is not easily subject to firm multi-year limits.

Table B13: Total Managed Expenditure 2002–03 to 2005–06

	£ billion			
	Outturn 2002–03	Estimate 2003–04	Projections 2004–05	2005–06
Departmental Expenditure Limits				
Resource Budget	235.6	252.1	264.2	283.6
Capital Budget	21.3	24.6	26.7	29.0
Less depreciation	–15.4	–10.5	–11.1	–11.9
Total Departmental Expenditure Limits	**241.6**	**266.3**	**279.9**	**300.7**
Annually Managed Expenditure				
Social security benefits[1]	105.6	112.8	117.7	123.0
Tax credits[1]	9.8	13.1	13.3	14.2
Housing Revenue Account subsidies	4.4	4.1	3.9	4.0
Common Agricultural Policy	2.7	2.6	2.5	2.5
Net public service pensions	1.3	–3.3	–3.8	–4.3
National Lottery	1.8	2.1	2.0	1.6
Non-cash items in AME	29.5	26.6	28.2	29.6
Other departmental expenditure	2.2	1.9	1.5	2.6
Net payments to EC institutions[2]	2.3	1.5	3.0	3.6
Locally financed expenditure	19.6	22.5	24.8	26.4
Central government gross debt interest	20.8	22.4	24.8	25.3
Public corporations' own-financed capital expenditure	2.0	2.5	2.6	2.5
Total AME before margin and accounting adjustments	**201.9**	**208.7**	**220.6**	**231.0**
AME margin	0.0	0.3	0.0	0.0
Accounting adjustments[3]	–24.4	–15.1	–13.2	–12.5
Annually Managed Expenditure	**177.5**	**193.9**	**207.4**	**218.4**
Total Managed Expenditure	**419.1**	**460.2**	**487.3**	**519.1**
of which:				
Public sector current expenditure	394.0	427.3	449.0	477.5
Public sector net investment	10.7	18.0	22.7	25.2
Public sector depreciation	14.4	14.8	15.5	16.3

[1] For 2002–03 to 2004–05, child allowances in Income Support and Jobseekers' Allowance, which, from 2003–04, are paid as part of the Child Tax Credit, have been included in the tax credits line and excluded from the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.

[2] Net payments to EC Institutions exclude the UK's contribution to the cost of EC aid to non-Member States (which is attributed to the aid programme).

Net payments therefore differ from the UK's net contribution to the EC Budget, latest estimates for which are (in £ billion):

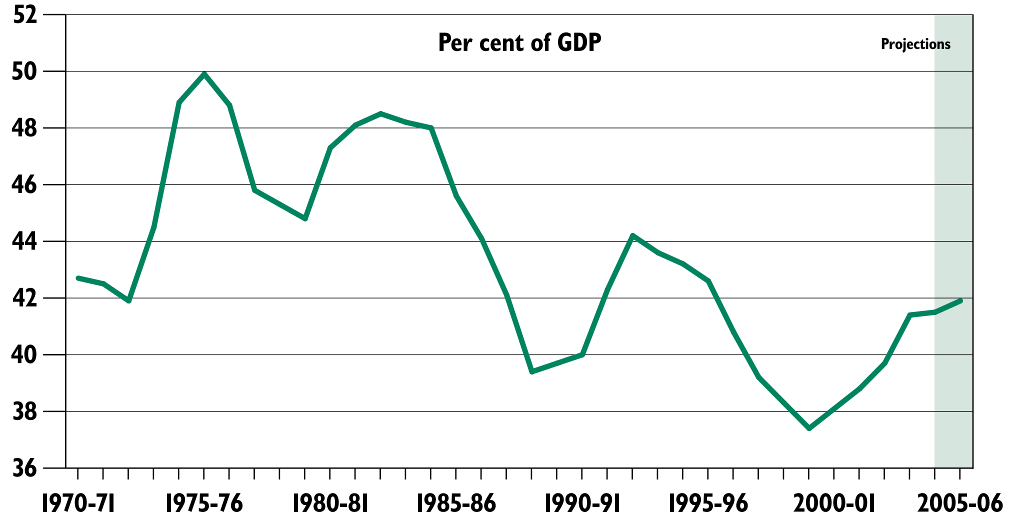
2002–03	2003–04	2004–05	2005–06
3.1	2.3	3.6	4.2

The trended forecast for 2003–04 is £3.0 billion.

[3] Excludes depreciation.

B62 Chart B4 shows TME as a percentage of GDP from 1970-71 to 2005-06.

Chart B4: Total Managed Expenditure



B63 Table B14 shows changes to DEL and AME components since the Budget. Figures for both aggregates have been adjusted to take account of reclassifications between DEL and AME, between resource and capital expenditure, and to take account of measures announced in this Pre-Budget Report. Forecasts of individual AME components were reviewed at the Budget and have been reviewed again for this Pre-Budget Report. The main economic assumptions underpinning the AME projections are set out in Box B2 and Table B3. In particular, it is assumed that the UK unemployment claimant count increases to 0.95 million in 2005-06, rising from recent levels of 0.93 million in line with the average of independent forecasts.

Table B14: Changes to Total Managed Expenditure since Budget 2003

	£ billion			
	Outturn 2002–03	Estimate 2003–04	Projections 2004–05	2005–06
Departmental Expenditure Limits				
Resource Budget	–5.9	3.0	0.4	0.1
Capital Budget	0.6	–0.5	–0.1	–0.1
Less depreciation	2.9	–0.1	0.0	–0.1
Total Departmental Expenditure Limits	**–2.4**	**2.5**	**0.4**	**–0.1**
Annually Managed Expenditure				
Social security benefits	0.1	1.8	1.0	1.1
Tax credits	0.0	1.4	1.2	1.7
Housing Revenue Account subsidies	0.1	–0.1	–0.1	–0.1
Common Agricultural Policy	0.1	0.2	0.2	0.2
Net public service pensions	–2.3	–3.5	–3.9	–4.2
National Lottery	–0.1	–0.1	0.1	0.1
Non–cash items in AME	1.6	1.3	1.9	2.1
Other departmental expenditure	–0.2	–0.3	–0.3	0.6
Net payments to EC institutions	0.0	–0.9	0.0	0.3
Locally financed expenditure	–1.1	–0.4	0.1	0.3
Central government gross debt interest	0.0	0.5	1.6	1.0
Public corporations' own–financed capital expenditure	–0.2	–0.1	0.0	–0.2
Total AME before margin and accounting adjustments	**–1.8**	**–0.2**	**1.7**	**2.8**
AME margin	0.0	–0.7	–2.0	–3.0
Accounting Adjustments	2.3	3.0	2.5	2.9
Annually Managed Expenditure	**0.5**	**2.1**	**2.2**	**2.6**
Total Managed Expenditure	**–2.0**	**4.5**	**2.6**	**2.6**
of which:				
Public sector current expenditure	–1.0	5.1	2.5	2.3
Public sector net investment	–1.5	–0.9	–0.3	–0.2
Public sector depreciation	0.6	0.4	0.3	0.4

B64 Table B15 shows DEL for resource and capital budgets by department. DEL for 2003-04 to 2005-06 was set in the 2002 Spending Review. These budgets are controlled on a full resource budgeting basis, which means that the full economic cost of departmental activity will be recognised in budgets. DEL for 2002-03 was set in the 2000 Spending Review, and was controlled on a near cash basis.

B65 Within DEL, there have been some minor classification changes or switches between capital and resource DEL which have not affected TME. The main change to total DEL is the addition to the special reserve in 2003-04. In Budget 2003, the Government made a special contingency provision of £3 billion to meet the costs of the military conflict in Iraq and its other international obligations. Of that special reserve, £1 billion was allocated to the Ministry of Defence DEL in 2002-03 with the rest remaining unallocated. A further £1.3 billion of current spending has been charged against the special reserve in 2003-04. In this Pre-Budget Report, the Government carries forward the unallocated special reserve into 2003-04 and for prudence, adds a further £500 million, taking provision in the special reserve in 2003-04 to £2.5 billion. A further £300 million will be added in 2004-05 as a prudent allowance against continuing commitments. This will ensure that the Government is able to meet its international commitments in Iraq and elsewhere in the war against terrorism.

B66 As part of the extension to the VAT strategy, an extra £50 million DEL has been allocated to HM Customs and Excise over the Spending Review 2002 period.

B67 It is assumed in this Pre-Budget Report that the outturn for 2003-04 will equal total DEL plans and that over the course of the year, underspends will offset the drawdown of end-year flexibility.

Table B15: Departmental Expenditure Limits – resource and capital budgets

	£ billion			
	Outturn		Plans	
	2002–03	2003–04	2004–05	2005–06
Resource Budget				
Education and Skills	21.1	22.8	23.9	25.9
Health	55.9	63.1	68.5	74.7
of which: NHS	54.2	61.4	66.5	72.7
Transport	6.1	7.7	7.5	8.4
Office of the Deputy Prime Minister	4.0	5.0	5.2	5.4
Local Government	37.4	41.0	44.4	48.0
Home Office	11.4	11.7	11.6	12.4
Departments for Constitutional Affairs	3.2	3.1	3.3	3.4
Attorney General's Departments	0.5	0.6	0.5	0.5
Defence	36.2[1]	32.0	31.5	32.3
Foreign and Commonwealth Office	1.5	1.7	1.5	1.6
International Development	3.6	3.8	3.8	4.5
Trade and Industry	4.2	4.9	5.0	5.5
Environment, Food and Rural Affairs	2.6	2.9	2.7	2.8
Culture, Media and Sport	1.2	1.4	1.5	1.5
Work and Pensions	7.3	8.3	8.1	8.2
Scotland[2]	16.6	18.7	19.4	20.7
Wales[2]	9.1	9.8	10.4	11.1
Northern Ireland Executive[2]	6.6	6.4	6.7	7.1
Northern Ireland Office	1.2	1.1	1.2	1.2
Chancellor's Departments	4.3	4.8	4.7	4.9
Cabinet Office	1.6	1.9	1.9	1.9
Invest to Save Budget	0.0	0.0	0.0	0.0
Reserve	0.0	0.3	0.8	1.6
Unallocated special reserve[3]	0.0	1.2	0.3	0.0
Allowance for shortfall[4]	0.0	–2.0	0.0	0.0
Total Resource Budget DEL	**235.6**	**252.1**	**264.2**	**283.6**
Capital Budget				
Education and Skills	2.7	3.4	3.8	4.3
Health	2.0	2.7	3.5	4.4
of which: NHS	1.9	2.6	3.4	4.4
Transport	3.0	3.3	3.6	3.3
Office of the Deputy Prime Minister	1.5	1.9	2.0	2.1
Local Government	0.2	0.3	0.3	0.3
Home Office	0.8	1.1	1.1	1.1
Departments for Constitutional Affairs	0.1	0.1	0.1	0.1
Attorney General's Departments	0.0	0.0	0.0	0.0
Defence	6.2	6.5	6.4	7.0
Foreign and Commonwealth Office	0.1	0.1	0.1	0.1
International Development	0.0	0.0	0.0	0.0
Trade and Industry	0.3	0.6	0.2	0.1
Environment, Food and Rural Affairs	0.3	0.4	0.3	0.3
Culture, Media and Sport	0.0	0.2	0.1	0.1
Work and Pensions	0.2	0.0	0.2	0.1
Scotland[2]	2.1	2.1	2.2	2.3
Wales[2]	0.7	0.8	0.9	1.0
Northern Ireland Executive[2]	0.5	0.4	0.5	0.5
Northern Ireland Office	0.1	0.1	0.1	0.1
Chancellor's Departments	0.3	0.3	0.3	0.3
Cabinet Office	0.2	0.6	0.2	0.2
Invest to Save Budget	0.0	0.0	0.0	0.0
Reserve	0.0	0.2	0.8	1.1
Allowance for shortfall[4]	0.0	–0.5	0.0	0.0
Total Capital Budget DEL	**21.3**	**24.6**	**26.7**	**29.0**
Depreciation	**–15.4**	**–10.5**	**–11.1**	**–11.9**
Total Departmental Expenditure Limits	**241.6**	**266.3**	**279.9**	**300.7**
Total education spending	53.3	58.6	62.9	68.5

[1] Change since Budget is due to application of reduction in cost of capital charge and discount rate previously omitted for 2002–03, and a revision to non cash in line with agreed asset management policy.
[2] For Scotland, Wales and Northern Ireland, the split between current and capital budgets is decided by the respective executives.
[3] £2.5bn allocated to the Special Reserve in 2003–04 against which £1.3bn has been charged to date.
[4] It is assumed that over the year underspend in total will offset the drawdown of end–year flexibility.

B68 Changes to AME programmes reflect a combination of factors discussed below.

B69 There has been a net increase in the social security benefits forecast since the Budget due to a number of factors, including benefit uprating and increases in expenditure on the Supporting People programme, which provides housing related support to vulnerable people. Unemployment related benefit expenditure has partially offset these increases because of a lower unemployment assumption than at the Budget.

B70 Compared to Budget 2003 forecasts, spending on low and moderate income families with children through the Child Tax Credit (CTC) and the Working Tax Credit (WTC) has increased for 2003-04 because of higher than predicted take-up by working families entitled to more than the family element of CTC. In addition, as shown in Table B4, total payments of CTC will be around £0.9 billion a year higher from 2004-05 because of the increase in the child element announced in this Pre-Budget Report. About £0.8 billion of this scores as spending. Much of the remaining forecast increase in expenditure in 2004-05 and 2005-06 reflects a switch between tax credits scoring as negative tax and those scoring as expenditure.

B71 Net public service pensions figures are reported on a Financial Reporting Standard 17 (FRS17) basis and record movements in the change in the liability of the various pension schemes including the accruing costs as members serve additional years. Changes reflect the initial overestimation of pension scheme liabilities following the introduction of FRS17 at Budget 2003, which have now been re-evaluated. National accounts pensions expenditure, which is recorded on a transactions basis, shows only small changes from Budget 2003.

B72 Net payments to EC institutions have been reduced by £900 million in 2003-04. This difference is primarily the result of switching from the use of a trend forecast at the Budget to a spot forecast for the Pre-Budget Report.

B73 Central government gross debt interest payments are higher than at the Budget. This reflects revisions to borrowing and slightly higher projections for inflation, affecting the accrued uplift for index-linked gilts, together with generally higher market expectations for interest rates.

B74 The main accounting adjustments, which consist of those items within TME but outside DEL and AME main programmes, are shown in Table B16. These adjustments are necessary to reconcile DEL and AME to national accounts. They include changes in respect of the adjustments to net public service pensions figures (see paragraph B71). Increases to the accounting adjustments are mainly the result of higher forecasts for VAT refunded on general government expenditure, due to higher than expected outturn data. Increased VAT refunds are offset by equivalent changes in receipts and are therefore TME neutral.

Table B16: Accounting adjustments

	£ billion			
	Outturn	Estimate	Projections	
	2002–03	2003–04	2004–05	2005–06
Removal of non-cash spending in DEL[1]	–9.5	–6.3	–7.1	–7.5
Financial transactions in DEL	–1.1	–1.6	–1.1	–1.1
Removal of non–cash spending in AME	–28.9	–21.4	–22.8	–23.6
Financial transactions in AME	–0.4	–0.1	0.7	0.6
Adjustments for public corporations	3.2	3.4	3.5	3.7
Central government non–trading capital consumption	9.4	9.7	10.2	10.7
VAT refunded on general government expenditure	8.8	10.4	11.2	12.4
EC contributions	–4.1	–4.5	–4.0	–3.9
Tax credits	1.3	0.8	0.8	0.9
Intra–general government debt interest	–3.6	–2.5	–2.8	–2.8
Other accounting adjustments	0.6	–2.9	–1.6	–1.9
Total accounting adjustments	**–24.4**	**–15.1**	**–13.2**	**–12.5**

[1] *Excluding depreciation in resource DEL.*

B75 Table B17 shows public sector capital expenditure from 2002-03 to 2005-06.

Table B17: Public sector capital expenditure

	£ billion			
	Outturn	Estimate	Projections	
	2002–03	2003–04	2004–05	2005–06
Capital Budget DEL	21.3	24.6	26.7	29.0
Locally financed expenditure	0.3	1.4	2.4	2.3
National Lottery	0.9	1.1	1.0	0.8
Public corporations' own-financed capital expenditure	2.0	2.5	2.6	2.5
Other capital spending in AME	0.6	2.9	5.4	7.0
AME margin	0.0	0.3	0.0	0.0
Public sector gross investment[1]	**25.1**	**32.9**	**38.2**	**41.6**
Less depreciation	14.4	14.8	15.5	16.3
Public sector net investment	**10.7**	**18.0**	**22.7**	**25.2**
Proceeds from the sale of fixed assets[2]	4.7	3.8	3.8	3.8

[1] *This and previous lines are all net of sales of fixed assets.*
[2] *Projections of total receipts from the sale of fixed assets by public sector.*

B76 Table B18 shows estimated receipts from loans and sales of assets from 2002-03 to 2005-06. The figures for sales of financial assets include proceeds of £0.1 billion for the sale of a stake in QinetiQ (formerly the Defence Evaluation and Research Agency) in the first quarter of 2003. The proceeds of the Public Private Partnership (PPP) will be £0.2 billion, including receipts in 2001-02 and those due in future years.

Table B18: Loans and sales of assets

	£ billion			
	Outturn	Estimate	Projections	
	2002–03	2003–04	2004–05	2005–06
Sales of fixed assets				
Central government	1.0	1.0	1.0	1.0
Local authorities	3.7	2.8	2.8	2.8
Total sales of fixed assets	**4.7**	**3.8**	**3.8**	**3.8**
Total loans and sales of financial assets	**–2.8**	**–2.2**	**–1.5**	**–1.5**
Total loans and sales of assets	**1.9**	**1.5**	**2.3**	**2.3**

FINANCING REQUIREMENT

B77 Table B19 presents projections of the net cash requirement by sector, giving details of financial transactions that do not affect net borrowing (the change in the sector's net financial indebtedness) but do affect its financing requirement.

Table B19: Public sector net cash requirement

	£ billion							
	2003–04				2004–05			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing	**38.0**	**–0.9**	**0.2**	**37.4**	**30.8**	**–0.1**	**0.4**	**31.1**
Financial transactions								
Net lending to private sector and abroad	2.3	–0.1	0.0	2.2	1.5	–0.1	0.0	1.4
Cash expenditure on company securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Accounts receivable/payable	2.2	0.1	0.0	2.3	1.4	0.1	0.0	1.5
Adjustment for interest on gilts	–1.3	0.0	0.0	–1.3	–2.6	0.0	0.0	–2.6
Miscellaneous financial transactions	0.0	0.0	–0.7	–0.7	0.0	0.0	–0.7	–0.7
Own account net cash requirement	41.2	–0.8	–0.5	39.9	31.2	0.0	–0.3	30.8
Net lending within the public sector	–0.7	2.0	–1.3	0.0	2.1	–1.0	–1.1	0.0
Net cash requirement[1]	**40.5**	**1.2**	**–1.8**	**39.9**	**33.3**	**–1.0**	**–1.4**	**30.8**

[1] *Market and overseas borrowing for local government and public corporation sectors.*

B78 Changes to the estimates of the accruals adjustments for central government receipts and spending since the Budget mean that the effect of accounts receivable/payable on the 2003-04 central government cash requirement is now £2.5 billion lower. In addition, latest available estimates on net lending to the rest of the public sector reduces the central government cash requirement by £0.7 billion in 2003-04 rather than increasing it by £2.1 billion, as expected at Budget 2003.

B79 Table B20 updates the financing arithmetic for 2003-04 in line with the updated fiscal forecasts. The central government net cash requirement for 2003-04 is now forecast to be £40.5 billion, an increase of £5.2 billion from the Budget 2003 forecast. The issuance of a US$3 billion bond in order to finance the official reserves and an increase in National Savings and Investments' forecast for their net contribution means that the net financing requirement for 2003-04 is now forecast to be £57.1 billion, an increase of £2.3 billion from the forecast published in Budget 2003.

B80 In order to meet the increase in the financing requirement, the Debt Management Office's gilt remit has been revised and they have been instructed to increase forecast gross gilts issuance by £2.3 billion to £49.7 billion. Full details of all these measures and a revised financing table for 2003-04 can be found on the Debt Management Office's website (www.dmo.gov.uk).

Table B20: Financing requirement forecast

	2003–04		
£ billion	**Provisional remit[1] March 2003**	**Revised remit April 2003**	**Pre-Budget Report**
Central government net cash requirement	**30.2**	**35.3**	**40.5**
Net financing of official reserves			**–1.6**
Gilt redemptions	21.1	21.1	21.1
Debt buy-backs			0.2
Gross Financing requirement	**51.3**	**56.4**	**60.2**
Less assumed net National Savings and Investments' contribution	1.5	1.5	3.0
Less change in DMO balance at the Bank of England	0.0	0.1	0.1
Net financing requirement	**49.8**	**54.8**	**57.1**
Changes in short-term debt			
Less changes in Ways and Means facility	0.0	0.0	0.0
Less increase in planned Treasury bill stock	3.2	3.2	3.3
Less change in other net short-term debt[2]	6.6	4.2	4.1
Planned gross gilt sales	**40.0**	**47.4**	**49.7**
Gilt sales to date (April–December 2003)			40.0
of which:			
Short conventionals (1–7 years)			13.1
Medium conventionals (7–15 years)			13.1
Long conventionals (>15 years)			8.9
Index-linked			4.9
Further planned gilt sales			
Short conventionals (1–7 years)			5.7
Medium conventionals (7–15 years)			0.0
Long conventionals (>15 years)			2.5
Index-linked			1.6

Note: Figures may not sum due to rounding.

[1] The Provisional Debt Management Report 2003-04 was published on 20 March 2003 in advance of Budget 2003 in order to comply with the Code for fiscal stability.

[2] Excluding DMO cash deposit at the Bank of England.

ANALYSIS BY SUBSECTOR AND ECONOMIC CATEGORY

B81 Table B21 shows a breakdown of general government transactions by economic category for 2002-03 to 2005-06. Table B22 shows a more detailed breakdown for public sector transactions by sub-sector and economic category for each of these years.

Table B21: General government transactions by economic category

	£ billion			
	Outturn	Estimate	Projections	
	2002–03	2003–04	2004–05	2005–06
Current receipts				
Taxes on income and wealth	143.3	147.5	163.1	178.8
Taxes on production and imports	142.2	150.8	160.2	169.8
Other current taxes	19.7	21.5	23.1	25.0
Taxes on capital	2.4	2.5	2.8	3.0
Social contributions	63.5	74.1	78.8	83.1
Gross operating surplus	9.4	9.7	10.2	10.7
Rent and other current transfers	2.0	1.6	1.7	1.7
Interest and dividends from private sector and abroad	3.9	3.5	4.3	4.4
Interest and dividends from public sector	7.2	7.7	8.0	8.4
Total current receipts	**393.5**	**418.8**	**452.2**	**484.9**
Current expenditure				
Current expenditure on goods and services	214.4	234.7	247.6	265.6
Subsidies	6.8	8.6	8.6	9.1
Net social benefits	128.8	138.3	145.2	151.9
Net current grants abroad	–0.6	–0.5	–1.4	–2.2
Other current grants	23.4	23.5	23.7	27.4
Interest and dividends paid	21.2	22.6	25.0	25.5
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**393.9**	**427.3**	**448.9**	**477.3**
Depreciation	9.4	9.7	10.2	10.7
Surplus on current budget	**–9.8**	**–18.1**	**–6.9**	**–3.1**
Capital expenditure				
Gross domestic fixed capital formation	13.0	18.9	23.2	25.2
Less depreciation	–9.4	–9.7	–10.2	–10.7
Increase in inventories	0.0	0.0	0.6	0.3
Capital grants (net) within public sector	1.4	0.5	0.6	0.6
Capital grants to private sector	7.8	9.8	10.6	12.3
Capital grants from private sector	–0.9	–0.9	–1.1	–1.0
AME margin	0.0	0.3	0.0	0.0
Net investment	**11.9**	**19.0**	**23.9**	**26.8**
Net borrowing[1]	**21.7**	**37.2**	**30.7**	**29.9**
of which:				
Central government net borrowing	23.8	38.0	30.8	30.5
Local authority net borrowing	–2.1	–0.9	–0.1	–0.6
Gross debt (Maastricht basis)				
Central government	347.1	383.0	418.9	453.8
Local government	52.7	53.8	52.8	51.2

[1] *Although this is based on the ESA95 definition of general government net borrowing (GGNB), the projections are identical to GGNB calculated on a Maastricht definition.*

Table B22: Public sector transactions by sub–sector and economic category

	£ billion			
	2002–03			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	143.3	0.0	–0.1	143.2
Taxes on production and imports	142.0	0.1	0.0	142.2
Other current taxes	3.8	15.8	0.0	19.7
Taxes on capital	2.4	0.0	0.0	2.4
Social contributions	63.5	0.0	0.0	63.5
Gross operating surplus	4.5	4.9	9.1	18.5
Rent and other current transfers	2.0	0.0	0.6	2.6
Interest and dividends from private sector and abroad	3.3	0.7	0.5	4.5
Interest and dividends from public sector	6.2	1.0	–7.2	0.0
Total current receipts	**371.0**	**22.5**	**3.0**	**396.5**
Current expenditure				
Current expenditure on goods and services	131.1	83.3	0.0	214.4
Subsidies	5.7	1.1	0.0	6.8
Net social benefits	115.6	13.1	0.0	128.8
Net current grants abroad	–0.6	0.0	0.0	–0.6
Current grants (net) within public sector	78.7	–78.7	0.0	0.0
Other current grants	23.3	0.0	0.0	23.4
Interest and dividends paid	20.9	0.3	0.1	21.3
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**374.7**	**19.2**	**0.1**	**394.0**
Depreciation	4.5	4.9	5.0	14.4
Surplus on current budget	**–8.2**	**–1.5**	**–2.1**	**–11.8**
Capital expenditure				
Gross domestic fixed capital formation	4.9	8.1	5.0	17.9
Less depreciation	–4.5	–4.9	–5.0	–14.4
Increase in inventories	0.0	0.0	–0.1	–0.1
Capital grants (net) within public sector	8.8	–7.4	–1.4	0.0
Capital grants to private sector	6.7	1.1	0.3	8.1
Capital grants from private sector	–0.4	–0.5	0.0	–0.9
AME margin	0.0	0.0	0.0	0.0
Net investment	**15.5**	**–3.6**	**–1.2**	**10.7**
Net borrowing	**23.8**	**–2.1**	**0.8**	**22.5**

Table B22: Public sector transactions by sub-sector and economic category

	£ billion			
	2003–04			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Taxes on income and wealth	147.5	0.0	–0.1	147.4
Taxes on production and imports	150.7	0.1	0.0	150.8
Other current taxes	4.0	17.5	0.0	21.5
Taxes on capital	2.5	0.0	0.0	2.5
Social contributions	74.1	0.0	0.0	74.1
Gross operating surplus	4.6	5.1	11.2	20.8
Rent and other current transfers	1.6	0.0	0.0	1.6
Interest and dividends from private sector and abroad	2.7	0.7	0.6	4.1
Interest and dividends from public sector	5.0	2.7	–7.7	0.0
Total current receipts	**392.7**	**26.1**	**4.1**	**422.8**
Current expenditure				
Current expenditure on goods and services	143.2	91.4	0.0	234.7
Subsidies	7.5	1.1	0.0	8.6
Net social benefits	123.4	14.9	0.0	138.3
Net current grants abroad	–0.5	0.0	0.0	–0.5
Current grants (net) within public sector	86.7	–86.7	0.0	0.0
Other current grants	23.5	0.0	0.0	23.5
Interest and dividends paid	22.4	0.3	0.1	22.7
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**406.2**	**21.0**	**0.1**	**427.3**
Depreciation	4.6	5.1	5.2	14.8
Surplus on current budget	**–18.2**	**0.0**	**–1.2**	**–19.3**
Capital expenditure				
Gross domestic fixed capital formation	8.4	10.5	4.4	23.3
Less depreciation	–4.6	–5.1	–5.2	–14.8
Increase in inventories	0.0	0.0	0.0	0.0
Capital grants (net) within public sector	7.5	–6.9	–0.5	0.0
Capital grants to private sector	8.6	1.2	0.3	10.1
Capital grants from private sector	–0.4	–0.5	0.0	–0.9
AME margin	0.3	0.0	0.0	0.3
Net investment	**19.9**	**–0.9**	**–1.0**	**18.0**
Net borrowing	**38.0**	**–0.9**	**0.2**	**37.4**

Table B22: Public sector transactions by sub-sector and economic category

	£ billion			
	2004–05			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	163.1	0.0	–0.1	163.1
Taxes on production and imports	160.1	0.2	0.0	160.2
Other current taxes	4.2	18.9	0.0	23.1
Taxes on capital	2.8	0.0	0.0	2.8
Social contributions	78.8	0.0	0.0	78.8
Gross operating surplus	4.9	5.3	11.5	21.6
Rent and other current transfers	1.7	0.0	0.0	1.7
Interest and dividends from private sector and abroad	3.4	0.9	0.6	4.9
Interest and dividends from public sector	4.3	3.7	–8.0	0.0
Total current receipts	**423.2**	**29.0**	**4.0**	**456.2**
Current expenditure				
Current expenditure on goods and services	151.2	96.5	0.0	247.6
Subsidies	7.4	1.2	0.0	8.6
Net social benefits	130.0	15.2	0.0	145.2
Net current grants abroad	–1.4	0.0	0.0	–1.4
Current grants (net) within public sector	91.1	–91.1	0.0	0.0
Other current grants	23.7	0.0	0.0	23.7
Interest and dividends paid	24.8	0.3	0.2	25.2
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**426.7**	**22.1**	**0.2**	**449.0**
Depreciation	4.9	5.3	5.4	15.5
Surplus on current budget	**–8.4**	**1.5**	**–1.5**	**–8.4**
Capital expenditure				
Gross domestic fixed capital formation	9.6	13.6	4.6	27.8
Less depreciation	–4.9	–5.3	–5.4	–15.5
Increase in inventories	0.6	0.0	0.0	0.6
Capital grants (net) within public sector	8.1	–7.5	–0.6	0.0
Capital grants to private sector	9.3	1.3	0.3	10.9
Capital grants from private sector	–0.4	–0.7	0.0	–1.1
AME margin	0.0	0.0	0.0	0.0
Net investment	**22.4**	**1.5**	**–1.2**	**22.7**
Net borrowing	**30.8**	**–0.1**	**0.4**	**31.1**

Table B22: Public sector transactions by sub-sector and economic category

	£ billion			
	2005–06			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	178.8	0.0	–0.1	178.8
Taxes on production and imports	169.6	0.2	0.0	169.8
Other current taxes	4.5	20.5	0.0	25.0
Taxes on capital	3.0	0.0	0.0	3.0
Social contributions	83.1	0.0	0.0	83.1
Gross operating surplus	5.2	5.6	12.0	22.8
Rent and other current transfers	1.7	0.0	0.0	1.7
Interest and dividends from private sector and abroad	3.3	1.1	0.7	5.1
Interest and dividends from public sector	4.5	3.9	–8.4	0.0
Total current receipts	**453.7**	**31.2**	**4.2**	**489.2**
Current expenditure				
Current expenditure on goods and services	161.9	103.7	0.0	265.6
Subsidies	7.8	1.3	0.0	9.1
Net social benefits	136.4	15.5	0.0	151.9
Net current grants abroad	–2.2	0.0	0.0	–2.2
Current grants (net) within public sector	96.9	–96.9	0.0	0.0
Other current grants	27.4	0.0	0.0	27.4
Interest and dividends paid	25.3	0.3	0.2	25.7
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**453.4**	**23.9**	**0.2**	**477.5**
Depreciation	5.2	5.6	5.6	16.3
Surplus on current budget	**–4.9**	**1.7**	**–1.6**	**–4.7**
Capital expenditure				
Gross domestic fixed capital formation	11.2	14.1	4.4	29.6
Less depreciation	–5.2	–5.6	–5.6	–16.3
Increase in inventories	0.3	0.0	0.0	0.3
Capital grants (net) within public sector	8.8	–8.2	–0.6	0.0
Capital grants to private sector	10.9	1.4	0.3	12.5
Capital grants from private sector	–0.4	–0.6	0.0	–1.0
AME margin	0.0	0.0	0.0	0.0
Net investment	**25.7**	**1.1**	**–1.5**	**25.2**
Net borrowing	**30.5**	**–0.6**	**0.0**	**29.9**

HISTORICAL SERIES

Table B23: Historical series of public sector balances, receipts and debt

Per cent of GDP

	Public sector current budget	Cyclically-adjusted surplus on current budget	Public sector net borrowing	Cyclically-adjusted public sector net borrowing	Public sector net cash requirement	Net taxes and social security contributions	Public sector current receipts	Public sector net debt[1]	Public sector net worth[2]
1970–71	6.7	7.3	–0.6	–1.2	1.2		43.3		
1971–72	4.2	5.2	1.1	0.0	1.4		41.4		
1972–73	2.0	2.2	2.8	2.6	3.6		39.0		
1973–74	0.3	–1.0	4.9	6.2	5.9		39.6		
1974–75	–1.1	–2.3	6.6	7.8	9.0		42.3	52.1	
1975–76	–1.6	–1.3	7.0	6.7	9.3		42.9	53.9	
1976–77	–1.2	–0.2	5.5	4.6	6.4		43.3	52.4	
1977–78	–1.4	–0.3	4.3	3.2	3.7		41.5	49.0	
1978–79	–2.6	–1.6	5.0	4.0	5.2	33.5	40.2	47.1	
1979–80	–1.9	–1.2	4.1	3.4	4.7	33.9	40.7	43.9	
1980–81	–3.0	–0.6	4.9	2.4	5.2	35.9	42.4	46.1	
1981–82	–1.4	3.0	2.3	–2.1	3.3	38.6	45.8	46.1	
1982–83	–1.5	2.9	3.0	–1.4	3.2	38.7	45.5	44.8	
1983–84	–2.0	1.5	3.8	0.3	3.2	38.2	44.4	45.3	
1984–85	–2.2	0.6	3.7	0.9	3.1	38.9	44.3	45.2	
1985–86	–1.2	0.4	2.4	0.8	1.6	38.1	43.2	43.4	
1986–87	–1.4	–1.3	2.1	2.0	0.9	37.8	42.0	41.1	
1987–88	–0.3	–1.7	1.0	2.3	–0.7	37.6	41.1	36.8	73.6
1988–89	1.7	–1.0	–1.3	1.3	–3.0	36.9	40.7	30.6	78.7
1989–90	1.4	–1.5	–0.2	2.7	–1.3	36.2	39.9	27.7	70.6
1990–91	0.4	–1.2	1.0	2.7	–0.1	35.9	38.9	26.2	60.0
1991–92	–1.9	–1.5	3.8	3.4	2.3	34.7	38.6	27.4	52.7
1992–93	–5.6	–3.7	7.6	5.7	5.9	33.7	36.6	32.0	40.0
1993–94	–6.2	–4.0	7.8	5.6	7.1	32.8	35.7	37.1	28.4
1994–95	–4.8	–3.3	6.3	4.8	5.3	34.0	36.9	40.8	27.7
1995–96	–3.3	–2.5	4.8	4.0	4.3	34.7	37.8	42.8	19.9
1996–97	–2.8	–2.3	3.5	3.0	2.9	34.8	37.2	43.7	16.3
1997–98	–0.1	–0.1	0.8	0.7	0.1	36.0	38.4	41.4	12.9
1998–99	1.1	0.8	–0.4	–0.1	–0.8	36.5	38.7	39.1	11.8
1999–00	2.1	1.8	–1.7	–1.3	–0.9	36.5	39.0	36.2	14.9
2000–01	2.1	1.4	–1.6	–0.9	–3.9	37.3	39.7	31.2	20.0
2001–02	0.9	0.6	0.1	0.3	0.3	36.7	38.8	30.2	24.9
2002–03	–1.1	–0.6	2.1	1.6	2.1	35.6	37.6	30.9	24.3

[1] *At end-March; GDP centred on end-March.*

[2] *At end-December; GDP centred on end-December.*

Table B24: Historical series of government expenditure

	£ billion (2002–03 prices)				Per cent of GDP			
	Public sector current expenditure	Public sector net investment	Public sector gross investment[1]	Total Managed Expenditure	Public sector current expenditure	Public sector net investment	Public sector gross investment[1]	Total Managed Expenditure
1970–71	165.8	31.1	50.9	216.7	32.6	6.1	10.0	42.7
1971–72	173.9	27.5	47.9	221.8	33.3	5.3	9.2	42.5
1972–73	181.3	26.4	47.7	229.0	33.1	4.8	8.7	41.9
1973–74	199.6	29.7	53.7	253.3	35.1	5.2	9.4	44.5
1974–75	220.9	31.4	57.1	278.1	38.8	5.5	10.0	48.9
1975–76	225.6	30.8	56.7	282.3	39.9	5.5	10.0	49.9
1976–77	232.1	25.2	51.9	284.1	39.9	4.3	8.9	48.8
1977–78	228.9	17.1	43.9	272.9	38.4	2.9	7.4	45.8
1978–79	235.8	14.9	42.3	278.2	38.4	2.4	6.9	45.3
1979–80	241.5	13.8	41.6	283.1	38.2	2.2	6.6	44.8
1980–81	248.9	11.1	39.3	288.1	40.8	1.8	6.4	47.3
1981–82	260.1	5.7	33.6	293.7	42.6	0.9	5.5	48.1
1982–83	265.5	9.3	36.4	301.9	42.7	1.5	5.9	48.5
1983–84	274.0	11.5	38.5	312.4	42.3	1.8	5.9	48.2
1984–85	281.5	10.1	35.8	317.3	42.6	1.5	5.4	48.0
1985–86	281.6	8.6	31.4	313.0	41.0	1.2	4.6	45.6
1986–87	286.0	5.1	28.3	314.4	40.1	0.7	4.0	44.1
1987–88	289.3	5.0	26.3	315.6	38.6	0.7	3.5	42.1
1988–89	282.3	2.8	24.9	307.2	36.2	0.4	3.2	39.4
1989–90	284.5	9.5	31.8	316.3	35.7	1.2	4.0	39.7
1990–91	286.0	11.5	30.8	316.8	36.1	1.4	3.9	40.0
1991–92	303.3	14.6	30.9	334.2	38.4	1.8	3.9	42.3
1992–93	318.2	15.9	31.1	349.3	40.3	2.0	3.9	44.2
1993–94	327.9	12.9	27.9	355.8	40.1	1.6	3.4	43.6
1994–95	339.0	12.8	28.2	367.2	39.8	1.5	3.3	43.2
1995–96	343.9	12.4	27.8	371.7	39.4	1.4	3.2	42.6
1996–97	344.6	6.8	20.6	365.2	38.5	0.8	2.3	40.8
1997–98	344.5	6.3	19.7	364.2	37.1	0.7	2.1	39.2
1998–99	344.4	7.0	20.6	364.9	36.1	0.7	2.2	38.3
1999–00	350.5	4.5	18.3	368.8	35.5	0.5	1.9	37.4
2000–01	369.6	5.3	19.3	388.9	36.2	0.5	1.9	38.1
2001–02	379.3	9.9	24.1	403.3	36.5	0.9	2.3	38.8
2002–03	394.0	10.7	25.1	419.1	37.3	1.0	2.4	39.7

[1] *Net of sales of fixed assets*

C FLEXIBILITY IN THE UK ECONOMY

C1 The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. Reforms which promote flexibility and fairness are central to achieving this goal. Rapid technological progress and strong competition in global markets mean that the profitability and competitiveness of different industries and occupations are continually evolving. A flexible economy responds to such changes in economic conditions efficiently and quickly. A high degree of flexibility minimises disruptions to output and employment and helps an economy to sustain high rates of productivity growth and employment. Flexible and dynamic markets are therefore a precondition for economic strength. Flexibility is especially important when a country needs to adjust to a country-specific shock within a monetary union, where monetary policy at a national level is not an option.

C2 The Government is committed to advancing flexibility and fairness together by enabling individuals and firms to cope with and respond to change. By investing in education and training, it has helped to equip people to adapt to new and changing employment opportunities. The National Minimum Wage and reforms to the tax and benefit system help to cushion the impact of economic shocks on household incomes, while high-quality and responsive services such as Jobcentre Plus provide incentives and practical support to enable people to rapidly enter the labour market. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

C3 In his statement to the House of Commons on 9 June 2003 on UK membership of the single currency,[1] the Chancellor gave a commitment to publish six-monthly reports on trends and progress in labour, product and capital markets. This document is the first of these six-monthly flexibility reports. It complements a range of other information which the Government produces on economic developments and structural policy reforms in both the UK and internationally, particularly across Europe. This report records progress on the Government's reforms of labour, product and capital markets, which promote flexibility and fairness.

C4 This annex is divided into two sections:

- the first section explains the importance of a flexible economy and the Government's approach of combining flexibility with fairness; and
- the second section sets out the action the Government has taken to boost flexibility in labour, product and capital markets since Budget 2003 and in this Pre-Budget Report.

[1] Available at www.hm-treasury.gov.uk

WHY FLEXIBILITY MATTERS

Why flexibility is needed

C5 Flexibility is the ability of firms and individuals to respond to economic change efficiently and quickly. Economic change can come in many different forms. Economic growth is driven by continual advances in technology that increase the efficiency with which existing goods and services can be produced and increase the range of goods and services that are provided. In addition, shifts in consumer demand for different products, the opening up of new markets, the emergence of new competitors and improvements or disruptions to the supply of natural resources all have important effects on the profitability of different firms and industries.

C6 In recent years, advances in information and communications technology, the increased integration of emerging markets with the global economy and significant movements in the price of oil have been prominent developments affecting industry. However, individual firms and households may also be affected by more localised changes that affect particular industries or particular firms within an industry. In a global age, such changes are happening faster than in the past. As a result, the economy is continually undergoing a process of structural change, in which the amount of labour and capital required by some industries declines, freeing up resources that may be profitably used in the production of new goods and services.

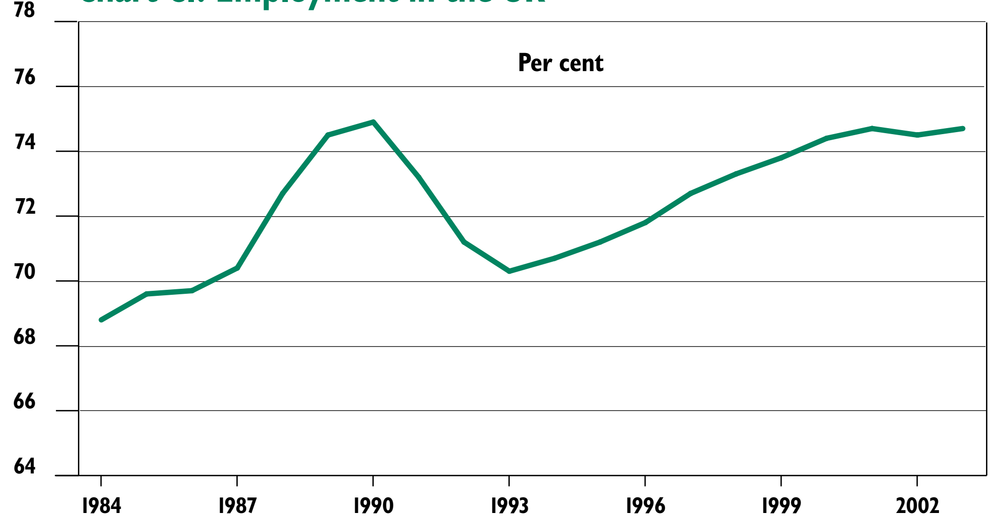
Characteristics of flexibility

C7 Economic flexibility describes an economy's capacity to adjust to such changes. There are many different ways in which workers and firms can adjust to change. For firms, adjustment may involve altering prices or changing a product line. For a worker, adjustment may mean learning a new skill, accepting a lower wage increase, moving into a different job in the same firm or even changing employer. Adjustment is achieved by a combination of changes occurring in the labour, product and capital markets. This can be supplemented if necessary by complementary changes in the stance of monetary and fiscal policy. Flexibility is about minimising the costs of adjustment.

C8 A flexible economy has the ability to adjust smoothly and rapidly, with movements in relative prices and quantities that enable the economy to maintain high levels of output and employment. However, stability at the macro-economic level may disguise considerable changes at a more disaggregated level. Between 1995 and 2003, UK employment grew by 2.2 million, but with marked differences in the rate of growth even at a broad level of industry aggregation.

C9 In an inflexible economy, weak adjustment capacity increases the likelihood that adjustment will be slower and more disruptive. In the worst case, output and employment may be permanently affected. This is a particular risk when the economy experiences substantial disruptions. For example, the 1991-92 recession led to the employment rate in the UK falling from 75 per cent in 1990 to around 70 per cent in 1993 and it was not until 2001 that it returned to its 1989 level, as shown in Chart C1. The effect was particularly acute for older male workers, many of whom were forced into involuntary early retirement. As a result, both personal incomes and national income were lower than they would have otherwise been.

Chart C1: Employment in the UK[1]



[1] Employment as a per cent of working-age population.

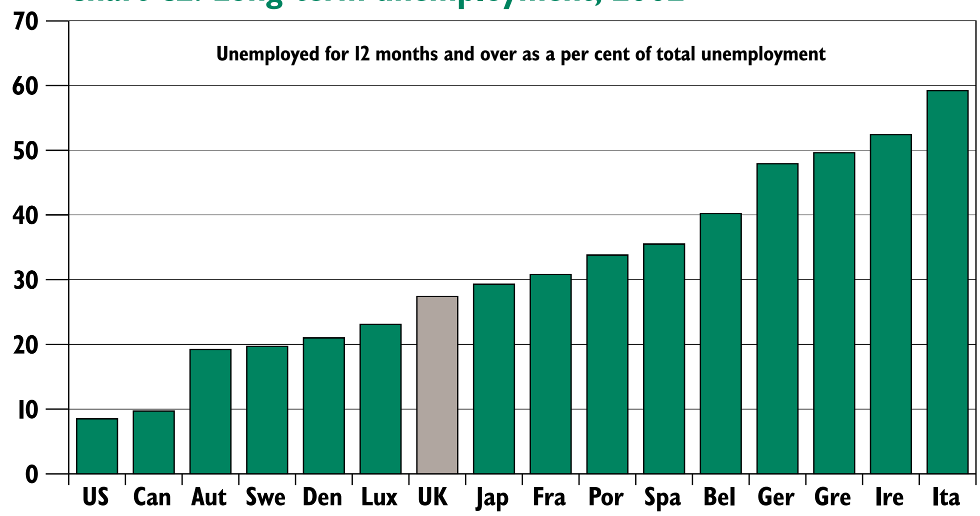
Source: ONS.

Flexibility and recent economic performance

C10 In recent years there have been striking differences in the performance of the leading industrial nations which appear to be associated with the overall flexibility of their economies. Between 1995 and 2002 labour productivity in the US grew by 2 per cent per annum on average, compared with 1.6 per cent in the UK and 1 per cent in the EU. While this partly reflects differences in the macroeconomic policy stance between countries, much of the difference appears to be more deep-seated, reflecting structural differences. The OECD estimates that the structural rate of unemployment in the euro area in 2003 is 8.1 per cent, compared with 5.2 per cent in the UK and 5.1 per cent in the US.

C11 Chart C2 illustrates that the UK has lower rates of long-term unemployment compared to a number of other major European countries. This is partly as a result of the New Deal regime, which has been effective at reducing long-term unemployment. However, the chart shows that the rate of long-term unemployment in the UK still remains above the low levels achieved in the US and Canada.

Chart C2: Long-term unemployment, 2002



Source: OECD.

C12 Policies that impact on labour, product and capital markets are an important determinant of the overall balance between flexibility and fairness in different economies. In the US, the minimum wage and Earned Income Tax Credit combined with low benefit replacement rates create a strong incentive for displaced labour to find new employment. In addition, relatively unrestrictive employment protection legislation has reduced the cost of providing employment and encouraged job creation. However, relatively ungenerous levels of out-of-work support mean that periods of unemployment can result in large reductions in family incomes. Well-developed capital markets in the US, including a vibrant venture capital market, have provided finance for business creation and expansion, and support an already strong entrepreneurial culture. These features have enabled the US to be at the forefront of developing and exploiting advances in information and communications technology (ICT). However, the US provides lower levels of publicly funded support to its citizens. For example, it does not have a national health insurance programme and 14 per cent of the population has no insurance coverage. The costs of health care are high and many Americans are at risk of being uninsured at some point in their lives.

C13 In Europe, labour market policy has placed greater emphasis on mitigating the effects of change. In many European countries relatively generous benefit systems help insure households against labour market shocks but at the same time reduce incentives for claimants to return to and progress in work, leading to relatively high structural levels of unemployment. These effects are to some extent mitigated by active labour market policies, especially in the Nordic countries. Furthermore, in some countries overly restrictive legislation governing conditions of employment has placed significant constraints on employers. The effect of these restrictions on overall flexibility is partially offset by high functional flexibility of the workforce as a result of effective workforce training programmes.

C14 Product market competition is more restricted in Europe than in the US, with some markets strongly segmented along national lines, particularly in utility and service industries. Similarly, capital market integration has been impeded by regulations that have restricted cross-border capital flows. EU Member States have committed themselves to a programme of economic reform to further promote the integration of European labour, product and capital markets. While there has been welcome progress in some areas – including modernisation of the EU's competition regime, steps towards liberalisation in markets such as energy and telecommunications, reform of the state aid regime, and increased employment – more work is required to deliver improved outcomes for the EU economy. As in previous years, the Government will publish a progress report on European economic reform ahead of the Spring European Council in March 2004.

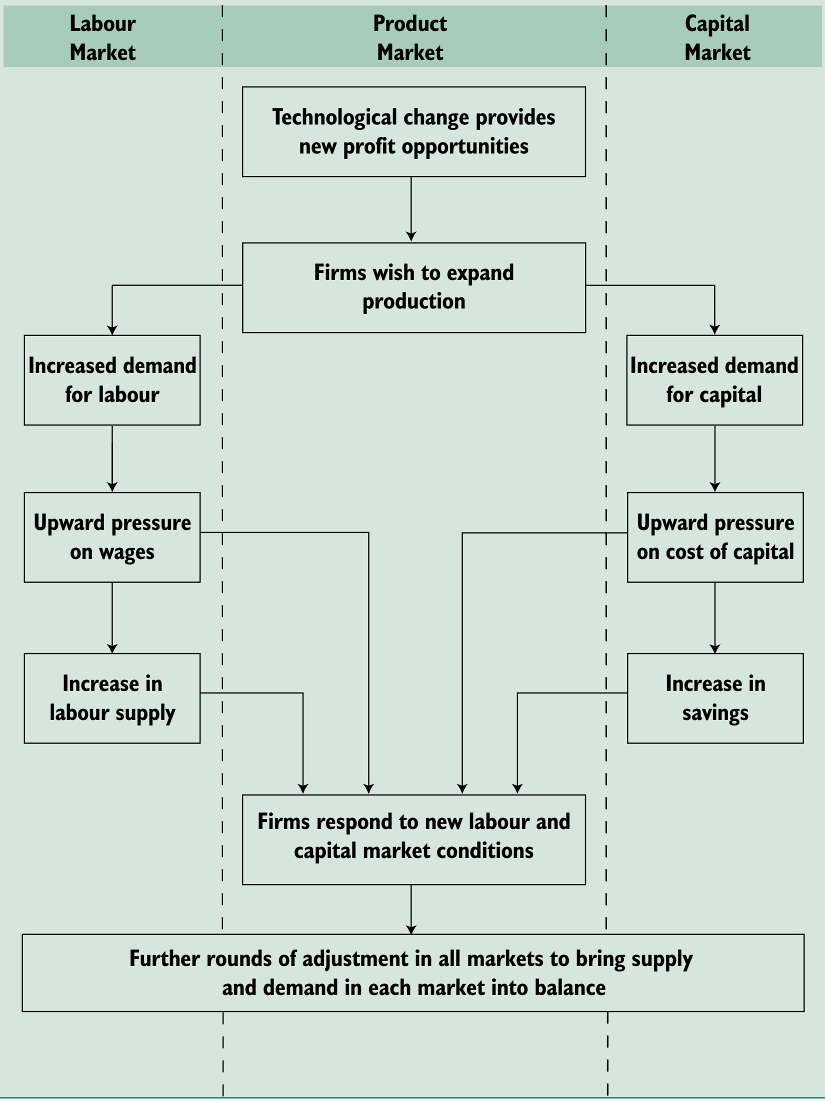
The UK's approach: combining flexibility and fairness

C15 The Government's objective is to build a stronger, more enterprising economy and a fairer society, maintaining stability and ensuring rising living standards for all. This entails an approach to economic reform that advances flexibility and fairness together, combining the best features of the US and European systems. Investment in education and workforce skills help individuals adapt to change. Reforms to the tax and benefit system provide national guarantees through a National Minimum Wage and a national tax credit system that help to insure households against fluctuations in their incomes while at the same time strengthening incentives to participation in the labour market. The Welfare to Work strategy provides assistance with job search and training. The Government's approach to increasing employment for all is discussed in more detail in Chapter 4 of this Pre-Budget Report, and its strategy for building a fairer society is set out in Chapter 5. The Government's reforms to the competition regime encourage firms to respond quickly to changes in market conditions and help to ensure that key product markets work better for consumers. The Government has also increased support for basic and applied research, encouraging innovation and helping businesses to harness the potential of new technologies. Policies such as the Savings Gateway, Child Trust Fund and ISAs have expanded access to capital markets and spread the benefits of saving and asset ownership. Investment in strong and flexible public services has helped to make them more efficient and responsive and extended opportunity and security for all.

Flexibility in labour, product and capital markets

C16 The overall flexibility of the economy depends on the interaction of flexibility in the labour, capital and product markets, as illustrated in Box C1. This interdependence implies that the overall flexibility of the economy depends on each market working as effectively as possible. The diagram illustrates how changes originating in the product market are transmitted to the labour and capital markets and back to the product market. Further rounds of adjustment and feedback will occur until the balance of supply and demand is restored in each market. Changes originating in labour and capital markets, for example, as a result of tax and benefit changes which affect labour supply or a change in risk aversion affecting the cost of capital, will similarly be transmitted to other markets, with the economy's overall adjustment reflecting the interactions between all three markets.

Box C1: Example of interaction between labour, product and capital markets



Labour market flexibility

C17 The performance of the labour market is central to the well being of the economy and society. A flexible and efficient labour market has the ability to adjust to changing economic conditions in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes. Backed up by policies which equip people to adjust rapidly to change and provide support for those who are not in employment, it implies an economy that is fairer, more competitive and more productive.

C18 The key characteristics of a flexible labour market are that:

- wages adjust to maintain the balance between labour supply and labour demand;
- the labour force is equipped with transferable skills that employers require, enabling the rapid redeployment of labour within or between firms when labour demand changes;
- firms do not find it prohibitively costly to create employment or to vary it when needed;
- workers are able easily to commute or move residence in order to find employment;
- working patterns meet the needs of both employers and employees, increasing labour supply; and
- there is an institutional environment that encourages labour force participation, equips people to adapt rapidly to change and provides support for those without employment, enabling them to remain active participants in the labour market.

C19 Chapter 4 of this Pre-Budget Report sets out the Government's overall strategy for ensuring employment opportunity for all. Achieving this aim requires a flexible labour market in which people are equipped to make effective and informed labour market choices. New measures introduced since Budget 2003 that promote flexibility and fairness in the UK labour market are summarised in the second section of this report.

Product market flexibility

C20 Product market flexibility relates to the ease with which firms are able to respond to changing market conditions. For individual firms or industries increased flexibility enables them to respond rapidly, allowing firms to exploit new opportunities and to deal with potential challenges effectively. Flexibility provides firms with the scope to succeed in a competitive market environment.

C21 The main characteristics of a flexible product market are that:

- there is a competitive environment which rewards efficiency, discourages waste and provides firms with strong incentives to adapt the range and quality of their goods and services to provide their customers with good quality products at competitive prices;
- there is a strong capacity for innovation, enabling firms to develop and implement new processes and products ahead of their competitors;
- there are low barriers to entry which allow new firms to challenge incumbents creating incentives for innovation and efficiency; and

- a regulatory environment in which the constraints on business yield clear benefits to the wider economy and are not disproportionately costly in terms of their effect on firms' incentives to hire, train, innovate and invest.

Capital market flexibility

C22 Capital markets contribute to the flexibility of the economy by ensuring that capital is employed effectively. Efficient capital markets ensure that businesses, entrepreneurs and innovators have ready access to the funds that they require in order to develop their ideas. Capital markets also play an important role in balancing the risks and returns of different uses of capital, screening out projects that have an unacceptably high level of risk.

C23 Flexible capital markets can also play a role in underpinning flexibility in labour and product markets. They should, for example, allow individuals to borrow when necessary in order to enhance their education and skills, with beneficial effects on productivity and on the employability of the individuals concerned. In product markets, flexible access to finance should allow firms to reallocate resources efficiently and to invest as appropriate in new processes and products.

C24 A flexible capital market can also promote fairness by enabling all individuals to take advantage of educational and business opportunities. However, government intervention may on occasions be required to ensure that information asymmetries do not lead to some individuals being unfairly denied access to capital markets.

C25 The main characteristics of a flexible capital market are that:

- borrowers have a range of financing options available to them that allow them to access the capital they require at a competitive price and on competitive terms. This applies particularly to firms seeking capital for high risk projects, where efficient capital markets are best placed to price the risk appropriately;
- investors have the ability to hold a diversified portfolio of assets spread across regions and sectors, so that they can use income from these assets to insure against a fall in income that is specific to their own region and sector; and
- there is sufficient borrowing and lending capacity on credit markets to allow households and business to smooth fluctuations in income.

Flexibility and the productivity challenge

C26 Many of the important characteristics of a flexible economy are also key drivers of productivity growth. The ability to switch resources readily between firms and industries improves the economy's resilience in adverse market conditions and its capacity to develop and implement the technological advances and organisational changes that raise productivity and wages. Chapter 3 of this Pre-Budget Report sets out the Government's overall strategy for promoting productivity and enterprise in the UK economy through reforms which boost competition, enterprise, skills, innovation and investment. New measures introduced since Budget 2003 which promote product and capital market flexibility are summarised in the next section of this report.

MEASURES TO PROMOTE FLEXIBILITY

C27 This section of the report summarises the action the Government has taken since Budget 2003 and in this Pre-Budget Report to promote flexibility and fairness in the UK economy.

Measures to promote flexibility and fairness in labour markets

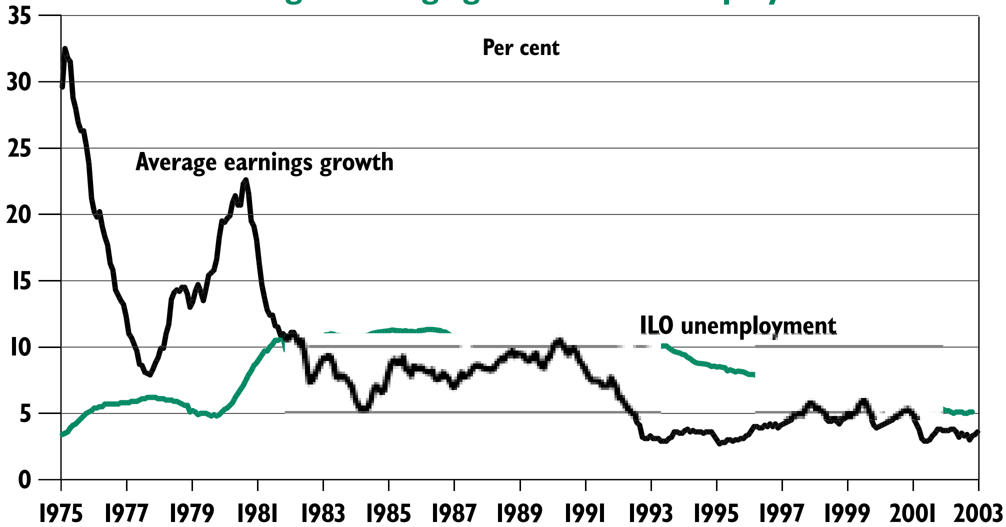
C28 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. Its strategy involves maintaining macroeconomic stability and promoting an enterprising economy with a dynamic and flexible labour market in which people are able to make effective and informed labour market choices. The Government has introduced a range of measures to advance flexibility and fairness in the UK labour market.

Enhancing wage flexibility

C29 In the labour market, as in other markets, price adjustment is an important factor that ensures that the market mechanism functions effectively. Wage levels are a major determinant of the supply of and demand for labour. A dynamic and flexible labour market requires wages to respond flexibly to shocks and to imbalances between supply and demand, both at the aggregate and sectoral level.

C30 Historically the UK has had to contend with accelerating wage inflation in the face of low levels of unemployment. However, as Chart C3 shows, in the most recent labour market upswing unemployment has fallen to historically low levels but the rate of wage growth has remained consistent with the inflation target and trend productivity growth of 2 per cent – a development consistent with the estimated fall in the structural unemployment rate since the early 1990s. This improvement in part reflects the successful reintegration of the long-term unemployed and marginalised groups into the labour market, which helps to ensure that the economy does not run into labour supply bottlenecks. This strategy is discussed later in this annex.

Chart C3: Average earnings growth and unemployment



Source: LFS and ONS.

C31 In an efficient labour market, wages should move to balance the supply of, and demand for, labour in regional and local labour markets. This process can be impeded by national pay agreements that fail to take account of local and regional conditions. The Government has amended the remits for the Pay Review Bodies to include a stronger local and regional dimension and is working with the rest of the public sector to increase the focus on respecting local pay conditions, side by side with UK-wide guarantees of a National Minimum Wage and the tax credit agenda.

Allsopp Review

C32 In light of the growing regional productivity and flexibility agenda, Christopher Allsopp was asked in February 2003 to undertake a review of statistics for economic policy-making and to produce a first report by the time of the Pre-Budget Report:

- the first report, described in more detail in Annex A, makes a number of recommendations **to improve the quality and availability of regional data**, including price and labour market data, to satisfy the growing demand for such data over the medium-term.

Promoting geographic mobility

C33 A labour force that is able to move within and between regions enhances labour market flexibility by enabling workers to move to available employment opportunities. In the UK geographic labour mobility is low compared to the US, as is the case elsewhere in Europe. The Government has been introducing a number of policies that aim to raise the ability and willingness of workers to commute or move location in order to find employment.

C34 The current Housing Benefit system is complex and can reduce work incentives and create barriers to geographic mobility. The Government has announced a number of Housing Benefit reforms to address these problems, discussed in more detail in Chapter 4. These include the piloting of a new local housing allowance (LHA) for tenants in the private sector in nine Pathfinder areas. This will give recipients greater certainty as to their level of entitlement and so increase their ability to choose where to live. In this Pre-Budget Report the Government announces:

- the intention to begin **LHA Pathfinders in the social sector** as soon as practical.

C35 The Government has introduced housing and planning reforms to increase housing supply and in turn make it easier for households to access employment opportunities wherever they occur. Analysis of the importance of housing market flexibility is provided in Box C2. The Deputy Prime Minister's Sustainable Communities statement in February 2003 detailed plans for a significant increase of 200,000 homes over and above existing plans by 2016. This will be backed by planning reforms to ensure local authorities make plans for at least ten years potential supply of housing, while prioritising brownfield development and driving up density. In this Pre-Budget Report, the Government:

- welcomes **the interim report of the Barker Review** on the factors affecting housing supply in the UK, discussed in more detail in Chapter 3, and looks forward to the final report in spring 2004;

- announces its intention to issue a consultation document on **tax transparent property investment trusts** at Budget 2004; and

- welcomes **Professor David Miles' interim review of the supply and demand side factors limiting the development of the fixed rate mortgages** in the UK, discussed in detail in Chapter 2, and looks forward to the final report at the time of Budget 2004.

Box C2: Housing and flexibility

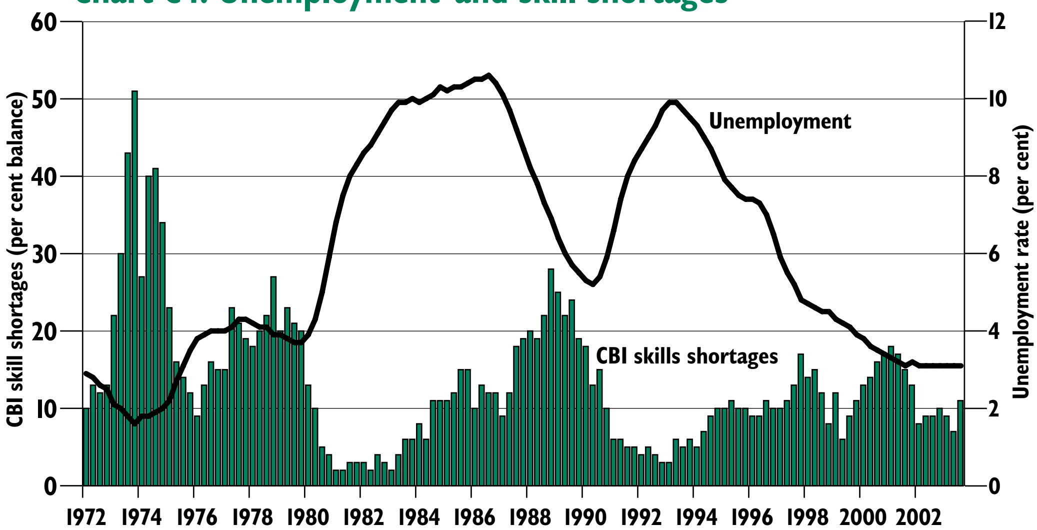
A stable and flexible housing market is essential to a healthy economy as housing market imbalances are a potential brake on economic development. The cost and availability of housing influences the geographical distribution and mobility of the labour force and may affect capacity levels in local labour markets. Conditions in local labour markets affect firms' location decisions and hence an inefficient housing market may also constrain investment and production decisions, influencing the longer-term development of local economies. In addition, volatility in housing markets affects the wider economy through private consumption, since changes in housing wealth affect the level of household spending. As movements in housing wealth are strongly pro-cyclical, this link tends to amplify the economic cycle. Consequently reduced volatility in housing markets could further promote macroeconomic stability.

The Government is committed to a comprehensive programme of action to improve the functioning of the UK housing market and to ensure a better match between the supply and demand for housing. The objective is to reduce the extent to which housing considerations may constrain labour market adjustment. The Government's reform programme is discussed in detail in this Pre-Budget Report and summarised in this annex.

Developing skills

C36 The quantity and quality of skilled labour in an economy are important determinants of economic performance and productivity growth. Skilled workers adapt faster and more effectively to change. They increase the ability of a firm to update its practices and products at the rate demanded by changing markets, making the economy more flexible. Chart C4 illustrates that in the past skills shortages have acted as a significant constraint on economic growth. While shortages have been less acute in recent years, improving skills acquisition remains fundamental to the long-term health of the economy.

Chart C4: Unemployment[1] and skill shortages[2]



Source: ONS and CBI

[1] *Claimant count unemployment rate.*
[2] *Respondents identifying skilled labour shortages as a factor limiting output.*

C37 The Government is committed to further action to develop skills. This Pre-Budget Report sets out a number of steps the Government has taken to develop workforce skills and so enhance flexibility in the UK, discussed in more detail in Chapter 3:

- the **extension of Employer Training pilots** to encourage skills training for a third year and to cover over a third of England;
- the publication of a **discussion paper on delivering incentives for membership bodies to provide workforce development**; and
- implementing measures announced in Budget 2003 to support the contribution migration makes to creating a skilled and flexible workforce, including changes to enhance the **Highly Skilled Migrant Programme,** and a new entitlement for international science and engineering students to work in the UK after graduation.

Employment flexibility

C38 Employment flexibility describes the provision of a range of working patterns that allow both employers and employees to find an arrangement that best meets their respective needs. Part-time and temporary work gives employers the flexibility to vary capacity levels and employees scope to balance their work and other responsibilities. Diverse patterns of employment can achieve a more efficient matching of labour demand and supply.

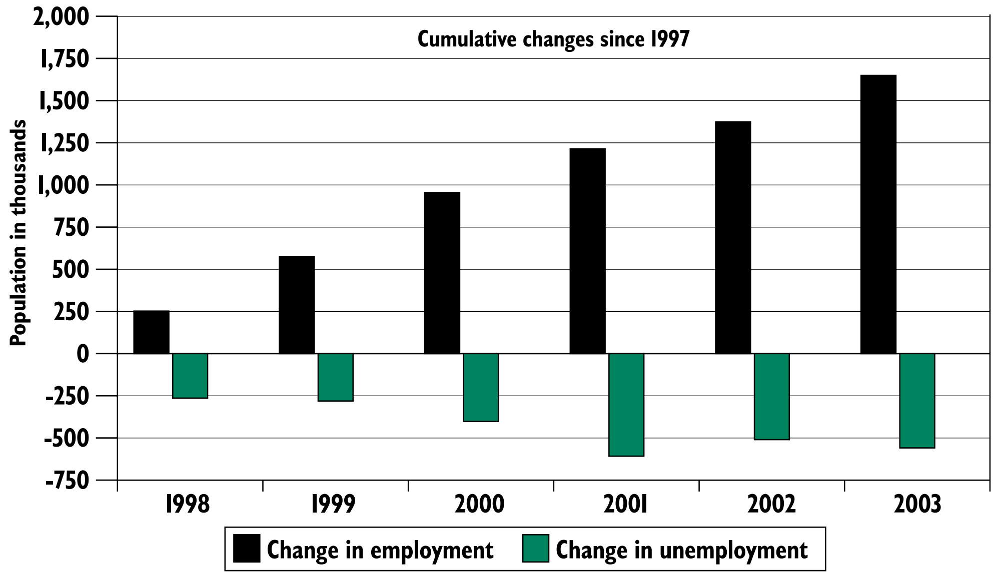
C39 The UK labour market shows a significant degree of employment flexibility, with a high incidence of part-time work, a wide distribution of hours worked and widespread adoption of flexible working practices, all of which are primarily a result of employee choice. However, employment flexibility can be increased further. The Government is keen to promote diverse forms of employment including the take up of self-employment. It is currently introducing a number of measures to promote employment flexibility, discussed in more detail in Chapters 4 and 5:

- a Small Business Services Review of the **routes off benefits into self-employment**, to report in spring 2004;
- promoting the **provision of employer supported childcare**; and
- an increase in the returns from **deferring the state pension**, promoting choice for those who wish to extend their working lives.

Improving labour market opportunities

C40 Since 1997, unemployment in the UK has fallen to levels last seen in the 1970s, the number of people in jobs has risen by 1.7 million and the employment rate is the highest in the G7, as illustrated in Chart C5.

Chart C5: Changes in employment and unemployment[1]



Source: LFS

[1] *Employed and unemployed population aged 16+.*

C41 While this performance is strong both by historical and international standards, not all groups have shared equally in the success. Employment opportunity for all means that everybody is given the right assistance and the right choices to return to the labour market while at the same time ensuring support for those that cannot work. Chapter 4 describes the measures the Government has introduced to provide opportunity and choice for all, including extensive programmes of support for those groups with special circumstances, such as the long-term unemployed, lone parents, partners of benefit claimants and sick and disabled people. The Government is also targeting support for people in disadvantaged areas and for ethnic minorities. In Chapter 4 of this Pre-Budget Report the Government announces further help for these groups:

- **enhanced help for lone parents**, increasing the number of work-focused interviews lone parents with children aged 14 or over are required to attend, and providing help with childcare costs in the week before starting work;
- **improving work incentives** in London by extending pilots of the £40 per week in-work credit to parents, including lone parents, who have been on certain benefits for a year or more;
- **extra support to help the unemployed**, by piloting mandatory short intensive work-focused courses at the six-month stage;
- an extension of eligibility for the **enhanced New Deal for partners**;
- **an extension of back to work help for those aged 60 and over and on the Pension Credit** by October 2004;
- **extra help for sick and disabled people**, enabling Jobcentre Plus personal advisers to provide additional voluntary support to Incapacity Benefit customers who want to return to work; and
- the existing Action Teams will be extended, two additional **Action Teams** will be introduced and Action Teams will have greater discretion to direct resources towards the most disadvantaged people.

Measures to promote flexibility and fairness in product markets

C42 Chapter 3 of this Pre-Budget Report sets out the Government's programme of reform aimed at promoting flexibility and boosting productivity growth in the UK economy by focusing on measures which boost competition, enterprise, innovation, skills and investment.

Competition

C43 Competition boosts flexibility by providing incentives for firms to respond quickly to changes in market conditions, technology and costs. Competition increases the incentives for firms to adopt more efficient working methods and to develop new products and services that meet the changing demands of consumers. The Government is committed to promoting competition in the UK economy and has taken significant steps to ensure that the UK competition regime ranks among the best in the world. The Enterprise Act (2002) has given full independence to UK competition authorities and given the Office of Fair Trading (OFT) more proactive powers to investigate markets where competition may be restricted or distorted. Empowered consumers promote competition in markets by providing signals and incentives for firms to respond quickly. Since Budget 2003 the Government has taken further steps to enhance competition, empower consumers and promote flexibility, discussed in more detail in Chapter 3:

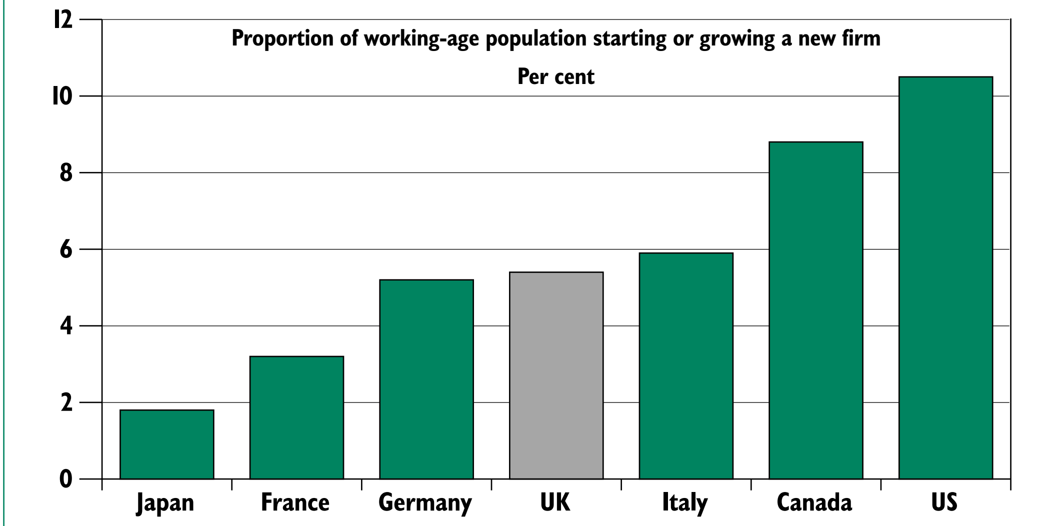
- an independent review into regulation of the **legal services market** aimed at promoting competition and innovation will report in December 2004;
- a review of the **Financial Services and Markets Act (FSMA)** including an assessment of its impact on competition; and
- measures to **improve competition in the supply of goods and services to the Government**.

C44 Government is also introducing a number of measures to promote competition in specific markets, discussed in further detail in Chapter 3.

Enterprise

C45 The Government is committed to building an enterprise society in which people from all backgrounds can consider and act on opportunities for enterprise. A strong entrepreneurial culture means that the economy is better equipped to identify and develop the opportunities offered by new technologies, new products and new markets, and generate new sources of income when existing production techniques and products lose their competitiveness. Chart C6 illustrates that the entrepreneurial culture in the UK is not as highly developed as in the US and Canada, where a much higher proportion of the population is engaged in starting or growing new firms.

Chart C6: The enterprise gap, 2002



Source: Global Entrepreneurship Monitor, 2002 Executive Report.

C46 In this Pre-Budget Report the Government has taken the following new steps to promote enterprise in the UK economy, discussed in more detail in Chapter 3:

- the **launch of a new businesslink.gov.uk website**, which will provide an online service for business advice;
- measures to support regional growth, **including details of the Local Authority Business Growth Incentives Scheme**, which will boost the role of local authorities in business growth;
- **reforms to reduce the regulatory burden on enterprise**, including the recent announcement of an increase in the statutory audit threshold to £5.6 million; and
- measures which will ensure **greater stability within the regulatory system** such as considering an extension of the common commencement date commitment for employment law to other areas of regulation, subject to the findings of the current DTI pilot.

C47 The Government has introduced significant reforms to modernise the business tax system and promote enterprise and flexibility. The Government has already cut the main and small companies' rates of corporation tax from 33 and 23 per cent to just 30 and 19 per cent. It has also introduced a generous capital gains tax taper for business assets – so that the UK now has one of the most favourable Capital Gains Tax (CGT) regimes in the world. This Pre-Budget Report announces further measures, discussed in more detail in Chapter 3:

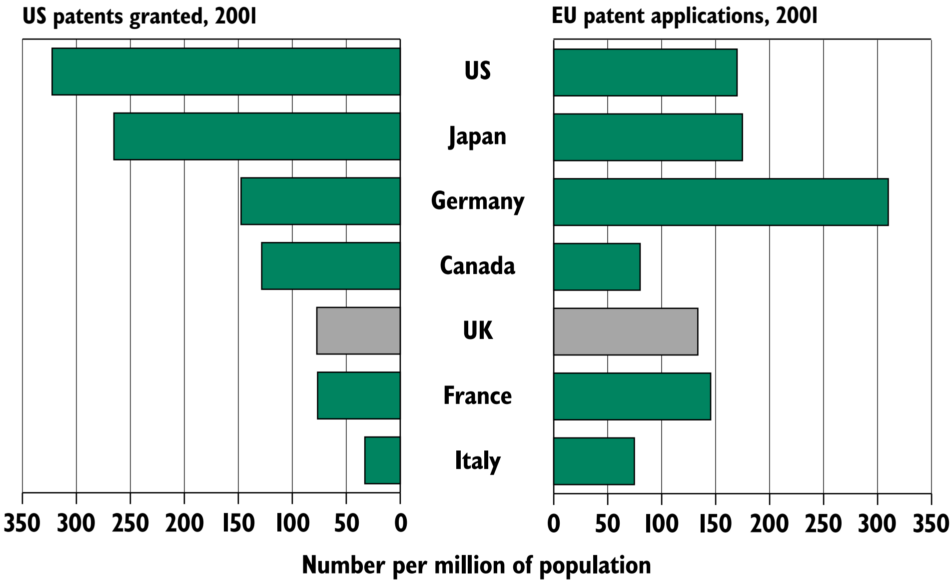
- **improvements to the VAT flat rate scheme**, including new lower rates, to enable more businesses to benefit fully from compliance savings; and
- a package of other **measures to improve the business tax system**.

Science and Innovation

C48 Through innovation business can harness the potential of new technologies and promote more efficient ways of working. Successful innovation extends the range of products that the economy can produce and reduces the costs of existing production methods. Both developments increase the productive potential of the economy and improve its resilience to global competition. However, the UK lags behind its major international competitors in some important aspects of innovation performance, for example, in terms of patents applied for and granted (Chart C7). The Government is pursuing various measures to promote innovation in the UK economy, discussed in more detail in Chapter 3. This Pre-Budget Report describes the steps the Government is taking including:

- a new, clearer and more accessible **R&D tax credit definition**; and
- the publication of the **Lambert Review of Business-University collaboration**.

Chart C7: Patents granted and applications, 2001



Source: NewCronos (Eurostat).

Investment

C49 Investing in new technology and capital is important if firms are to respond to new opportunities in a competitive and entrepreneurial way. Where there are financial or structural barriers to new investment, firms' competitiveness will be constrained. In addition, investment in underlying infrastructure can help to facilitate flexibility in wider labour and product markets by making both labour and products more mobile. The Government has today announced the following steps to promote investment in the UK economy, discussed in more detail in Chapter 3:

- an increase in the **qualification thresholds for SMEs** to allow more businesses to benefit from higher first year capital allowances; and
- a proposed scheme for a **Business Premises Renovation Allowance**, subject to state aid approval.

Planning reform **C50** The Government is committed to reforming the planning system to make it more strategic, streamlined and flexible, helping to deliver the Government's objectives of increasing enterprise and productivity and promoting investment. Key measures will be introduced in the first Planning Bill for more than a decade, which is expected to receive Royal Assent by Spring 2004. The reforms include the abolition of county structure plans, the introduction of a more flexible local development plans system and legislation for Business Planning Zones to speed up development in disadvantaged areas. The Government will be issuing a revised planning policy statement on town centres in England, for consultation, which aims to encourage investment and growth in town centres. It is also undertaking reform of planning obligations, addressing potential delays in negotiated section 106 agreements by proposing a new optional planning charge which developers could choose to pay in place of a conventional negotiated agreement. The planning system is also one of the important factors considered by the Barker Review in its study of housing supply in the UK.

Measures to promote flexibility and fairness in capital markets

C51 Capital markets contribute to the flexibility of the economy by providing entrepreneurs and firms with the finance that they require to fund their activities. A flexible capital market ensures that finance is provided at the lowest price appropriate to the investment risk borne by the provider. Efficient capital markets enable individuals to smooth out fluctuations in their income by offering a wide range of saving vehicles and allowing individuals to borrow prudently against future income.

Securities settlement **C52** The ability of companies to raise capital in a cheap and flexible manner is important in allowing them to respond to market developments and to drive forward their efforts to raise their business performance. An important part of achieving cheap and flexible access to capital is having an efficient securities settlement system. Electronic settlement can bring cost savings for issuers and investors, and increase flexibility in the issuance of securities. In 1998 the Bank of England produced a Securities Settlement Priorities Review. In response to the review's final outstanding recommendation the Government:

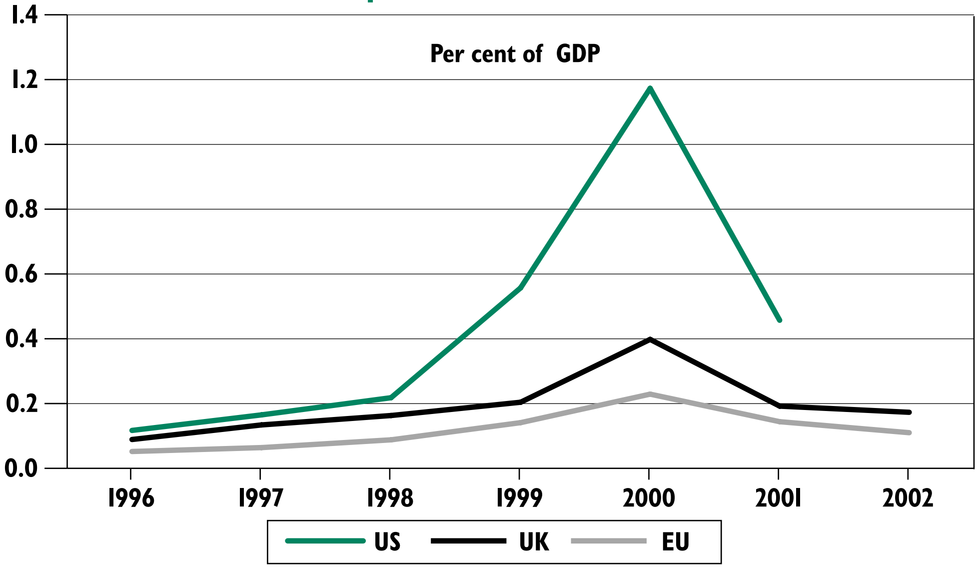
- legislated in June 2003 to allow for the **electronic settlement of money market instruments, and migration of money market instruments** to an electronic settlement system was completed in October 2003.

SME Finance **C53** The ability to access external sources of finance is essential if small businesses are to take full advantage of the investment opportunities available to them. Access to funds enables entrepreneurs and innovators to develop their ideas, contributing to improvements in productivity and ensuring that resources get directed to where they can be most profitably employed. Chart C8 shows that the UK has a large venture capital market compared to European countries but a smaller market than the US. However, the Government believes there is more to do to promote access to finance for small business. The Government has published *Bridging the finance gap: next steps in improving access to growth capital for small businesses* alongside this Pre-Budget Report which announces:

- measures to overcome barriers to raising finance for small business, including a pathfinder round of **Enterprise Capital funds** and proposed enhancements **to Venture Capital Trusts and the Enterprise Investment Scheme**;

- launch of an independent **review of the Small Firms Loan Guarantee**; and
- a package of measures to enhance **small firms' awareness of the range of finance options** open to them.

Chart C8: Venture capital investments[1]



Source: Eurostat Structural Indicators.

[1] Early stage, expansion and replacement rate.

Investment and Corporate Governance

C54 A good framework for investment decisions and corporate governance ensures that savings are put to their most effective use and reallocated on a timely basis. Improving transparency of market signals and enhancing institutional responsiveness to competitive pressure are key elements of flexibility. This helps to promote better company performance, higher returns to investors and a lower cost of capital. The Government has taken a series of steps to aid this process by promoting greater accountability and transparency in the links between investors and companies, which is discussed in further detail in Chapter 3 of this Pre-Budget Report. Most recently the Government has:

- endorsed the introduction of the **new Combined Code**, which was issued in July 2003 and takes effect for listed companies with reporting years beginning on or after 1 November 2003;
- introduced a bill, based on the **legislative recommendations of the Co-ordinating Group for Accounting and Audit (CGAA) and the Swift Review**, to enhance auditor independence and to strengthen financial reporting;
- engaged with the industry on key issues still outstanding from the **Myners review of institutional investment**; and
- worked on measures **to improve the competence of pension fund trustees**, to be included in the forthcoming Pensions bill.

Sandler Review

C55 Flexible capital markets provide an effective range of products for saving and investment to smooth consumption in response to fluctuations in income. In July 2002, a report for the Government by Ron Sandler recommended improvements in savings vehicles through the development of low-cost and risk-controlled stakeholder products. To take forward the agenda in the Sandler Report, the Government has:

- published a **response paper** in July 2003 in which it announced specifications for a simple set of low cost products;
- announced **that all Sandler stakeholder medium-term products and life insurance products** will be brought into the stocks and share components of ISAs from 2005; and
- worked to ensure that the **EU Investment Services Directive** takes account of product regulation as a middle way between full advice services and execution-only services.

Capital Markets integration

C56 Greater integration of international capital markets should make capital allocation more efficient. This will ensure savers get the best return on their money and are able to hold a diversified portfolio of assets while funds flow to firms offering the best investment opportunities thereby encouraging innovation. To this end the Government will continue to work towards the creation of an integrated EU capital market and greater integration of EU-US capital markets. Recent important steps in this direction have included:

- the adoption by the EU in July 2003 of the **Prospectus Directive**, which will enable companies to raise capital across the EU on the basis of a single prospectus; and
- the UK encouraging a more intensive **EU-US dialogue on financial services issues**, in particular to look beyond the short term to ensure that issues are dealt with before they become pressing concerns.

CONCLUSIONS

C57 The ability of economies to adjust flexibly to changes in technology and in market conditions has been an important characteristic of successful economies since the Industrial Revolution. It is especially true of the current era, in which rapid technological change and globalisation provide increased opportunities to dynamic and flexible economies, but have also increased the costs arising from inflexibility and slow adjustment. As was highlighted in the Treasury's economic assessment of the case for joining EMU, a high level of flexibility is especially important when a country needs to adjust to country-specific shocks within a monetary union, since a country-specific monetary policy response is not an option.

C58 The Government recognises that it is important to ensure that the institutional and regulatory environment supports flexible adjustment in labour, product and capital markets, equipping the economy to respond to current and future opportunities and challenges. The Government also recognises that flexibility should be accompanied by policies that support individuals as they respond to change, so that flexibility is accompanied by fairness.

C59 This report highlights a range of specific measures that the Government is undertaking in pursuit of these objectives. A review of progress on the Government's reform agenda will be published at the time of Budget 2004.

LIST OF ABBREVIATIONS

ACD	Active Communities Directorate
AEI	Average earnings index
AHC	After housing costs
ALMPs	Active labour market policies
AME	Annually Managed Expenditure
APD	Air passenger duty
BCC	British Chamber of Commerce
BEA	Bank Enterprise Award
BHC	Before housing costs
BoE	Bank of England
CAP	Common Agricultural Policy
CASC	Community Amateur Sports Club
CAT	Charges, Access and Terms
CBI	Confederation of British Industry
CC	Competition Commission
CCAs	Climate Change Agreements
CCL	Climate change levy
CGAA	Coordinating Group for Accounting and Audit
CEO	Chief Executive Officer
CFL	Compact fluorescent lamps
CGT	Capital gains tax
CHAI	Commission for Healthcare Audit and Improvement
CHD	Coronary heart disease
CIC	Community Interest Company
CIPS	Chartered Institute of Purchasing and Supply
CIS	Construction Industry Scheme
CPA	Comprehensive Performance Assessment
CPI	Consumer Prices Index
CTC	Child Tax Credit
CTF	Child Trust Fund
DCA	Department of Constitutional Affairs
DEFRA	Department for Environment, Food and Rural Affairs
DEL	Departmental Expenditure Limit
DETR	Department of Environment, Transport and the Regions
DfES	Department for Education and Skills
DfID	Department for International Development
DfT	Department for Transport
DMO	Debt Management Office
DoJ	Department of Justice

DPTC	Disabled Person's Tax Credit
DTI	Department of Trade and Industry
DVLA	Driver and Vehicle Licensing Agency
DWP	Department for Work and Pensions
ECA	Enhanced capital allowance
ECF	Enterprise Capital Fund
EIS	Enterprise Investment Scheme
EMA	Educational Maintenance Allowance
EMU	Economic and Monetary Union
EPCS	Environment, Protective and Cultural Services
EPD	Energy Products Directive
ESM	Energy saving materials
ESRC	Economic and Social Research Council
ETP	Employer Training Pilot
ETS	Emissions Trading Scheme
EU	European Union
EU ETS	EU Emissions Trading Scheme
EYF	End-year flexibility
FDI	Foreign Direct Investment
FE	Further Education
FED	Foreign earnings deduction
FOS	Financial Ombudsman Service
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act
FTC	Federal Trade Commission
G7	Group of Seven. A group of seven major industrial nations (comprising: Canada, France, Germany, Italy, Japan, UK and US).
GAD	Government Actuary's Department
GCSE	General Certificate of Secondary Education
GDP	Gross Domestic Product
GGNB	General government net borrowing
GSS	Government Statistical Service
GVA	Gross Value Added
HEIF	Higher Education Innovation Fund
HGV	Heavy Goods Vehicle
HIPC	Heavily Indebted Poor Countries
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales
ICT	Information and Communications Technology

IFF	International Finance Facility
IHT	Inheritance Tax
ILO	International Labour Organisation
IMF	International Monetary Fund
IP	Intellectual property
ISA	Individual Savings Account
ISC	Institutional Shareholders Committee
IT	Information Technology
JSA	Jobseeker's Allowance
LEA	Local Education Authority
LFS	Labour Force Survey
LGA	Local Government Association
LHA	Local housing allowance
LMI	Labour market information
LPC	Low Pay Commission
LPG	Liquefied Petroleum Gas
LSC	Learning and Skills Council
MA	Modern Apprenticeship
MDG	Millennium Development Goal
MDRs	Marginal deduction rates
MIG	Minimum Income Guarantee
MPC	Monetary Policy Committee
MSW	Municipal solid waste
MtC	Million tonnes of carbon
MTIC	Missing Trader Intra-Community
NAO	National Audit Office
ND25+	New Deal for those aged 25 and over
NDDP	New Deal for disabled people
NDLP	New Deal for lone parents
NDYP	New Deal for young people
NETA	New Electricity Trading Agreement
NETCEN	National Environmental Technology Centre
NG	Natural gas
NGO	Non-Governmental Organisation
NHS	National Health Service
NICs	National Insurance Contributions
NICE	National Institute for Clinical Excellence
NIESR	National Institute of Economic and Social Research
NOX	Oxides of nitrogen
NSF	National Service Framework

NTSSC	Net tax and social security contributions
NVQ	National Vocational Qualification
ODPM	Office of the Deputy Prime Minister
OECD	Organisation for Economic Cooperation and Development
OFCOM	Office of Communications
OFT	Office of Fair Trading
OFWAT	Office of the Water Services
OGC	Office of Government Commerce
ONS	Office for National Statistics
OPEC	Organisation of Petroleum Exporting Countries
PCT	Primary Care Trust
PEP	Personal Equity Plan
PPAF	Police Performance and Assessment Framework
PPP	Public Private Partnership
PPP	Purchasing power parity
PRS	Private rented sector
PSA	Public Service Agreement
PSNB	Public sector net borrowing
QC	Queen's Counsel
R&D	Research and Development
RDA	Regional Development Agency
RO	Renewables Obligation
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
RRS	Rapid Response Service
SARS	Severe Acute Respiratory Syndrome
SBS	Small Business Service
SDAs	Service Delivery Agreements
SFLG	Small Firms Loan Guarantee
SME	Small and medium-sized enterprise
SMP	Statutory Maternity Pay
SRIF	Science Research Infrastructure Fund
SRO	Science Research Organisation
SVR	Standard Variable Rates
TESSA	Tax Exempt Special Savings Account
TME	Total Managed Expenditure
TUPE	Transfer of Undertakings (Protection of Employment)

UK GAAP	UK Generally Accepted Accounting Practices
UN	United Nations
USD	United States Dollar
ULSD	Ultra-low sulphur diesel
ULSP	Ultra-low sulphur petrol
VAT	Value Added Tax
VCS	Voluntary and community sector
VCT	Venture Capital Trust
VED	Vehicle excise duty
WEO	World Economic Outlook
WFTC	Working Families' Tax Credit
WTC	Working Tax Credit
WTO	World Trade Organisation

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