Pre-Budget Report

December 2006

Investing in Britain's potential:

Building our long-term future

HM TREASURY

Cm 6984

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Pre-Budget Report

December 2006

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. The 2006 Pre-Budget Report, *Investing in Britain's potential: Building our long-term future*, presents updated assessments and forecasts of the economy and public finances, reports on how the Government's policies are helping to deliver its long-term goals and describes the reforms the Government is considering ahead of Budget 2007 and on which it will be consulting in the months ahead. The Pre-Budget Report:

- **shows that the economy is stable and growing and that the Government is meeting its strict rules for the public finances;**
- **provides further help for families and children, including from April 2009 every mother-to-be will be eligible for Child Benefit from week 29 of their pregnancy;**
- **improves enforcement of the National Minimum Wage by increasing by 50 per cent the resources to tackle non-compliance;**
- **sets out a new ambition for the 2007 Comprehensive Spending Review of at least 3 per cent savings per year across central and local government, releasing further resources for the challenges ahead;**
- **makes a new commitment for capital investment in education to rise from £8.3 billion in 2007-08 to £10.2 billion in 2010-11;**
- **sets out a new ambition of world-class skills, taking forward the recommendations of the Leitch Review;**
- **sets out further measures to boost productivity and growth, to promote scientific research and reform planning and transport infrastructure;**
- **promotes fairness in the tax system, including action to tackle tax avoidance;**
- **takes further steps to tackle the global challenges of climate change, including an increase in all rates of air passenger duty with effect from 1 February 2007, in recognition of the environmental costs of flying; and**
- **announces an increase in line with inflation in the main road fuel duties, alongside measures to support the use of cleaner fuels.**

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

1.2 The long-term decisions the Government has taken – giving independence to the Bank of England, new fiscal rules and a reduction in debt – have created a strong platform of economic stability. In the UK, with low and stable inflation, interest rates set by the Monetary Policy Committee to meet the Government's symmetric inflation target, and fiscal policy supporting monetary policy over the cycle, the economy has grown continuously throughout this period. The UK economy is currently experiencing its longest unbroken expansion since quarterly records began, with GDP now having grown for 57 consecutive quarters.

Long-term opportunities and challenges

1.3 The global economy is in the midst of radical transformation with far reaching and fundamental changes in technology, production and trading patterns. Rapid technological change continues to impact on how individuals, business and communities interact with each other and how they expect to interact with the state. Global security is being reshaped as the international community responds to the ongoing threat of international terrorism, conflict and the challenges of ending world poverty. The pressures that economic and population growth are placing on the earth's natural resources and climate are increasingly apparent, presenting an urgent need for international cooperation.[1]

I.4 This transformation will present both challenges and opportunities for the UK. Individuals, businesses and communities all need to be ready to respond to the changing global environment. Stable, flexible, skilled and innovative economies will prosper. This Pre-Budget Report sets out further reforms to lock in stability and to invest in the UK's future – including a new ambition for world-class skills, a commitment to further investment in education, reforms to the UK's planning and transport infrastructure and measures to tackle the global challenge of climate change.

I.5 Fairness must go alongside flexibility, providing security and support for those that need it and ensuring that everyone has the opportunity to fulfil their potential. The reforms of the welfare state, introduced since 1997, reflect the Government's aims of eradicating child poverty, supporting families to balance their work and family life, 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 announces further measures to help support families, children and pensioners.

I.6 This Pre-Budget Report describes the next steps the Government is taking to enhance its long term goals of:

- **maintaining macroeconomic stability, ensuring the fiscal rules are met and that inflation remains low;**
- **raising the sustainable rate of productivity growth,** through reforms that promote enterprise and competition, enhance flexibility and promote science, innovation and skills;
- **providing employment opportunity for all,** by promoting a flexible labour market which sustains a higher proportion of people in employment than ever before;
- **ensuring fairness,** by providing security for people when they need it, tackling child and pensioner poverty, providing opportunity for all children and young people and delivering security for all in retirement;
- **delivering world-class public services,** with extra investment alongside efficiency, reform and results; and
- **addressing environmental challenges,** such as climate change and the need for energy efficiency.

MAINTAINING MACROECONOMIC STABILITY

I.7 The Government's long term economic goal is to maintain macroeconomic stability, ensuring the fiscal rules are met at all times 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 public finances, full details of which are set out in Annexes A and B.

The policy framework

I.8 The Government's macroeconomic framework is based on the principles of transparency, responsibility and accountability, and is designed to ensure lasting stability so that businesses, individuals and the Government can plan effectively for the long term. The Bank of England has operational independence to meet the Government's symmetrical inflation target. Fiscal policy is underpinned by clear objectives and two strict rules which ensure sound public finances over the medium term. The fiscal rules underpin the Government's public spending

[1] *Long-term opportunities and challenges for the UK: analysis for the 2007 Comprehensive Spending Review*, HM Treasury, November 2006

framework which facilitates long-term planning and provide departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes.

Economic Prospects

1.9 Growth of the UK economy since Budget 2006 has been higher than forecast. Domestically, growth has been driven by higher than expected business investment. Externally, the recovery in the euro area has boosted export growth. The UK economy is currently experiencing its longest unbroken expansion on record, with GDP now having grown for 57 consecutive quarters. With volatility in the UK economy at historically low levels and now the lowest in the G7, the domestic stability delivered by the Government's macroeconomic framework puts the UK in a strong position to respond to the global economic challenges of the next decade.

1.10 In light of new evidence published since Budget 2006, the Treasury has reviewed the underpinning assumptions for its neutral trend growth assumption from 2007 onwards, which it has revised to continue at 2 3/4 per cent a year, consistent with the neutral rate since 2001. This revised 2 3/4 per cent trend rate of output growth anchors the Pre-Budget Report economic forecast. GDP is forecast to grow by 2 3/4 per cent in 2006, above the Budget 2006 forecast range, rising to 2 3/4 to 3 1/4 per cent in 2007 when the output gap is expected to close. Growth is expected to remain close to trend in 2008 and 2009.

The public finances

1.11 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. 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*. Table 1.2 lists the key Pre-Budget Report policy decisions and their impact on the public finances. Further details are set out in Annex B.

The fiscal rules

1.12 The interim forecast update of the projections for the public finances published in this Pre-Budget Report and summarised in Table 1.1, show that the Government is meeting its strict fiscal rules:

- the current budget since the start of the current economic cycle in 1997-98 shows an average annual surplus up to 2006-07 of 0.1 per cent of GDP and the Government is therefore meeting the golden rule on the basis of cautious assumptions. There is a margin against the golden rule of £8 billion in this cycle, including the Annually Managed Expenditure (AME) margin. Both the current budget and the cyclically adjusted current budget move into surplus by 2008-09; and
- public sector net debt remains low and stable over the forecast period, remaining below 39 per cent of GDP, below the 40 per cent ceiling set in the sustainable investment rule.

Table 1.1: Meeting the fiscal rules

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Golden rule							
Surplus on current budget	-1.2	-0.6	-0.1	0.3	0.5	0.6	0.8
Average surplus since 1997-1998	0.1	0.1	0.0	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	-1.0	-0.4	-0.1	0.3	0.5	0.6	0.8
Sustainable investment rule							
Public sector net debt[1]	36.4	37.5	38.2	38.6	38.7	38.7	38.5

[1] *Debt at end March; GDP centred on end March.*

1.13 An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the *2006 Long-term public finances report*. Using a range of sustainability indicators, the report shows that the public finances are sustainable in the longer term. In addition, the UK is well placed relative to many other countries to meet the challenges of an aging population.

MEETING THE PRODUCTIVITY CHALLENGE

1.14 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance. In the increasingly knowledge-driven global economy, science, innovation and creativity are important drivers of productivity growth, backed up by a highly skilled workforce and a competitive and enterprising economy. Historically, the UK has experienced comparatively low rates of productivity growth. However, UK performance has improved in relation to other major economies in recent years. The Government's long term goal is for the UK to continue to close the productivity gap by achieving a faster rate of growth than its main competitors.

Action so far **1.15** The Government's strategy focuses on five key drivers of productivity performance:

- **improving competition** which promotes flexible markets and increases business efficiency and consumer choice;
- **promoting enterprise,** including through reducing the regulatory burden on business, to ensure that UK firms are well-placed to respond to opportunities in a rapidly changing global market;
- **supporting science and innovation** which is central to success in the international economy, as global restructuring focuses developed economies toward knowledge-based and high value-added sectors;
- **raising UK skills** to create a more flexible and productive workforce, and to meet the long-term challenge of rising skills levels in emerging markets; and
- **encouraging investment** to increase the stock of physical capital supported by stronger, more efficient capital markets. In the global economy, attracting international capital and investment will require macroeconomic stability and a robust and efficient investment environment.

Next steps **1.16** Building on the reforms and initiatives already introduced, the 2006 Pre-Budget Report sets out the next steps the Government is taking to strengthen the drivers of productivity growth and meet the long-term challenges and opportunities of the global economy, including:

- **investing in a new ambition for world-class skills,** increasing adult skills across all levels and strengthening employer voice in their provision – by taking forward the recommendations of the Leitch Review;
- **investing in the growth of the UK's science and innovation system** – through a single health research fund of at least £1 billion, taking forward the recommendations of the Cooksey Review, and ensuring a more balanced, coherent and flexible regime for intellectual property, as set out in the Gowers Review;
- **enabling greater flexibility in the land use planning system** to ensure it contributes to economic growth while delivering its wider sustainable development goals – by taking forward the Barker Review;

- **investing in transport infrastructure** to maximise the return on investment in transport – by taking forward the recommendations of the Eddington Transport Study;
- **investing in the growth of sustainable housing supply** – including further acceleration of the release of surplus public sector land and greater ambitions for assisted home ownership through shared equity schemes; and
- **increasing business flexibility by reducing unnecessary burdens on business** – by creating certainty for business, by implementing the recommendations of the Varney Review of HMRC Links with Large Business, and driving forward implementation of the Hampton Review's risk-based approach to regulation, and the Davidson Review's recommendations to reduce any gold plating of EU legislation.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.17 The Government's long-term objective for the labour market is to realise employment opportunity for all – the modern definition of full employment. There has been considerable progress on this objective, particularly in those areas and among those groups of people who had previously been most disadvantaged. The Government aims to go further, however, and has set a long-term aspiration for an employment rate equivalent to 80 per cent of the working age population. This will involve reaching out to the hardest to help, moving people from inactivity to labour market participation and encouraging more individuals to take personal responsibility to move from welfare to work.

Action so far **1.18** The Government's strategy for extending employment opportunity to all builds on the strong performance of the UK labour market over recent years. Employment in the UK reached 29 million for the first time in 2006. This is the highest figure since comparable records began in 1971. The working age employment rate is now 74.5 per cent, up from 72.7 per cent in 1997, while unemployment has fallen to 5.6 per cent. Chapter 4 describes the successful action the Government has taken to increase employment opportunity, through:

- **delivering employment opportunity to all,** to provide everyone who is able to work with the support they need to move into work as quickly as possible;
- **extending employment opportunity** to those groups and regions which have faced the greatest barriers to work;
- **enhancing skills and mobility,** to ensure that everyone can fulfil their potential in the labour market and that business has access to the skilled workforce they need to compete in the global economy; and
- **making work pay,** through the National Minimum Wage and tax credits which create a system of support that provides greater rewards from work, improving incentives for individuals to participate in the labour market.

Next steps **1.19** The 2006 Pre-Budget Report describes the further steps the Government is taking to build on this success and further strengthen the labour market, with a long-term vision for extending support to the inactive, the low-skilled and those who face particular barriers to work. The Pre-Budget Report announces:

- **extending the support offered to lone parents who move into work** by maintaining the In-Work Credit in the current pilot areas for a further six months;

- **improving the Jobseeker's Allowance intervention regime** by offering expert work-search support at the new claim stage, and extending the Job Grant of £100 (£250 to claimants with children) to 18-24 year old jobseekers;
- **improving enforcement of the National Minimum Wage by increasing by 50 per cent the resources allocated to tackle non-compliance and raising penalties for the seriously non-compliant;**
- **providing funding to improve the administration of Housing Benefit and to raise awareness that Housing Benefit is available to those in work;**
- **taking forward measures to simplify and reduce error in the benefits system; and**
- **raising the earnings disregard to Housing Benefit and Council Tax Benefit in line with indexation to £15.45 in April 2007,** ensuring that claimants gain from increases in the rate of Working Tax Credits.

BUILDING A FAIRER SOCIETY

1.20 The Government's long-term economic goal is to combine flexibility with fairness. Policies that ensure fairness act to minimise the short-term costs that can be associated with the changes that are needed in flexible outward-looking economies. Fairness provides security and support for those that need it and ensures that everyone has the opportunity to fulfil their potential in the global economy, now and in the future. The Government is also at the forefront of global efforts to achieve the Millennium Development Goals for global poverty, and to reduce debt in the poorest countries.

Action so far **1.21** Chapter 5 describes the range of reforms the Government has undertaken 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 fulfil their potential;
- **support for pensioners** to tackle poverty and ensure security in retirement for all pensioners, with extra help for those who need it most and rewards for those who have saved modest amounts;
- **steps to encourage saving,** including through the introduction of the Child Trust Fund, stakeholder pensions and Individual Savings Accounts; and
- **measures and reforms to improve the tax system,** and to ensure that everyone pays their fair share toward extra investment in public services.

Next steps **1.22** Building on these reforms, the Government is committed to taking the long-term decisions to promote opportunity and fairness. The Pre-Budget Report announces:

- **from April 2007, the value of the child element of Child Tax Credit will rise by £80 to £1,845 per year;**
- **from April 2009, additional support for all families, with every mother-to-be becoming eligible for Child Benefit from week 29 of their pregnancy, so that women will be up to £200 better off;**

- **an extension of the Warm Front programme, targeting 300,000 of the most vulnerable pensioner and other households, community by community;**
- **making Individual Savings Accounts (ISAs) permanent, beyond 2010,** to provide stability for savers and certainty for the industry. In addition, the introduction of a package of reforms to the ISA, designed to simplify the regime, will make it more flexible for savers and providers and further promote saving;
- **a package of measures responding to the consultation on the role of the third sector in social and economic regeneration,** including the establishment of a new £30 million Community Asset Transfer fund and the guarantee of three years of funding passed on to third sector organisations;
- **the establishment of an international research collaborative for the development sciences,** led by a high level steering board including leading scientists; and
- **further reforms to modernise the tax system and protect tax revenues,** including work to tackle tax avoidance.

DELIVERING HIGH QUALITY SERVICES

Action so far **I.23** The Government's aim is to deliver world-class public services through sustained investment and far-reaching reform. High quality education and training, a modern health service, a fair and effective criminal justice system and a fast and reliable transport network provide the essential foundations for a flexible economy and a fair society, which is well placed to prosper in the increasingly competitive global environment.

I.24 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;
- **significant extra resources for public services,** consistent with the fiscal rules; and
- **challenging efficiency targets** for all Departments, delivering over £21 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

Next steps **I.25** A decade on from the first Comprehensive Spending Review (CSR), the Government is now conducting a second CSR, reporting in 2007. In preparation for the 2007 CSR, this Pre-Budget Report announces:

- **solid progress in the Government's SR04 efficiency programme,** with departments and local authorities reporting gains of £13.3 billion by September 2006, over halfway towards the target of over £21 billion by 2007-08;
- building on this success, **the baseline savings ambition for the 2007 CSR period will be at least 3 per cent per year across central and local government,** with a focus on net cashable savings to free-up resources to meet the challenges ahead;
- **administration budgets across departments will be reduced by at least 5 per cent per year in real terms over the 2007 CSR period,** releasing resources for reallocation to frontline services;

- **an early CSR07 settlement for the Department for Constitutional Affairs,** which will see its budget fall by an annual average of 3.5 per cent in real terms over the 2007 CSR period;

- **an early CSR07 settlement for education capital with investment rising from £8.3 billion in 2007-08 to £10.2 billion in 2010-11,** a total of £36 billion over the next four years; and

- **the publication of Sir David Varney's review of public service transformation,** making recommendations to strengthen and join up public service delivery and make public services more efficient and responsive to the needs of users.

1.26 The Pre-Budget report outlines further measures directing resources to the Government's priorities, including:

- **a further £130 million direct to schools in England in 2007-08,** including to support personalised teaching and extended services;

- an increased focus on small group and one-to-one support, with **the Every Child a Reader scheme, rolled out nationally to 30,000 children a year by 2010-11**; **and an additional £10 million in 2007-08 to increase personalised support in schools** where boys are falling behind; and

- **an additional £84 million to support the ongoing expansion of counter-terrorism capabilities in the Intelligence Agencies.**

PROTECTING THE ENVIRONMENT

1.27 The Government is committed to delivering a strong economy based not just on high and stable levels of growth and employment but also on high standards of environmental stewardship. Growth in the developed world, accompanied with the rapidly growing and highly populated economies of China and India, will place increasing demands on the world's resources and environment over the coming decade. Meeting this long-term challenge requires action at a local and national level, but crucially also through international cooperation. Climate change is a very significant challenge, and the recently published *Stern Review on the Economics of Climate Change*[2] has highlighted how long-term global prosperity will be undermined if early and coordinated international action is not taken.

Action so far **1.28** Chapter 7 describes the steps the Government has taken to deliver its environmental objectives, including:

- **tackling climate change** and reducing emissions of greenhouse gases in line with domestic as well as international targets – in particular through the EU Emissions Trading Scheme and the Climate Change Levy;

- **improving air quality** to ensure that air pollutants are maintained below levels that could pose a risk to human health – including through support for cleaner fuels and vehicles;

- **improving waste management,** so that resources are used more efficiently and waste is re-used or recycled to deliver economic value – for example through increases in the landfill tax; and

- **protecting the UK's countryside and natural resources,** to ensure that they are sustainable economically, socially and physically – in particular by introducing the aggregates levy.

[2] *Stern Review on the Economics of Climate Change, October 2006,* Cambridge University Press

Next steps **1.29** The Government is committed to delivering sustainable growth, a better environment and to tackling the global challenges of climate change. It is using a range of economic instruments to address the challenges posed by sustainable development, whilst taking into account other social and economic factors. This Pre-Budget Report sets out the next stage in the Government's strategy for tackling the global challenge of climate change including:

- **promoting the development of a global carbon market** through the expansion and strengthening of the EU Emissions Trading Scheme and linking it to schemes outside the EU;
- **taking further steps towards realising carbon capture and storage technology,** including tendering for consulting engineers to help enable a decision in 2007 on whether to support a UK-based demonstration plant;
- **an increase in all rates of air passenger duty,** with effect from 1 February 2007, in recognition of the environmental costs air travel;
- **an inflation-based increase of 1.25 pence per litre (ppl) in the rate of road fuel duty with effect from midnight tonight;** and the same increase of 1.25 ppl in duty for rebated fuels, maintaining the differential with main fuel duty rates;
- **a package of measures to encourage the development of the biofuels market** and innovative types of biofuels;
- **an ambition for all new homes to be zero carbon within a decade with a time-limited stamp duty exemption** for the vast majority of new zero-carbon homes that meet this standard;
- **legislation to ensure householders installing microgeneration are not subject to income tax on any payment for surplus electricity exported back to the grid**; and
- **the extension of the Landlords Energy Saving Allowance** to 2015 and to corporate landlords.

1.30 The Pre-Budget Report also reports on the Government's strategy for tackling other environmental challenges, including:

- **confirmation that the standard rate of landfill tax will increase by £3 per tonne to £24 per tonne with effect from 1 April 2007.** The Government will also consider the case for steeper increases in the tax from 2008.

PRE-BUDGET REPORT POLICY DECISIONS

1.31 Consistent with 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 2006. The fiscal impact of these measures is set out in Table 1.2. Full details are provided in Annex B.

1.32 Chart 1.1 presents public spending by main function. Total managed expenditure (TME) is expected to be around £555 billion in the current financial year, 2006-07. TME is divided into Departmental Expenditure Limits (DEL), shown in Table B18, and Annually Managed Expenditure (AME), shown in Table B16.

Table 1.2: Estimated costs for Pre-Budget Report policy decisions and others announced since Budget 2006[1]

	£ million			
	2006-07	2007-08	2008-09	2009-10
Increasing employment opportunity for all				
Increase in Housing Benefit disregard	0	-5	-	-
Supporting people into work through extending the job grant	*	-5	-	-
Building a fairer society				
July renewal deadline for Child and Working Tax Credits [2]	0	+60	+20	+10
Tackling Managed Service Companies	0	+350	+450	+250
Film tax reliefs: transitional arrangements	0	-20	-20	*
Life assurance companies reform	0	-15	-20	-10
Simplification of general insurers' reserves	0	0	+130	+150
VAT: partial exemption special method	0	+20	+20	+25
Construction Industry Scheme deduction rates	0	+250	-10	-20
Increasing travellers' allowance from outside the EU	0	-15	-15	-15
Protecting revenues				
Controlled Foreign Companies: repeal of public quotation exemption [3]	+20	+125	+160	+160
Tackling avoidance using structured finance arrangements	+10	+15	+15	+15
Countering corporation tax avoidance	+110	+180	+195	+195
Life assurance companies: valuation rules	+70	+95	+95	+95
Stamp duty land tax anti-avoidance	+25	+75	+70	+70
Countering CGT avoidance	0	+70	+130	+120
Protecting the environment				
Air passenger duty rates [4]	+165	+1,000	+1,100	+1,200
Fuel duties: revalorise main rates from 7 December 2006	-190	0	0	0
Fuel duties: maintain the differential for rebated oils from 7 December 2006	-20	0	0	0
Rebated oils: changes to excepted vehicle schedule	0	-5	0	0
Extension of the Landlords Energy Saving Allowance	0	0	-10	-10
Other policy decisions				
Direct payments to schools	0	-155	-	-
TOTAL POLICY DECISIONS	**+190**	**+2,020**	**+2,310**	**+2,235**

** Negligible*

- Included within the current spending growth assumption from 2008-09 onwards.

[1] Costings shown relative to an indexed base.

[2] The savings in AME spending as a result of this measure are included within the current spending growth assumption from 2008-09 onwards.

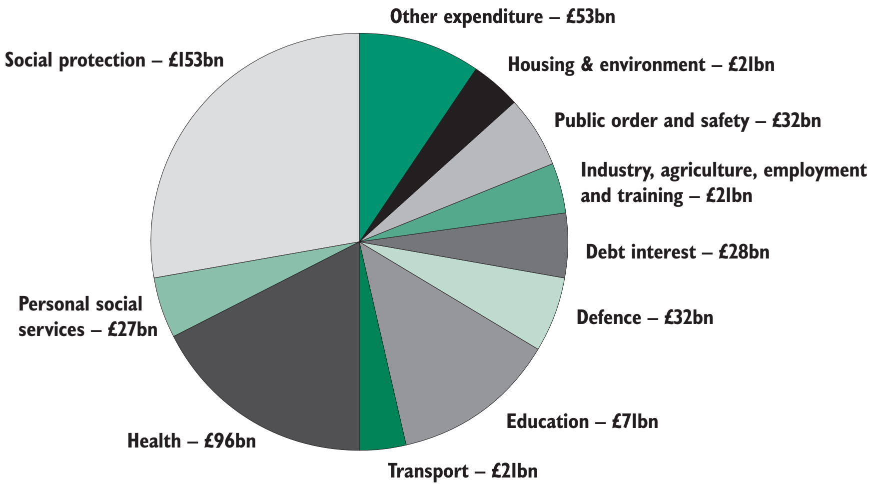
[3] Alongside the revenue raised by this measure, forecast tax revenues have been adjusted as a result of the European Court of Justice ruling on the taxation of Controlled Foreign Companies and the Government's response to it, as described in Chapter 5. The impact on tax revenues of this adjustment is estimated as:

2006-07	2007-08	2008-09	2009-10
-15	-100	-175	-250

[4] The costing assumes revalorisation annually from 1 April 2008.

Chart 1.1: Government spending by function

Total managed expenditure: £555 billion

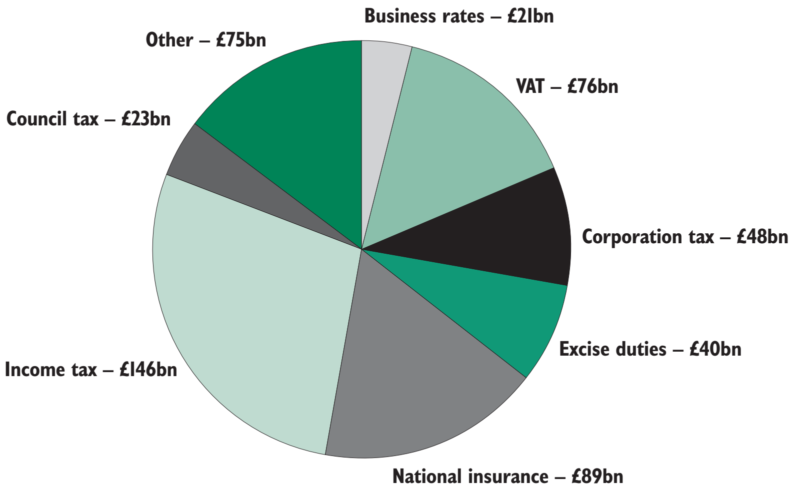


Source: HM Treasury, 2006-07 near-cash projections. Spending re-classified to functions compared to previous presentations and is now using methods specified in international standards. Other expenditure includes spending on general public services; recreation, culture, media and sport; international 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.

1.33 Chart 1.2 shows the different sources of government revenues. Public sector current receipts are expected to be around £518 billion in 2006-07. Table B13 provides a more detailed breakdown of receipts consistent with this chart.

Chart 1.2: Government receipts

Total receipts: £518 billion



Source: HM Treasury, 2006-07 projections. 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

The UK economy is currently experiencing its longest unbroken expansion on record, with GDP now having grown for 57 consecutive quarters.

Growth of the UK economy since Budget 2006 has been higher than forecast, with slightly above-trend growth narrowing the output gap. Domestically, growth has been driven by higher than expected business investment. Externally, the recovery in the euro area has boosted export growth. Together, these developments have further helped to rebalance UK economic growth.

The 2006 Pre-Budget Report projections for the public finances show that the Government is meeting its strict fiscal rules:

- **the current budget shows an average surplus as a percentage of GDP over the current economic cycle, even using cautious assumptions, ensuring the Government is meeting the golden rule. Beyond the end of the current cycle, the current budget moves clearly into surplus; and**
- **public sector net debt is projected to remain low and stable over the forecast period, stabilising at a level below the 40 per cent ceiling set in the sustainable investment rule.**

An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2006 *Long-term public finance report*. The report confirms that on the basis of current policies the public finances are sustainable in the long term.

THE MACROECONOMIC FRAMEWORK

2.1 The UK economy is currently experiencing its longest unbroken expansion since quarterly National Accounts data began, with GDP now having grown for 57 consecutive quarters. With volatility in the UK economy at historically low levels and now the lowest in the G7, the domestic stability delivered by the Government's macroeconomic framework puts the UK in a strong position to respond to the global economic challenges of the next decade.

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.

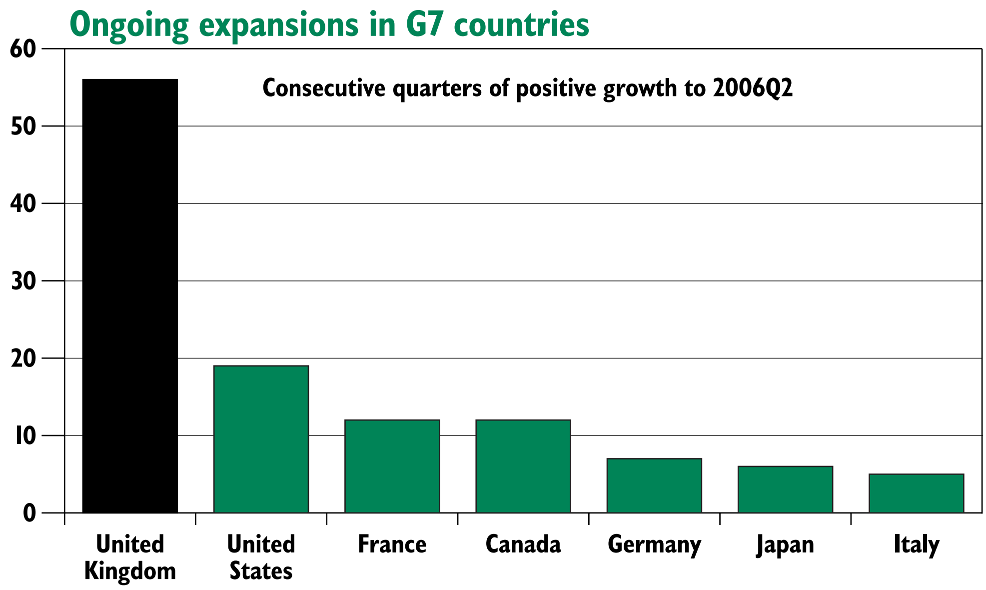
2.3 The macroeconomic framework is based on the principles of transparency, responsibility and accountability.[1] The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term while allowing fiscal policy to support monetary policy over the economic cycle. 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] Further details can be found in *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002

Box 2.1: Economic stability

The Government's macroeconomic framework is delivering economic stability, with both sustained growth and low inflation. Stability promotes economic performance through:

- **establishing domestic resilience and enabling policy flexibility in the face of economic shocks;**
- **giving firms and individuals the best macroeconomic environment in which to make decisions about the allocation of resources; and**
- **avoiding the erosion of human and physical capital that is associated with volatile swings in output.**



Source: OECD Economic Outlook 79.

The UK economy has now expanded in 57 consecutive quarters, an unprecedented period of unbroken growth since the quarterly National Accounts began. This prolonged expansion is not only without precedent in the post-war history of the UK, but is also the longest on post-war record for any G7 economy and the longest ongoing expansion of any OECD country.

It will be at least nine years before the UK's current expansion could be eclipsed by another G7 country. The next longest ongoing expansion in a G7 economy is in the US, where growth has been unbroken for just under five years. This compares with the UK where there have been positive rates of growth for over 14 years.

Monetary policy framework

2.4 Since its introduction in 1997, the monetary policy framework has consistently delivered inflation close to the Government's target. The framework is based on four key principles:

- clear and precise objectives. 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 Monetary Policy Committee (MPC) in setting interest rates to meet the Government's target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt publication 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. If inflation deviates by more than one percentage point above or below 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 duration of the deviation and how the proposed action meets the remit of the MPC.

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

Fiscal policy framework

2.6 The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*[2] – 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.

2.7 These objectives are implemented through two strict 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.

2.8 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

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

- 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.

Public spending framework

2.9 The fiscal rules underpin the Government's public spending framework. The golden rule states that, over the economic cycle, the Government will only borrow to invest. Departments are therefore given separate resource and capital allocations, which increases the efficiency of public spending as public investment is not crowded out by 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.

Financial stability framework

2.10 The framework for co-operation on financial stability between the Bank of England, the Financial Services Authority (FSA) and HM Treasury is set out in the 2006 Memorandum of Understanding.[3] The Memorandum of Understanding between the three authorities defines the roles and responsibilities of the three authorities in maintaining financial stability, and for financial crisis management and in responding to operational disruptions to the financial sector.

2.11 The Standing Committee on Financial Stability, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss individual cases and developments relevant to financial stability, focusing on risks to the financial system. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure and coordinates the three authorities' response and contingency plans. In the event of a crisis, it would meet at short notice and is the principal forum for agreeing policy, and, where appropriate, coordinating and agreeing action between the three authorities.

[3] The 2006 Memorandum updates the version published in 1997.

Box 2.2: Independence for statistics

Following the commitment made by the Chancellor in November 2005, and a full public consultation, the Government has introduced to Parliament in this session legislation for the reform of the UK statistical system.

This will build on earlier reforms, helping to reinforce the quality and integrity of statistics produced in government, supporting the Government's agenda for better public services, and contributing to long-term stability in the UK economy.

The bill, introduced on 21 November 2006, will establish an independent Statistics Board, responsible for promoting and safeguarding the quality and comprehensiveness of all official statistics, wherever produced in government. As part of this, the Board will have a statutory duty to set professional standards in a code of practice, and to assess independently all National Statistics against this code.

The Board will also replace Ministers as the top layer of governance for the Office for National Statistics. The Board will be independent of ministerial control, established as a Non-Ministerial Department, with special funding arrangements outside the normal Spending Review process. Following decisions by Northern Ireland, Scotland and Wales to participate in the new arrangements, the full benefits of the legislation will be realised, strengthening the statistical system for users across the UK.

Further details of the Government's proposals, including the Government's public consultation document, the Government's response to the consultation, as well as the bill and associated documentation, can be found on the HM Treasury website at www.hm-treasury.gov.uk.

PERFORMANCE OF THE FRAMEWORK

2.12 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.

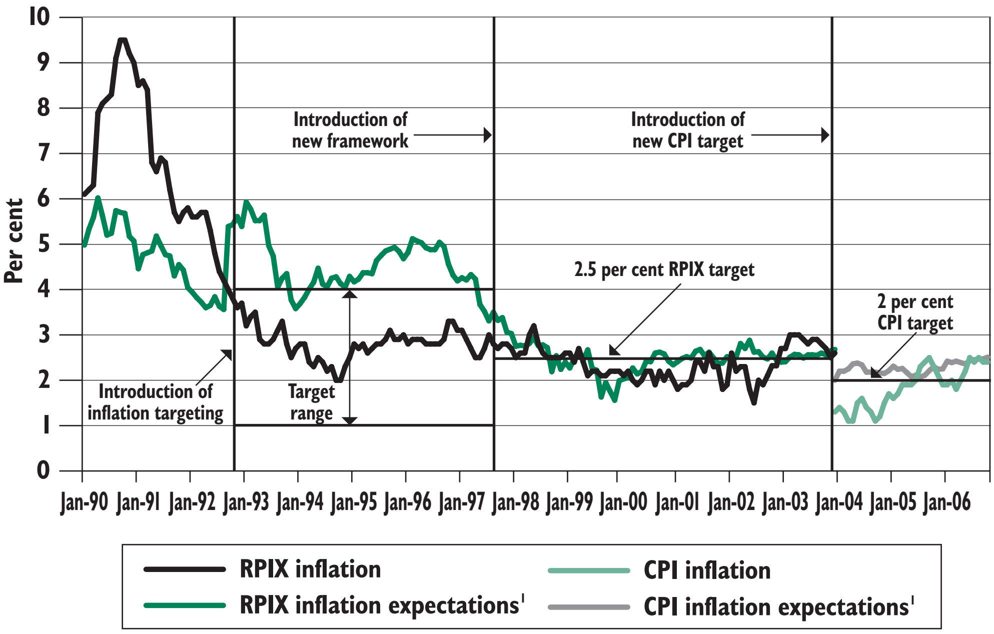
Monetary policy

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

- the annual rate of increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target value of $2^1/_2$ per cent, the longest period of sustained low inflation for the last 30 years; and
- inflation expectations have remained close to target following the switch to a 2 per cent CPI target. CPI inflation has been within 1 percentage point of its target at all times since its inception in December 2003.

2.14 The monetary policy framework has given the MPC the flexibility to respond decisively to unexpected economic events over recent years. Consistent with its forward-looking approach, the MPC cut interest rates by a $^1/_4$ percentage point in August 2005, responding to the slackening in the pressure of demand on supply. This year, as growth has strengthened and measured inflation has moved above target, the MPC has acted by raising the official Bank rate by 25 basis points in August and November.

Chart 2.1: Inflation performance and expectations



[1] *Implied expectations of average RPI inflation ten years ahead are derived from the difference between yields on nominal and index-linked government bonds. Implied CPI inflation expectations are derived from these RPI expectations and stylised assumptions about expected differences between RPI and CPI inflation in the medium-term, including that the geometric averaging lowers CPI inflation by 0.5 percentage points relative to RPI inflation.*

Source: ONS, Bank of England and HM Treasury.

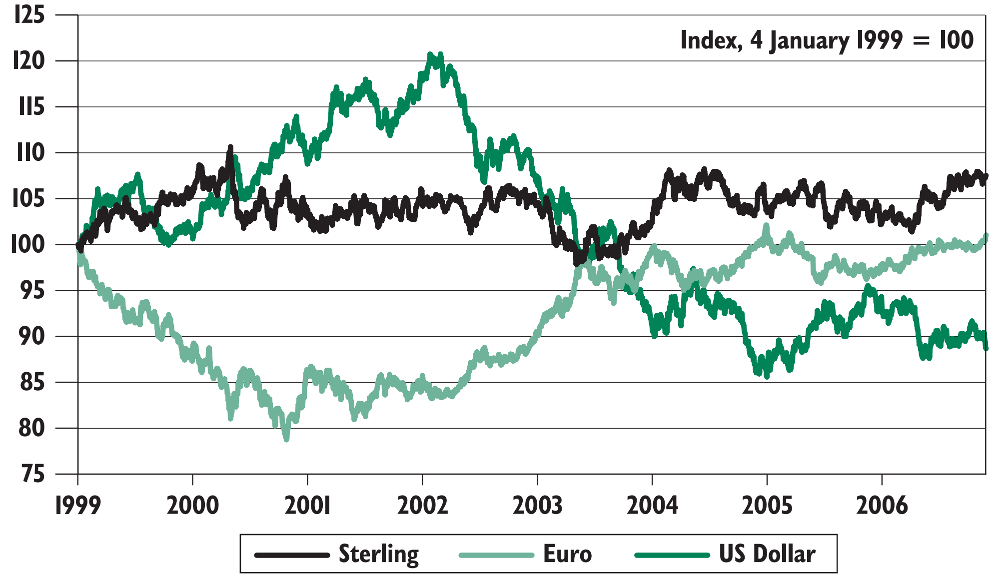
2.15 Low inflation expectations and a period of entrenched macroeconomic stability have helped long-term interest rates remain at historically low levels. Low long-term interest rates reduce the Government's debt interest payments, free up resources for public services and help promote investment. Over the current economic cycle, long-term spot interest rates have averaged 5 per cent compared with an average of just over 9 per cent in the previous cycle.

2.16 Ten-year forward rates, which abstract from cyclical influences, are around 0.9 percentage points lower than those in the United States and slightly above those in the euro area.[4] Ten-year forward rates in November 2006, at 4.1 per cent, are at the same rate as a year earlier. This compares with a rate of 8 per cent in April 1997, before the introduction of the new macroeconomic framework.

2.17 Alongside the UK's macroeconomic stability in recent years, the effective exchange rate has also been relatively stable, as seen in Chart 2.2. The sterling effective exchange rate remains close to levels at Budget 2004, having remained within a narrow band of just under $3^1/_2$ per cent of its average level over the period. Since the introduction of the euro in 1999, the volatility of sterling's effective exchange rate has been under half that of the euro and around a quarter of that of the US dollar.

[4] Ten-year forward rates are market expectations, formed today, of short rates in ten years' time. They are less affected by short-term factors, such as the current cyclical position of the economy, than spot rates and are therefore a better basis for making international comparisons when cyclical conditions differ.

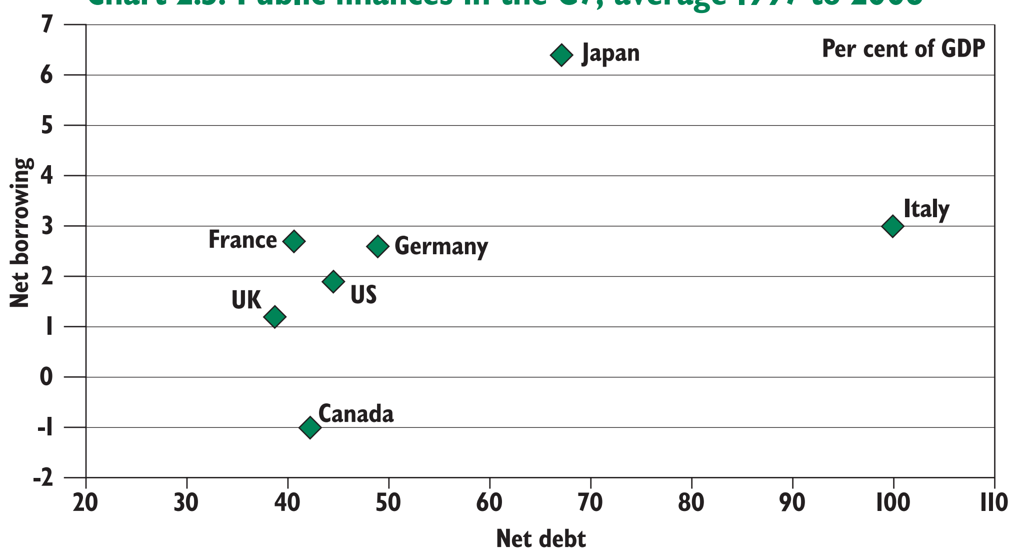
Chart 2.2: Movements in leading effective exchange rate indices since 1999



Source: Bank of England.

Fiscal policy **2.18** The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Public sector net debt was reduced from just under 44 per cent of GDP in 1996-97 to just over 30 per cent in 2001-02, creating room for an historically unprecedented rise in public sector net investment, which has risen as a share of GDP in six successive years. Public sector net borrowing was reduced sharply from 1997-98 on, with surpluses over 1998-99 to 2000-01 when the economy was above trend. Net borrowing increased to allow fiscal policy to support monetary policy as the economy moved below trend in 2001, but remained low and stable. Even at its peak during this cycle, borrowing as a share of the economy stayed well below half the rates of the late 1990s. As Chart 2.3 shows, since 1997 the UK's public finances compare favourably with other countries.

Chart 2.3: Public finances in the G7, average 1997 to 2006



Source: OECD Economic Outlook 79, June 2006

2004 Spending Review

2.19 The 2004 Spending Review set spending plans for the years 2005-06 to 2007-08, locking in the increased investment of previous spending reviews while providing for further investment in the most crucial areas of the public services. These plans provide for:

- current spending to increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;
- public sector net investment rising to 2$^{1}/_{4}$ per cent of GDP from 2006-07 onwards, compared with 0.5 per cent of GDP in 1999, to continue to address historic under-investment in the UK's infrastructure while meeting the sustainable investment rule; and
- agreed efficiency targets for all departments, delivering over £21 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

Comprehensive Spending Review

2.20 The overall spending limits set in Budget 2004 and confirmed in the 2004 Spending Review remain sustainable and fully consistent with the fiscal rules. Building on these firm foundations, the 2007 Comprehensive Spending Review (CSR) will provide the opportunity for a fundamental and long-term review of the Government's priorities and expenditure. As outlined in more detail in Chapter 6, the CSR will take a zero-based approach to assessing the effectiveness of departments' baseline expenditure in delivering the outputs to which they are committed, and consider the further investments and reforms needed to ensure that the UK's public services are equipped to meet the global challenges of the decades ahead. The CSR will set departmental spending plans for 2008-09, 2009-10 and 2010-11, with allocations for 2007-08 held to the agreed figures already announced at the 2004 Spending Review.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.21 The Government's macroeconomic framework has continued to deliver an unprecedented period of sustained economic growth with low inflation. UK GDP has now expanded in 57 consecutive quarters, the longest unbroken expansion since quarterly National Accounts began in 1955, and the longest ongoing expansion among all OECD countries.

2.22 UK GDP growth has been stronger than expected at the time of Budget 2006. GDP has expanded by 0.7 per cent in each of the last four quarters. There has been a greater degree of rebalancing of growth than estimated at Budget 2006. Investment has been growing faster than GDP since the middle of 2005, while private consumption has been growing slightly slower. In particular, business investment in the third quarter of 2006 was up 7 per cent on a year earlier. There has been some rebalancing on the output side of the economy too, where ongoing service sector growth has been supported by some recovery in the manufacturing sector. Finally, there has been some rebalancing between domestic and external sources of demand, supported by the strengthening in euro area growth this year.

Table 2.1: Summary of world forecast

	Percentage change on a year earlier unless otherwise stated				
	Outturn	Forecasts			
	2005	2006	2007	2008	2009
World GDP	$4^3/_4$	5	$4^3/_4$	$4^1/_2$	$4^1/_2$
Major 7 countries[1]					
Real GDP	$2^1/_2$	$2^3/_4$	$2^1/_4$	$2^1/_2$	$2^1/_2$
Consumer price inflation[2]	$2^1/_2$	$2^1/_2$	$2^1/_4$	2	2
Euro area GDP	$1^1/_2$	$2^1/_2$	2	$2^1/_4$	$2^1/_4$
World trade in goods and services	$7^1/_4$	$8^3/_4$	$7^1/_2$	$7^1/_2$	7
UK export markets[3]	$5^3/_4$	$7^3/_4$	$6^1/_2$	$6^1/_4$	$6^1/_4$

[1] *G7: US, Japan, Germany, France, UK, Italy and Canada.*

[2] *Per cent, Q4.*

[3] *Other countries' imports of UK goods and services weighted according to their importance in UK exports.*

2.23 The world economy is now in its third consecutive year of growth of around 5 per cent. Continued buoyancy in emerging markets, particularly in Asia, is expected to sustain global growth at similar rates in 2007. Since 2003, world growth has been driven by the US and Asia, particularly China. Through 2006, growth in the US has moderated, largely due to lower residential investment. This has been offset by a broadening of the recovery in the euro area, an improvement in growth in Japan and continued momentum in the rest of Asia and other emerging economies.

2.24 World trade has recovered strongly, with growth rising from zero in 2001 to 10 per cent in 2004. Following a $7^1/_4$ per cent increase in 2005, it is expected to grow by $8^3/_4$ per cent in 2006 and $7^1/_2$ per cent in 2007. Growth in world trade has been heavily orientated towards Asia.

Economic prospects

2.25 Given the new evidence published since Budget 2006, the Treasury has reviewed the underpinning assumptions for its post-2006 neutral trend output growth assumption, which it has revised to continue at $2^3/_4$ per cent a year, consistent with the neutral rate since 2001.

2.26 Since Budget 2006, many external institutions, including the OECD, National Institute of Economic and Social Research, Oxford Economics and Goldman Sachs, have revised up their estimates of the UK's trend rate of output growth in the post-2006 period. The Treasury's $2^3/_4$ per cent neutral trend output growth estimate for the post-2006 period lies within the range of these external estimates, cited in Box A4. The Treasury's cautious trend output growth assumption of $2^1/_2$ per cent, used for the purposes of projecting the public finances, is materially below the comparable range of external estimates. The National Audit Office has audited this change to the post-2006 cautious trend growth assumption and has concluded, in light of external forecasts and other information, that the revised assumption is reasonable and cautious.

2.27 With growth in recent years having been stronger and more balanced than was evident at the time of Budget 2006, and that pattern having continued in 2006, the Pre-Budget Report economic forecast is for growth to continue at close-to-trend rates throughout the forecast horizon, to 2009. The output gap is currently estimated to be around $-^1/_4$ per cent and is expected to close early in 2007.

2.28 Growth in 2006 is expected to be $2^3/_4$ per cent, above the Budget 2006 forecast range. Growth in 2007 as a whole is forecast to reach $2^3/_4$ to $3^1/_4$ per cent, in line with the Budget forecast, reflecting above-trend growth in the second half of 2006 and early 2007. The recent momentum of business investment in particular is expected to carry through into 2007, and private sector business surveys point to strong output growth in the near term. Favourable supply-side conditions, with subdued growth in earnings and unit wage costs, should also support GDP growth next year. With the output gap closing early in 2007, and in the absence of clear evidence that momentum in the economy will carry output above trend during 2007, the Pre-Budget Report forecast is for growth to be close to trend in the second half of 2007 and to remain at 2½ to 3 per cent in 2008 and 2009.

2.29 The rebalancing of growth that has taken place since the beginning of 2005 is expected to continue. Private consumption is forecast to grow at slightly slower rates than the overall economy, reflecting the effect of higher than expected inflation on real incomes, the effect of recent interest rate increases and a higher propensity to save. Business investment gathered momentum in the first three quarters of 2006, growing by 5¼ per cent on a year earlier, significantly above the Budget forecast range for the year as a whole of 1 to 1½ per cent. The outlook for business investment is positive. Profitability is expected to remain strong and the cost of capital to remain low by historical standards. Net trade made a neutral contribution to GDP growth in 2005 and is expected to make a small negative contribution in 2006. With solid underlying export growth and somewhat slower import growth, the impact of net trade on GDP growth is expected to be broadly neutral from 2007.

2.30 CPI inflation is expected to remain above target into the first half of 2007, before quickly returning to target, with monetary policy keeping inflation expectations firmly anchored. The impact of higher food and energy prices, particularly domestic utility tariffs, discussed in Box A6, is expected to unwind during 2007 without having fed through to second-round inflationary pressures. The lack of evidence of any second-round effects on other prices supports the view that the recent rise in inflation will be temporary. It is notable that producers of energy-intensive manufactured goods have passed very little of the rise in input prices on to customers, absorbing the impact in margins. Similarly, average earnings growth has remained subdued. The absence of second-round effects reflects the credibility of the Government's monetary policy framework in successfully anchoring inflation expectations.

Table 2.2: Summary of UK forecast[1]

	Outturn	Forecasts			
	2005	2006	2007	2008	2009
GDP growth (per cent)	1¾	2¾	2¾ to 3¼	2½ to 3	2½ to 3
CPI inflation (per cent, Q4)	2¼	2½	2	2	2

[1] *See footnote to Table A10 for explanation of forecast ranges.*

Risks

2.31 Risks to the 2006 Pre-Budget Report economic outlook are broadly balanced, both globally and domestically.

2.32 The key uncertainty identified in Budget 2006 concerned the tension between cyclical indicators of the degree of slack in the economy and the output gap implied by the trend growth arithmetic. Following National Accounts revisions, particularly those published in the 2006 Blue Book, the coherence between the latest output gap estimate and the cyclical indicators has improved, but considerable uncertainty remains over the extent to which official population and labour supply data adequately measure migration flows. If inflows have been higher than measured, it may imply a greater degree of slack in the economy or more scope for growth.

2.33 Domestic risks are broadly balanced across the components of demand, with potential downside risks to the private consumption forecast, but significant upside risks to business investment growth. Surveys of consumers' saving intentions suggest that the pick-up in the household saving ratio over the past year could continue and exceed the Pre-Budget

Report forecast. Offsetting that, developments in the housing market have been somewhat stronger than expected and could be associated with higher consumption growth. In recent months, survey indicators of manufacturing activity have moderated somewhat, although forward-looking indicators of manufacturing export orders remain strong.

2.34 Despite business investment growth having been revised up in the Pre-Budget Report forecast, there are still significant upside risks. In particular, corporate profitability remains strong, as explained in Box A9, and financing conditions remain benign. Both factors could support stronger growth in business investment while data revisions, including the incorporation of own-account software investment by ONS in summer 2007 (see Box A8), could affect measured business investment growth.

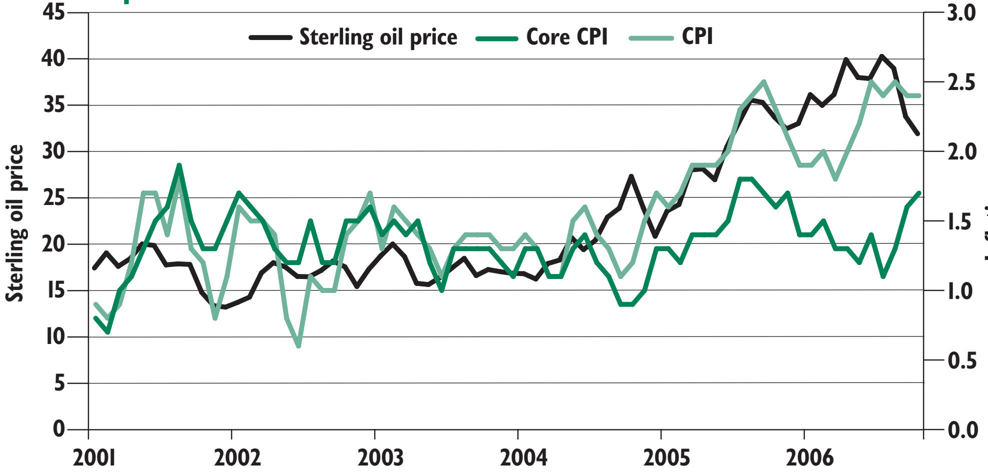
2.35 With CPI inflation currently above target, largely driven by the temporary impact of higher energy and food prices, as outlined in Box 2.3, there is a risk to the forecast from rising inflation expectations and second-round effects on inflation. However, monetary policy has kept inflation expectations firmly anchored and earnings growth has remained subdued.

Box 2.3: The effect of oil prices on the UK economy and public finances

Oil prices have increased sharply since 2004, driven partly by demand from emerging markets. Higher oil prices have adverse effects on the supply side, dampening output and demand and leading to higher consumer inflation. Demand is weakened through the erosion of consumers' purchasing power due to higher fuel costs and added pressure on businesses' profit margins in response to higher production costs.

Whether higher oil prices lead to a temporary increase in consumer inflation or a more sustained rise depends on the extent of second round effects in wages and costs in response to the original increase in oil prices. The initial impact of higher oil prices led to an increase in CPI, which reached 2.5 per cent in June and August this year, with some additional impetus from higher food prices. However, core inflation[a] has remained below 2 per cent, in line with the average of recent years. This is consistent with the lack of evidence of any second-round effects from higher energy and food prices in the UK. However, it is important to remain vigilant. As the Chancellor stated earlier this year in his letter to the Pay Review Bodies, *"It will be important to ensure that public sector pay increases do not contribute to inflationary pressures in the economy going forwards. To do so would risk converting a temporary increase in inflation into a permanent increase. The Pay Review Bodies should therefore continue to base their pay settlements on the achievement of the inflation target of 2 per cent"*.

Impact of oil on headline and core inflation



Oil prices also affect the UK's public finances. While higher oil prices have a positive effect on tax revenues from petroleum revenue tax and North Sea corporation tax, there are a number of offsetting effects that limit the overall impact on the public finances. The scale and timing of these effects is extremely uncertain, as they depend on the responses of individuals and businesses to rising prices. The offsetting effects include:

- any temporary increase in inflation, which increases the indexation of allowances and limits for income tax and national insurance contributions and of indexation of tax credits and social security benefits. Higher inflation also increases the costs of servicing indexed-linked bonds;
- higher petrol pump prices, which reduces the demand for road fuels and therefore reduces revenues from fuel duties; and
- possible impacts on the wider economy, for example, if higher input prices reduce companies' profit margins, receipts from non-North Sea corporation tax will fall.

[a] *Measures of core inflation exclude certain items from the CPI basket whose price effects might be considered to be temporary and/or volatile, for example, energy prices and seasonal food prices.*

Caution and the public finances

2.36 For this Pre-Budget Report, the Comptroller and Auditor General audited the change to the Treasury's post-2006 cautious trend output growth assumption used for the public finances forecasts, which it has revised to continue at $2^1/_2$ per cent a year. The Comptroller and Auditor General found that the Treasury's revised underlying growth rate assumption is below the range of external forecasts of the long term growth rate. It is also at or below the average of external forecasters' medium term growth projections. The review concluded that on this basis the revised Treasury assumption is reasonable and cautious.

2.37 The Comptroller and Auditor General audited the Treasury's equity price assumption and found that the assumption of linking equity price growth to that of money GDP has a theoretical and hence reasonable basis, though in practice, the relationship is unlikely to be valid at all times. The review also concluded that for the 2003 to 2006 period, the assumption proved to be a cautious one for most of the projections of the public finances made in the three years, as outturn equity prices exceeded the Treasury's forecasts.

2.38 The Comptroller and Auditor General also audited the assumption on the consistency of the price indices used to project the public finances with the CPI, which is used in the definition of the inflation target. The review confirmed that over the period 2003 to 2006 the series were, and that for the future they remain, consistent with each other and with the CPI.

Box 2.4: The UK's international and European objectives

In both a global and a European context, there is a need to address the challenges of structural economic reform, resist protectionist pressures and promote free trade. The UK is working closely with the G7/8, the EU, International Financial Institutions and other international partnerships, including emerging market economies, to promote global prosperity and economic stability, tackle unfairness and deliver social justice, and promote environmental stewardship, by:

- **pushing for progress on the commitments made in 2005 by donors to provide an extra $50 billion in aid each year to help achieve the Millennium Development Goals; promoting debt relief for a wider group of countries than the heavily indebted poor countries who have received 100 per cent multilateral debt relief; establishing a $4 billion vaccination programme through the International Finance Facility for Immunisation and catalysing the development of new vaccines through a pilot Advanced Market Commitment scheme;**
- **strengthening the ability of EU and global institutions to respond to global challenges to economic stability – including increasing the IMF's focus on credible and independent surveillance, reforming the IMF's governance and supporting reform of the UN's institutional operations;**
- **promoting structural reform in the EU through the further development of a competitive Single Market equipped for the changing global environment; reform of the EU budget through the fundamental review and improved financial management; radical Common Agricultural Policy reform; measurable reductions in EU administrative burdens, and greater use of a risk-based approach to regulation; and monitoring progress on Lisbon agenda reforms;**
- **ensuring sustainable, reliable and affordable energy sources by promoting transparent and open international energy markets – building on the 2005 Hampton Court summit agenda with EU partners and continuing work on extending the principles of the G7 oil initiative to gas;**
- **building a global consensus, in line with the conclusions of the Stern Review, on the need to stabilise greenhouse gas concentrations and fostering an international response to the threat of climate change by effectively pricing carbon through a global carbon market; promoting investment in low-carbon technologies worldwide; promoting European and international energy efficiency standards; and assisting developing countries to adapt to climate change; and**
- **promoting external openness and a freer and fairer international trading system, in the face of rising protectionism – using the last window of opportunity to deliver an ambitious and pro-development outcome to the Doha Development Round, which increases market access in agriculture, industrial goods and services, ends export subsidies and substantially reduces all trade-distorting domestic support. The Government is also pressing for concrete and credible Aid for Trade financing to help poor countries build their capacity to trade.**

RECENT FISCAL TRENDS AND OUTLOOK

2.39 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 2006 and in this Pre-Budget Report, in accordance with the *Code for fiscal stability*.

2.40 The forward-looking fiscal projections described in this section are complemented by the 2006 *End of year fiscal report*, published alongside this Pre-Budget Report, which provides detailed retrospective information on the public finances in 2004-05 and 2005-06.

Table 2.3: Fiscal balances compared with Budget 2006

	Outturn[1]	Estimate[2]	Projections				
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Surplus on current budget (£ billion)							
Budget 2006	**–11.4**	**–7.1**	**1**	**7**	**10**	**12**	
Effect of forecasting changes	–3.7	–1.0	–5	–5½	–5	–4	
Effect of policy decisions since Budget 2006	0.0	0.2	2	2½	2	2	
PBR 2006	**–15.1**	**–7.9**	**–1**	**4**	**7**	**10**	**14**
Net borrowing (£ billion)							
Budget 2006	**37.1**	**35.8**	**30**	**25**	**24**	**23**	
Changes to current budget	3.7	0.8	3	3	3	1½	
Changes to net investment	–3.3	0.1	–1	–½	–1	–1	
PBR 2006	**37.5**	**36.8**	**31**	**27**	**26**	**24**	**22**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2006	–0.3	0.4	0.7	0.7	0.7	0.8	
PBR 2006	**–1.0**	**–0.4**	**–0.1**	**0.3**	**0.5**	**0.6**	**0.8**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2006	2.4	1.9	1.6	1.6	1.6	1.5	
PBR 2006	**2.8**	**2.6**	**2.2**	**1.9**	**1.7**	**1.5**	**1.3**
Net debt (per cent of GDP)							
Budget 2006	36.4	37.5	38.1	38.3	38.4	38.4	
PBR 2006	**36.4**	**37.5**	**38.2**	**38.6**	**38.7**	**38.7**	**38.5**

Note: Figures may not sum due to rounding.

[1] *The 2005-06 figures were estimates in Budget 2006.*

[2] *The 2006-07 figures were projections in Budget 2006.*

Outturn for 2005-06

2.41 The outturn for the current budget for 2005-06 is around £3.7 billion lower than the Budget 2006 estimate, while net borrowing is now around £0.4 billion higher. Further details are given in Annex B.

2.42 As Table 2.3 shows, the main fiscal aggregates are broadly in line with the forecast at Budget time. Where there are differences between the Pre-Budget Report projections for the current budget and net borrowing and those in Budget 2006, these are largely due to areas unrelated to the strength of the economy, most notably lower receipts from North Sea oil revenues, as well as some higher spending as a result of high oil prices feeding through to domestic inflation. These are shown in Table 2.4, and discussed in more detail below.

Estimate for 2006-07

2.43 The estimates for net borrowing in 2006-07, of 2.8 per cent of GDP, and for the current surplus, of a deficit of 0.6 per cent, remain unchanged from Budget 2006. This represents a fall from 2005-06 to 2006-07 in the current budget deficit of around £7.2 billion. Net borrowing also fell, but due to the rise in net investment the reduction was lower, down by £0.7 billion compared with 2005-06.

2.44 In contrast to the main aggregates, the cyclically-adjusted measures for this year and next have changed since Budget 2006. These changes follow upward revisions to the estimates of economic growth during the past three years and stronger growth, which have directly fed through to the profile of the output gap. Cyclically-adjusted net borrowing is on a declining trend and by 2009-10 returns close to the levels set out in the Budget, and then falls below Budget projections, reaching 1.3 per cent of GDP at the end of the projection period. As discussed in Annex A, there remain considerable uncertainties about the current estimate of the output gap, so precise estimates of cyclically-adjusted balances should be treated with caution.

2.45 The receipts forecast for 2006-07 is slightly higher than at Budget time. National insurance contributions and taxes on wages and salaries are unchanged from Budget 2006, as record levels of employment are offset by lower than expected average earnings growth. Other income tax receipts are higher than expected. Capital taxes and stamp duties have been boosted by the rise in the equity market. Receipts are now expected to grow by 6.6 per cent for the year as a whole, in line with outturns for the first seven months of 2006-07.

2.46 Central government spending for the first seven months of 2006-07 has shown strong growth over the corresponding period in the previous year. Overall public current expenditure is higher by £1.4 billion in 2006-07 and by £2.4 billion in 2007-08 compared with Budget 2006. Growth is expected to moderate over the rest of the year partly due to changes in the timing of grant payments, explained further in Annex B.

Table 2.4: Public sector net borrowing compared with Budget 2006

	Estimate [1]	Projections			
	2006-07	2007-08	2008-09	2009-10	2010-11
Budget 2006 (£ billion)	**35.8**	**30**	**25**	**24**	**23**
Changes since Budget 2006					
North Sea revenues	–0.1	3	2	1	1
Impact of higher 2006 inflation on tax & expenditure[2]	0.9	1½	1½	1½	1½
Other tax and expenditure changes	0.4	–½	1	1½	1
Total before discretionary measures	**36.9**	**33**	**30**	**28**	**27**
Discretionary measures	**–0.2**	**–2**	**–2½**	**–2**	**–2**
2006 Pre-Budget Report	**36.8**	**31**	**27**	**26**	**24**

Note: Figures may not sum due to rounding.

[1] The 2006-07 figures were projections in Budget 2006.

[2] This assumes that spending changes continue throughout the projection period.

Changes in receipts

2.47 A reduction in expected North Sea oil revenues accounts for almost all of the decline in forecast receipts, before discretionary measures, compared with Budget 2006. As discussed in Box B2, the lower forecast is due to higher capital investment in the North Sea, increased operating expenditure, lower than anticipated production and a stronger dollar-sterling exchange rate.

2.48 Other changes in receipts are much less significant. Projected revenues from consumption taxes are slightly lower than at the Budget. Moderate rates of consumption growth and a change in the composition of spending result in modest growth in VAT receipts. Higher levels of employment have a positive impact on receipts over the forecast period. Including discretionary measures, the current receipts forecast is in line with that at Budget 2006.

Changes in spending

2.49 The forecast for expenditure before discretionary measures is slightly higher than at the time of the Budget for 2006-07 and 2007-08. Projections for Departmental Expenditure Limits (DEL) up to 2007-08 are based on 2004 Spending Review allocations. Projections for Annually Managed Expenditure (AME) are higher for this year and next. This is in part due to the impact of higher inflation on the cost of servicing indexed-linked bonds and on indexed-linked social security benefits, as shown in Table 2.4.

Discretionary policy changes

2.50 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 strict 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.

2.51 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all decisions announced in this Pre-Budget Report or since Budget 2006. This includes:

- an increase in air passenger duty with effect from 1 February 2007, as part of further steps to tackle the global challenges of climate change, in recognition of the environmental costs of flying;
- a further £130 million direct to schools in England in 2007-08, including to support personalised teaching and extended services; and
- action to protect tax revenues and further modernise the tax system, including a number of measures to tackle tax avoidance.

2.52 The fiscal impact of these and other measures is set out in Annex B. As usual, 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

2.53 Table 2.5 presents the key fiscal aggregates based on the five themes of fairness and prudence, long-term sustainability, economic impact, financing and European commitments. It illustrates the Goverment's performance against its fiscal rules, and shows that the Goverment is meeting its strict fiscal rules over the economic cycle.

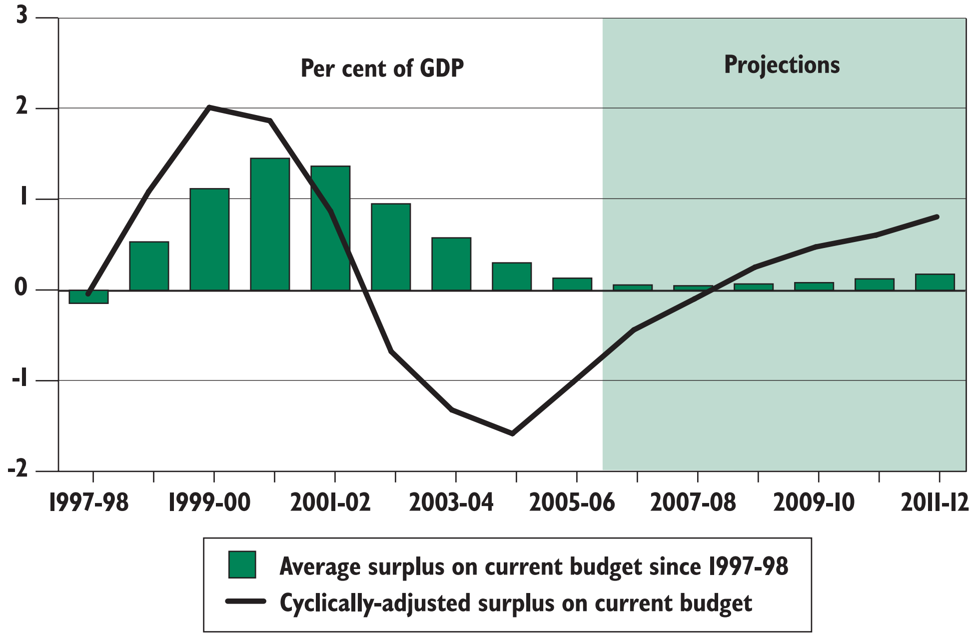
Table 2.5: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate[1]			Proiections		
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Fairness and prudence							
Surplus on current budget	–1.2	–0.6	–0.1	0.3	0.5	0.6	0.8
Average surplus since 1997-98	0.1	0.1	0.0	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–1.0	–0.4	–0.1	0.3	0.5	0.6	0.8
Long-term sustainability							
Public sector net debt[1]	36.4	37.5	38.2	38.6	38.7	38.7	38.5
Core debt[1]	35.8	36.7	37.4	37.8	38.0	38.0	37.8
Net worth[2]	27.0	25.7	24.9	24.9	24.6	24.6	24.6
Primary balance	–1.4	–1.1	–0.6	–0.2	0.0	0.1	0.3
Economic impact							
Net investment	1.8	2.2	2.2	2.2	2.2	2.2	2.2
Public sector net borrowing (PSNB)	3.0	2.8	2.3	1.9	1.7	1.5	1.3
Cyclically-adjusted PSNB	2.8	2.6	2.2	1.9	1.7	1.5	1.3
Financing							
Central government net cash requirement	3.2	3.2	2.5	2.1	2.1	1.8	1.9
Public sector net cash requirement	3.2	2.9	2.4	2.0	2.0	1.6	1.7
European commitments							
Treaty deficit[3]	2.8	2.7	2.2	1.9	1.7	1.5	1.3
Cyclically-adjusted Treaty deficit[3]	2.6	2.5	2.2	1.9	1.7	1.5	1.3
Treaty debt ratio[4]	42.7	43.7	44.1	44.2	44.2	44.0	43.6
Memo: Output gap	–0.4	–0.2	0.0	0.0	0.0	0.0	0.0

[1] *Debt at end March; GDP centred on end March.*
[2] *Estimate at end December; GDP centred on end December.*
[3] *General government net borrowing on a Maastricht basis.*
[4] *General government gross debt on a Maastricht basis.*

Golden rule **2.54** 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 it is therefore an important indicator of intergenerational fairness. The current budget strengthens through the projection period, returning to surplus in 2008-09 and showing a surplus of 0.8 per cent of GDP in 2011-12.

Chart 2.4: Meeting the golden rule



Source: HM Treasury.

2.55 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation 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 in 1997-98.[5]

2.56 The average surplus on the current budget since the start of the current cycle in 1997-98 is positive in every year of the projection period. The economy is projected to return to trend in early 2007 which means that the average annual surplus on the current budget over the whole cycle would be 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £8 billion in this cycle, including the AME margin.

2.57 With the economy assumed to return to trend in early 2007, the projections show that the current budget moves into surplus in 2008-09, with the surplus rising to 0.8 per cent of GDP by 2011-12. At this early stage and based on cautious assumptions, the Government is on course to meet the golden rule after the end of this economic cycle.

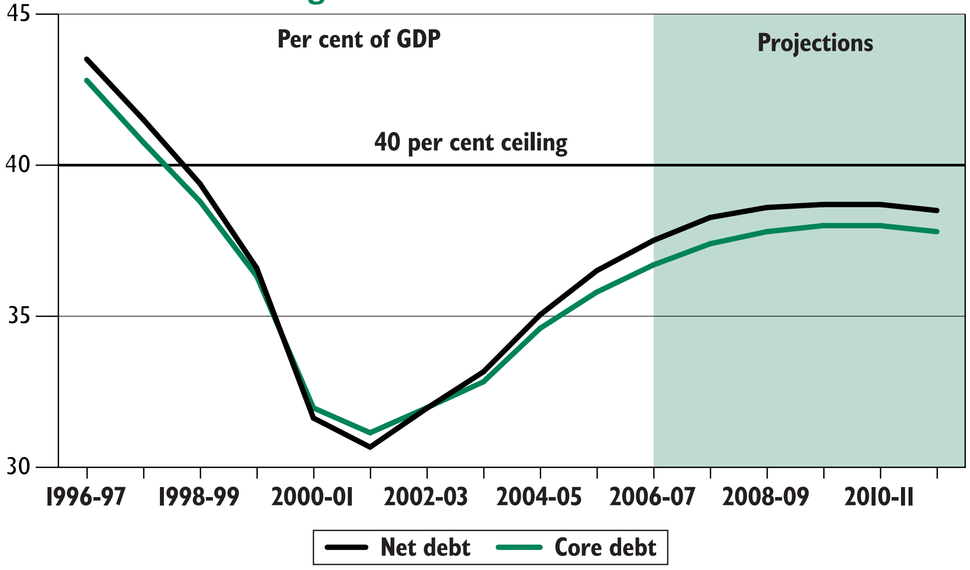
Sustainable investment rule

2.58 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector net 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.

[5] Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002.

2.59 Chart 2.5 shows that, despite output being below trend since 2001 and the addition of finance leases, net debt remains below 40 per cent throughout the projection period, and starts to decline, reaching 38.5 per cent of GDP by the end of the projection period. Therefore the Government meets its sustainable investment rule while continuing to borrow to fund increased long-term capital investment in public services. Chart 2.5 also illustrates projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt rises only modestly from 36.7 per cent in 2006-07 to 37.8 per cent of GDP at the end of the projection period.

Chart 2.5: Meeting the sustainable investment rule

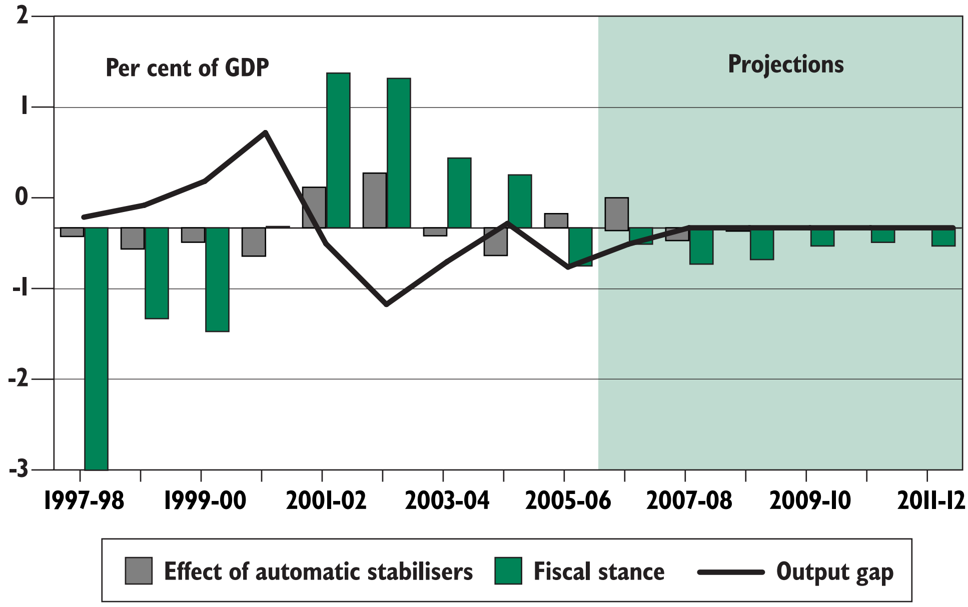


Source: ONS and HM Treasury.

Economic impact

2.60 While the primary objective of fiscal policy is to ensure sound public finances, fiscal policy also affects 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). These can be broken down into changes due to the effects of the automatic stabilisers and those due to the change in the fiscal stance, as illustrated in Chart 2.6.

Chart 2.6: Fiscal policy supporting monetary policy

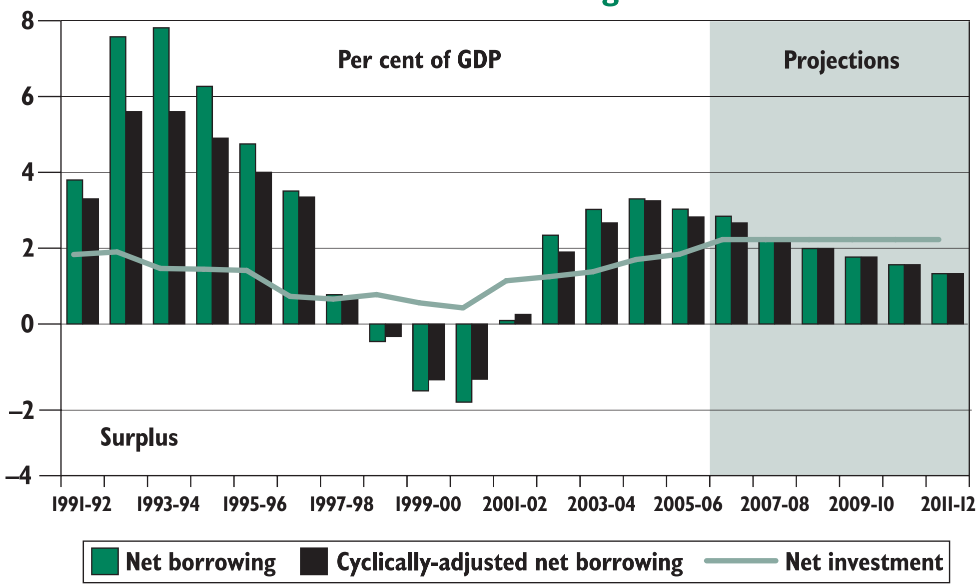


Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, i.e. the difference between PSNB and the cyclically-adjusted PSNB.

Source: HM Treasury.

2.61 During the late 1990s, the fiscal stance and the automatic stabilisers tightened at a time when the economy was above trend. As the economy moved below trend in 2001, the automatic stabilisers and the fiscal stance supported the economy. With the economy approaching trend levels, fiscal policy in 2006-07 is expected to be slightly tighter, and further moderate fiscal tightening is forecast over the projection period.

Chart 2.7: Public sector net borrowing and net investment



Source: ONS and HM Treasury.

2.62 On average since 1997-98 public sector net investment has exceeded net borrowing, reflecting the average surplus on the current budget. This is projected to continue as the Government borrows to invest in public services while continuing to meet its strict fiscal rules. Chart 2.7 shows net borrowing falling to 1.3 per cent of GDP by the end of the projection period.

Financing

2.63 The forecast for the central government net cash requirement for 2006-07 is unchanged from that at Budget time. The forecast for the central government net financing requirement for 2006-07 has been revised from £65.0 billion in Budget 2006 to £59.0 billion, a decrease of £6.0 billion. It has been decided to meet this lower financing requirement by decreasing gilt sales by £0.5 billion to £62.5 billion and by decreasing the planned end financial year Treasury bill stock by £5.5 billion to £15.6 billion. Further details and a revised financing table can be found in Annex B.

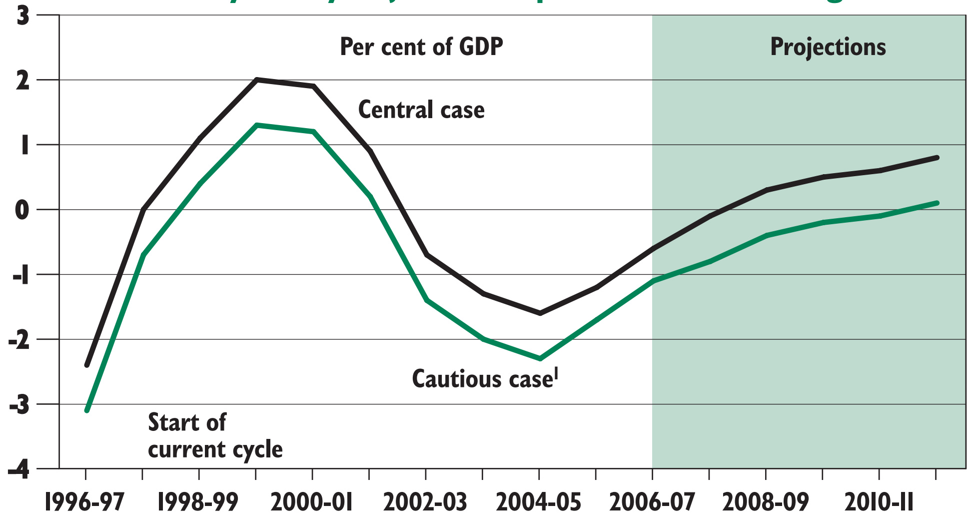
European commitments

2.64 The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box A1 and as reflected in reforms to the Pact agreed in March 2005. 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 is meeting its fiscal rules over the cycle, maintaining low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with a prudent interpretation of the Pact.

Dealing with uncertainty

2.65 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 safety margin into the public finance projections to guard against unexpected events. The degree of caution in the assumptions underpinning the public finance projections increases over the projection period. 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 a $^1/_4$ percentage point lower than its neutral view.

Chart 2.8: Cyclically-adjusted surplus on current budget



[1] Cautious case assumes trend output 1 percentage point lower in relation to actual output than the central case.
Source: HM Treasury.

2.66 A second important source of potential error results from misjudging the position of the economy in relation to trend output. 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 projections for this cautious case.

2.67 The Government is, on the basis of cautious, independently-audited assumptions, meeting the golden rule in the central case. In the cautious case, Chart 2.8 shows that the cyclically-adjusted balance will be in surplus at the end of the projection period.

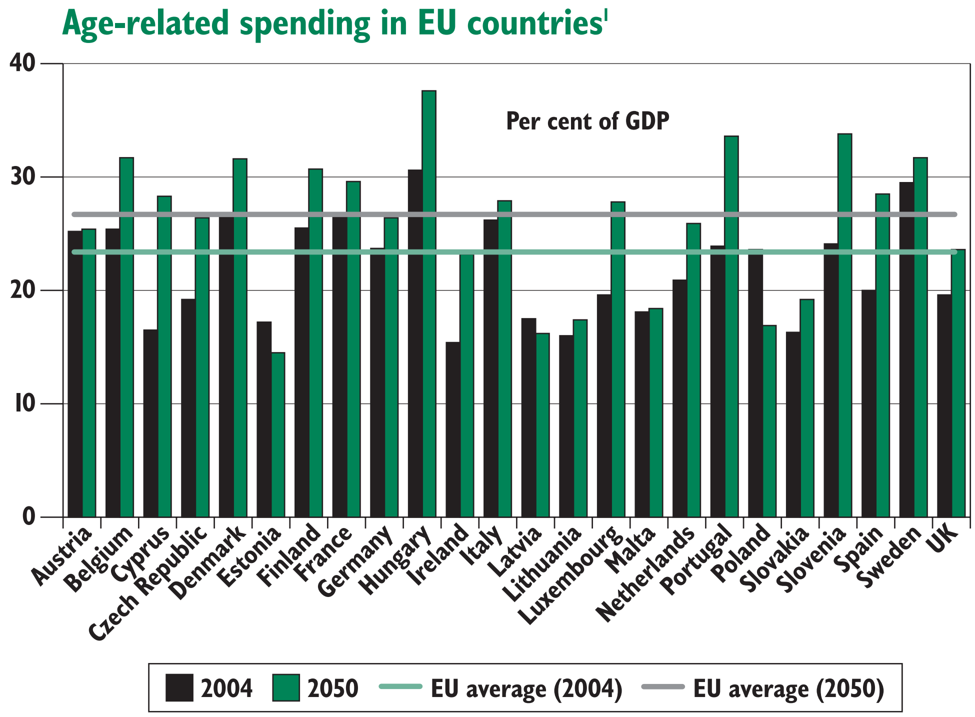
LONG-TERM FISCAL SUSTAINABILITY

2.68 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 set out in the *Code for fiscal stability*.

2.69 An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2006 *Long-term public finance report*. Based on the latest population projections the report provides a comprehensive analysis of long-term economic and demographic developments and their potential impact on the public finances. The 2006 *Long-term public finance report* concludes that the public finances remain sustainable over the long term. Box 2.5 provides more information on fiscal challenges in EU Member States.

Box 2.5: Age-related spending in EU countries

Many European countries face significant challenges from ageing populations. In February 2006, the European Union's Economic Policy Committee published age-related expenditure projections for the 25 Member States for the period 2004 to 2050.[a] The projections cover pensions, health care, long-term care, education, unemployment transfers and, in some cases, social contributions. The chart shows that age-related spending in the UK is projected to rise only moderately over the next five decades - in contrast with substantial projected increases in some other countries - and that it will be similar in 2050 to the EU average now.



[1] Projections for the Czech Republic, Cyprus, Estonia, France and Hungary do not include long-term care. Projections for Greece are not shown as they do not include pension projections.
Source: Economic Policy Committee and European Commission, February 2006.

[a] *The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)*, Economic Policy Committee and European Commission, February 2006.

3 MEETING THE PRODUCTIVITY CHALLENGE

In an increasingly integrated and competitive global economy, raising UK productivity is critical to delivering continued economic growth and sustained increases in standards of living. Raising productivity requires the openness and flexibility to seize new opportunities in the global economy, while making the essential long-term investments needed to support business growth – including in vital infrastructure and skills. In the last decade, significant progress has been made to strengthen UK productivity growth, through investment in infrastructure, a more highly skilled workforce, and increasing the attractiveness and openness of the UK as a place to invest. This 2006 Pre-Budget Report sets out how the Government is building on this success to lay the foundations for sustained long-term productivity growth, through further measures to increase flexibility and openness, reduce regulatory burdens on business, alongside increased long-term investment:

- **investing in a new ambition for world-class skills, increasing adult skills across all levels and strengthening employer voice in their provision – by taking forward the recommendations of the Leitch Review;**
- **investing in the growth of the UK's science and innovation system – through a single health research fund of at least £1 billion, taking forward the recommendations of the Cooksey Review, and ensuring a more balanced, coherent and flexible regime for intellectual property, as set out in the Gowers Review;**
- **enabling greater flexibility in the land use planning system to ensure it contributes to economic growth while delivering its wider sustainable development goals – by taking forward the Barker Review;**
- **investing in transport infrastructure to maximise the return on investment in transport – by taking forward the recommendations of the Eddington Transport Study;**
- **investing in the growth of sustainable housing supply – including further acceleration of the release of surplus public sector land and greater ambitions for assisted home ownership through shared equity schemes; and**
- **increasing business flexibility by reducing unnecessary burdens on business – by creating certainty for business, by implementing the recommendations of the Varney Review of HMRC Links with Large Business, and driving forward implementation of the Hampton Review's risk-based approach to regulation, and the Davidson Review's recommendations to reduce any gold plating of EU legislation.**

Globalisation and productivity

3.1 In an increasingly integrated global economy, raising UK productivity is critical to delivering continued economic growth and sustained increases in standards of living. The UK's success will depend on building a flexible, open economy with a highly skilled workforce and well developed infrastructure, able to take advantage of accelerating changes in technology, production and trading patterns. In the last decade, significant progress has been made to strengthen UK productivity growth, through investment in infrastructure, a more highly skilled workforce supporting an increasingly knowledge-based economy, and increasing the attractiveness of the UK as a place to invest. This 2006 Pre-Budget Report sets out how the Government is building on this success to lay the foundations for sustained long-term productivity growth, through increased flexibility and openness and increased investment in infrastructure. This strategy is guided by the analysis the Government has set out in *Long-term opportunities and challenges for the UK: analysis for the 2007 Comprehensive Spending Review*, published on 27 November this year.

The five driver framework

3.2 The Government's approach to improving the UK's long-term productivity performance has two broad strands: maintaining macroeconomic stability to enable firms and individuals to plan for the future, and implementing microeconomic reforms to remove the barriers which prevent markets from functioning efficiently. This Pre-Budget Report sets out the Government's next stage of reforms to raise productivity growth, through the five key drivers of productivity:

- improving competition, to enable the adoption of innovative business practices and increased business efficiency;
- promoting enterprise, to support entrepreneurship and the strengthening of the UK's enterprise culture;
- supporting science and innovation, to ensure that the UK capitalises on the creation of new knowledge and its translation into new goods and services;
- raising skills levels, to support the development of a more flexible, responsive and productive workforce; and
- encouraging investment, to enhance the stock of physical capital and ensure its efficient utilisation.

UK productivity performance

3.3 Productivity and employment growth are key determinants of higher standards of living and enhanced quality of life. As discussed in *Productivity in the UK 6: Progress and new evidence*, published alongside Budget 2006, historically, UK productivity has lagged behind that of other major industrialised countries. However, the recent data shows that the UK is making significant progress towards closing the productivity gap with its main competitors. The UK has significantly improved its position since 1995 on both key measures of productivity – output per worker and output per hour. On an output per worker basis, the UK closed the gap with Germany, halved the gap with France, and is the only G7 country to have kept pace with impressive US performance. On an output per hour basis, since 1995, the UK has narrowed the gap with France by 10 percentage points, narrowed the gap with Germany by 13 percentage points and kept pace with US performance. Further detail is set out in Box 3.1.

Box 3.1: UK productivity performance

Chart (a) shows the reduction in the UK's output per worker gap with France, Germany and the US. The UK is now experiencing its longest period of combined productivity and employment growth since the 1950s. This achievement is significant, as strong employment growth is usually associated with lower productivity growth, since new workers are initially less productive while they learn job specific skills. Chart (b) shows the UK's enhancement of both its productivity and employment performance.

Chart a: International comparisons of output per worker

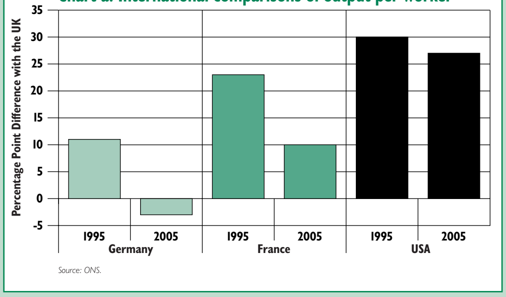
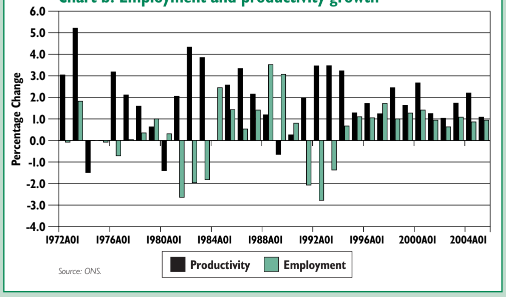


Chart b: Employment and productivity growth



There are encouraging signs that the UK is on course to raise productivity performance over the current economic cycle, compared with previous cycles. Trend productivity growth over the first half of the economic cycle (1997H1 – 2001Q3) was 2.6 per cent per year compared with 1.9 per cent in the previous economic cycle. Moreover, recent upward revisions to output growth, coupled with robust growth in 2006, show that actual productivity growth has so far averaged 2.4 per cent between 2001Q3 and 2006Q3, clearly above HM Treasury's forecast of 2.15 per cent. Recent outturns significantly increase confidence in the post-2001 productivity projection.[a] However, as discussed in *Productivity in the UK 6: progress and new evidence*, actual productivity growth is influenced by cyclical factors. Therefore HM Treasury's approach is to assess the UK's trend productivity performance once the cycle has come to an end or between two on-trend points.

[a] For further details, refer to: *Trend Growth: new evidence and prospects* – published alongside this Pre-Budget Report.

Product and capital market flexibility

3.4 Flexible product and capital markets enable more efficient allocation of resources and clearer price signals, promoting competition and encouraging innovation. This flexibility enables firms to respond rapidly to changing market conditions in the increasingly integrated global economy. This chapter reports on progress in enhancing the UK's product and capital market flexibility. In addition, the UK is also working with international partners to respond to the impacts of globalisation, as discussed in Box 2.4.

European economic reform

3.5 Strengthening economic reform in Europe remains a key priority for the UK. Following the progress made during the UK Presidency of the European Union (EU) in 2005, the Government has continued to press the case for improvements in the European regulatory environment, as well as for open markets and more pro-active use of competition policy. Box 3.3 sets out the principles that should guide Single Market policy, reflecting the new challenges presented by globalisation. The UK has also outlined how governments can help individuals meet these challenges by providing 'social bridges' to future jobs,[1] enabling individuals to increase their employability and take advantage of changes in the labour market. Further structural reform in the EU is still needed to create more competitive, open

[1] For a discussion of this approach, see: *Social Bridges – meeting the challenges of globalisation*, HM Treasury and the Swedish Ministry of Finance, April 2006. Available at www.hm-treasury.gov.uk

and flexible economies necessary for Europe to compete in the global market. In this context, the UK welcomes the recent updates by Member States reporting on their progress in implementing their 2005 National Reform Programmes to promote growth, employment creation and productivity.

Productivity in the regions

3.6 The Government's goal is to make sustainable improvements in the economic performance of all English regions by 2008, and over the long-term reduce the persistent gap in growth rates between the regions.[2] The progress made by the Government in meeting this target is set out in Box 3.2. The Regional Development Agencies (RDAs) were established by the Government with a statutory remit to lead the strategic economic development of their regions. As set out most recently in the Devolving Decision Making Review, economic performance can best be improved, and regional disparities overcome, by investing in the drivers of productivity and encouraging greater regional and local flexibility.[3]

Box 3.2: Regional economic performance

HM Treasury, the Department of Trade and Industry (DTI) and the Department for Communities and Local Government (DCLG) have joint responsibility for delivering the Government's Public Service Agreement (PSA) target to:

'make sustainable improvements in the economic performance of all English regions by 2008 and over the long term reduce the persistent gap in growth rates between the regions, demonstrating progress by 2006.'

The primary indicator used is a measure of nominal Gross Value Added per head, for which only 2003-04 data has been collected. However, measurement of this PSA target is only meaningful when taken over a complete economic cycle. While this data suggests some evidence of positive progress in narrowing the gap in growth rates between regions, it would be premature to reach conclusions about the effectiveness of long-term interventions. More detailed evidence of progress is available in a technical note accompanying this Pre-Budget Report.[a]

[a] *Regional Economic Performance: Progress to date*, HM Treasury, DTI, DCLG, December 2006

Sub-national economic development and regeneration

3.7 The Government recognises that more needs to be done to release the economic potential of England's regions, cities and localities, and to respond more effectively to the ongoing challenge of tackling pockets of deprivation, in order to maximise the productivity growth of the country as a whole. To address this, in Budget 2006 the Government announced a Review of Sub-National Economic Development and Regeneration to consider the efficiency and effectiveness of regional and local interventions. It is based on an analysis of the drivers of growth at the sub-national levels, and the potential impacts of globalisation and technological change.

Regional Development Agencies

3.8 As part of the Sub-National Review, the Government is undertaking an assessment of the impact, efficiency and accountability of sub-national delivery agencies, including RDAs. This work will assess the outcomes of RDA spending and will consider the long-term delivery challenges facing the network. It will help RDAs identify further opportunities for efficiency savings and ensure a robust prioritisation of their activities in a way that will promote regional competitiveness in a national context and a global marketplace.

[2] The Devolved Administrations in Scotland, Wales and Northern Ireland work in partnership with the UK Government to promote economic development in their territories.

[3] See for example *Devolving Decision Making: 3 – Meeting the regional economic challenge: The importance of cities to regional growth*, HM Treasury, ODPM, and DTI, March 2006

3.9 Building on their role as strategic leaders of economic growth in each region, the RDAs will contribute to the development of regional policy in Budget 2007 in three key areas: the role of the private sector in regional economic development; regional economic strategies and their impact on competitiveness in a global context; and improving RDA evaluation. In addition, to help develop the regional evidence base on the sub-national drivers of economic growth, the Government is supporting a new centre for spatial economics research, which will be established in 2007.

3.10 In line with HM Treasury's series of Devolved Decision Making Reports and the Local Government White Paper, the Sub-National Review is considering how to deliver further devolution to regions and localities and to achieve greater cooperation between regions, sub-regions (including city regions) and local authorities.[4] The Review is also considering how to improve the accountability, governance and funding arrangements that underpin sub-national economic development. This includes ensuring the effectiveness of regional and local business support interventions, as described in more detail later in this chapter. The Sub-National Review's conclusion will feed into the 2007 Comprehensive Spending Review (CSR), taking account of the Leitch Review of Skills, the Eddington Transport Study, the Barker Review of Land Use Planning, (all discussed later in this chapter), and the Lyons Inquiry into Local Government (discussed in Chapter 6).

COMPETITION

3.11 Competition rewards efficiency, flexibility and innovation in business, driving productivity. Competitive and open markets at home increase the global competitiveness of UK firms, raising economic growth and standards of living in the UK and benefiting consumers by ensuring lower prices and a greater variety of goods and services.

Promoting competition

Creating the framework

3.12 The Government has instituted a number of reforms aimed at developing a UK competition regime rated as among the world's best. The Enterprise Act 2002, which developed from the Government's 2001 White Paper: *A World Class Competition Regime*,[5] aimed at establishing:

- strong, proactive, and independent competition authorities;
- a modernised merger regime;
- stronger market study and investigation powers;
- stronger deterrence of cartels; and
- a stronger mechanism for real redress for third parties.

3.13 Good progress has been made in achieving these aims, with the UK competition regime maintaining its position among the top three globally while improving its overall rating and expanding its lead over the EU and other competition regimes.[6]

[4] *Strong and Prosperous Communities*, DCLG, October 2006. Available at www.communities.gov.uk

[5] *A World Class Competition Regime*, DTI White paper, 2001. Available at www.dti.gov.uk

[6] *Peer Review of Competition Policy*, KPMG and DTI, May 2004. Available at www.dti.gov.uk

Competition authorities

3.14 The Enterprise Act provided the two UK competition authorities – the Office of Fair Trading (OFT) and the Competition Commission (CC) – with:

- independence, by removing ministerial involvement from almost all cases;
- stronger powers to punish anti-competitive behaviour and identify, investigate and remedy markets; and
- a more proactive approach, establishing an OFT Board able to determine its strategic direction and priorities for public enforcement.

3.15 As a result of the Enterprise Act and other reforms, both the UK competition authorities are now independently rated among the top five globally.[7] Between 2000 and 2005, they launched investigations into 800 mergers (remedying 24 considered anti-competitive) and 150 potential abuses of dominance or cartel cases (making formal decisions on 39 of these), generating consumer savings of at least £750 million.

A modernised merger regime

3.16 The Enterprise Act gave the OFT the power to investigate mergers and a duty to refer those anticipated to result in a 'substantial lessening of competition' to the CC for in-depth investigation and possible remedial action. A 2004 survey of experts rated the UK merger regime as 6.4 out of 7, well above the rating before the Enterprise Act.[8] Since the Act came into effect in 2003, over 550 mergers have been investigated by the OFT (compared with under 400 investigations in the previous three years) with almost 40 referred to the CC. Conservative estimates by the OFT suggest that between 2000 and 2005, the competition authorities' merger work led to £640 million in consumer savings.

Investigating markets

3.17 The Enterprise Act strengthened the OFT's powers to study markets not working and to refer those with features that may adversely affect competition to the CC for further investigation and possible remedy. Market inquiries have proved to be an important tool in securing consumer welfare. Recent examples include:

- an OFT study into car warranties, leading to between £60 million and £85 million in annual savings to car owners and fleet operators; and
- CC remedies following a market investigation into store cards earlier this year, resulting in consumer savings of at least £55 million a year.

3.18 This year, the OFT has launched studies into the online shopping market and UK airports, used last year by an estimated 40 percent of consumers and over 200 million passengers respectively.[9] The OFT has also announced its intention to refer a third market, the payment protection insurance market, to the CC for further investigation, which could lead to consumer savings of around £1 billion.[10]

Deterring cartels

3.19 The Enterprise Act gave the OFT new surveillance and information gathering powers for identifying groups of producers fixing prices or limiting supply through cartel activity and introduced criminal penalties, including up to five years imprisonment, for individuals involved in such activities. Since 2003, the OFT has identified numerous cartels and has imposed over £25.5 million in fines. In the past year alone, the OFT has begun informal inquiries into 20 potential cartel cases and launched formal investigations into four.

[7] With the OFT and the CC ranked 5th and joint 1st (with the EU and the two US competition authorities) respectively. *Competition Authorities Annual Ranking*, Global Competition Review, 2006. Available at: www.globalcompetitionreview.com

[8] In 2001 the UK merger regime received a rating of 6.0. *Peer Review of Competition Policy*, Ibid.

[9] *Internet Shopping – Some Key Data*, OFT, 2006. Available at: www.oft.gov.uk; Summary of activity at UK airports, CCA, 2005. Available at www.caa.co.uk

[10] *Payment protection insurance: Report on the market study and proposed decision to make a market reference*, OFT, 2005

Private enforcement

3.20 The Enterprise Act strengthened the legal framework for private redress cases, allowing a wider range of cases to be investigated, and providing those affected by anti-competitive activities with the possibility of obtaining direct compensation. Work continues to ensure the advantages of private enforcement are fully realised.

3.21 The Government recognises the need for continued monitoring and improvement of the competition framework, in line with the target of creating the world's best competition regime. Over the coming year, the Government intends to:

- work with the competition authorities and the European Commission to identify and eliminate any barriers to real redress for parties injured by anti-competitive behaviour; and
- support the European Commission in reforms aimed at achieving a proactive and independent EU competition regime, able to open the Single Market to further competition.

European competition policy

3.22 The Government strongly believes that Europe must continue to strengthen and deepen the Single Market. Amid growing protectionist sentiment in some Member States, the Government welcomes the Commission's decision to undertake a fundamental review of the Single Market, and believes it is a timely opportunity to look at how Europe should respond to the new challenges it faces. Consolidating the Single Market requires the ongoing promotion and maintenance of competitive markets to ensure that Europe's economy maintains the flexibility to develop in response to the changing global environment. Box 3.3 sets out the principles that the Government believes should guide Europe's approach to the Single Market.

Box 3.3: Review of the Single Market

The European Commission's Review of the Single Market, which will report next year, provides an opportunity to look again at the core principles that guide policy on the Single Market. The Government believes that a new approach is necessary to equip Europe to compete in the 21st century global economy. It is advocating a more outward-looking, reforming and pro-competition approach. The UK Government's report, to be published early next year to feed into the Commission's Review, will set out the following principles, which it believes should guide Single Market policy:

- **be clear about the purpose – recognising the Single Market as a means of achieving prosperity for Europe's citizens, policies should focus on outcomes, enhancing competition and promoting enterprise and innovation, to deliver jobs and growth;**
- **be focussed on priorities – a more systematic approach, with policy priorities based on sound analysis of where benefits are greatest, using robust impact assessments and greater use of market investigations and targeted enforcement of EU law. Action should focus on key markets such as energy and financial services, which impact on the wider European economy;**
- **take action at the right level – there must be greater clarity of the respective roles of Member States and the Commission, including identifying appropriate areas for Commission action, and emphasising where cooperation, coordination and mutual recognition between Member States should be improved; and**
- **deliver a modern and flexible framework – Single Market objectives should be achieved using all the available policy tools, including pro-active competition policy, better regulation principles, and proportionate, more flexible legislation, to enable Europe to adapt to the pace of global change. For example, consideration should be given of extension of the Lamfalussy process[a] in Financial Services to other sectors.**

[a] As set out in the *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, 2001. Available at: www.europa.eu

ENTERPRISE

3.23 Enterprise is a key driver of a modern, dynamic economy. A healthy business sector creates wealth and employment, generates competitive pressure that drives innovative activity, and improves the range, quality and prices of goods and services for consumers. The Government is committed to ensuring a flexible, open economy that can allow business to respond to the pressures of globalisation, while prioritising the necessary investment that firms need to be successful. The Government will continue to drive forward regulatory reform to free up businesses' productive time, modernise and simplify tax administration, and lay the foundations for a vibrant entrepreneurial culture in the UK.

Delivering better regulation

3.24 Globalisation increases competition and places a premium on a strong and flexible business environment. As markets become more competitive, it is important to do more to ensure the right conditions are in place so that businesses and individuals can respond to new opportunities and incentives. Key to achieving this is the removal of the burden of unnecessary regulation and traditional routine inspection and enforcement. Regulations need to be fit for purpose and their enforcement risk-based, with resources focused on areas where the risks to society are greatest, so that businesses are enabled to compete effectively in the global economy.

3.25 It is no longer the case that most businesses, if unregulated, will act irresponsibly. Well-informed consumers, responsible companies, organised labour, pressure and interest groups have all encouraged businesses to take measures to reduce risk to society. In this context, it is clear that regulatory regimes need to adapt to the changing world of the 21st century. To this end, Philip Hampton reported, in March 2005,[11] on the scope for promoting more efficient approaches to regulatory inspection and enforcement while continuing to deliver excellent regulatory outcomes. The Hampton Review argues for the creation of a regulatory system, at national and local level, in which risk assessment is the basis for all regulators' enforcement programmes. The Hampton principles outline a risk-based approach to regulation, appropriate for a world of increasing competition.

3.26 The UK Government has taken several important steps to ensure that the domestic regulatory framework adjusts to this new environment, and details are provided in this chapter on:

- the legislative framework;
- progress on implementing the Hampton Review recommendations;
- better regulation at local authority level;
- a proportionate and fair penalty regime; and
- targets for reducing administrative burdens.

Legislative and Regulatory Reform Act

3.27 The Legislative and Regulatory Reform Act received Royal Assent on 8 November 2006. The Act provides for a statutory Code of Practice, which will oblige all listed regulators to have regard to the Hampton principles. A new draft of this Hampton Code will be consulted on and the Government intends that it should be enacted by autumn 2007, before coming into force on 1 April 2008. This will legally oblige listed regulators to have regard to the Hampton principles when forming policy, rules, codes and guidance. Any business that believes a regulator is failing to have regard to the Code in relation to these functions will be able to seek redress through the relevant regulator or the Parliamentary Ombudsman. It may also be possible to apply for judicial review of the regulator's actions.

3.28 The Act replaces the Regulatory Reform Act 2001, and will:

- provide ministers with order-making powers that, subject to stringent substantive and procedural safeguards, will allow government departments to deliver their ambitious plans for removing unnecessary burdens on the public, private and voluntary sectors;
- encourage regulators to be more transparent, accountable, proportionate, consistent and targeted in their approach to regulation, by putting these five principles of good regulation, developed by the Better Regulation Commission, on a statutory footing; and
- make the transposition of European Community obligations into domestic law more straightforward, while also making it easier for individuals and organisations to understand and work with this legislation.

Implementing Hampton

3.29 To outline early progress in delivering the recommendations of the Hampton Review, the Government published *Implementing Hampton: from enforcement to compliance*, in November this year. A summary is set out in Box 3.4 below.

[11] *Reducing Administrative Burdens*, Philip Hampton, March 2005

Box 3.4: Implementing Hampton: from enforcement to compliance

The Government has undertaken a review the of progress made in implementing the Hampton Review. The key finding was that, while regulators have begun to make progress, more work will be needed to ensure that they are compliant with the Hampton principles. The report shows that:

- **regulators are beginning to make progress in cutting forms. Six regulators have either carried out, or are in the process of carrying out, full reviews of all their existing forms.[a] Technological developments, including online forms and e-returns, have also decreased the time spent form filling. For example, the Health and Safety Executive is cutting 54 per cent of forms and Companies House online returns save business £11.5 million annually ;**
- **all regulators with inspection functions are applying a risk-based approach to some areas of enforcement, while progress is being made towards full implementation of the risk-based approach;**
- **regulators are increasingly providing more easily accessible and better-targeted advice through websites with personalised information, e-newsletters, sector specific publications, seminars and workshops. However, regulators need to start monitoring the effectiveness of their advice more regularly and consider consolidating advice; and**
- **good progress is being made on the Hampton recommendation to merge 31 bodies into seven by 2009. Twelve have already been merged, agreement has been reached to merge a further twelve, and departments are deliberating on another twelve (potentially more mergers in total than originally envisaged). This will reduce the number of interfaces with which businesses have to deal.**

The Government has set in place further measures, outlined in this chapter, to ensure compliance by regulators, at both local and national level, with the Hampton principles.

[a] The Health and Safety Executive, the Environment Agency, the Civil Aviation Authority, the Human Fertilisation and Embryology Authority, the Patent Office, and the Food Standards Agency.

Local Better Regulation Office

3.30 Eighty per cent of inspections are carried out by local authorities and, while initiatives like the Retail Enforcement Pilot demonstrate good practice, there is little evidence of the risk-based approach being applied consistently. To encourage the implementation of the Hampton principles at a local level, the Government:

- has brought forward the timetable for establishing the Local Better Regulation Office (LBRO) from 2009 to 2007;
- will detail local authority regulatory services, including trading standards, environmental health, and licensing, in the scope of the Hampton Code of Practice;
- will give the LBRO powers to issue statutory guidance to which local authorities must have regard, for example to ensure that a vigorous adoption of the risk-based approach reduces inspections and information requirements. In the meantime, the LBRO will spread good practice on risk-based enforcement at the local level;
- will give the LBRO powers to tackle inconsistencies in enforcement between local authorities; and

- will legislate to place the principle of home and lead authority on a statutory footing so that firms operating in more than one local authority will face a consistent and risk-based approach across their business.

3.31 To drive up performance at the local level, the Government will consider how best to measure progress in implementing the Hampton Review's recommendations, including developing, with business, performance indicators to ensure compliance with the Hampton principles. In the context of the 2007 CSR work on the performance framework, and in keeping with the Government's commitments in the recent Local Government White Paper, the Better Regulation Executive (BRE) and the LBRO will work with business over coming months to consider suitable measures.

3.32 In order to ensure that local authorities and businesses focus their attention on high-risk areas of enforcement, **Peter Rogers, Chief Executive of Westminster City Council, has agreed to examine approximately 60 areas of legislation that local authorities enforce, and recommend, by Budget 2007, around five specific high-risk national priorities.** Local authorities would then be free to add local priorities to the areas of national concern identified. Together with a LBRO that will work with the local services inspection gatekeeping proposals, as set out in the recent Local Government White Paper, these proposals should result in a substantially rationalised burden around regulatory services for local authorities.

Retail Enforcement Pilot

3.33 As noted earlier in this chapter, early delivery of the Hampton principles is being achieved through the Retail Enforcement Pilot. The pilot has developed a new, co-ordinated and risk-based planning system to reduce the burden of unnecessary inspections by up to 33 percent for compliant retail businesses. The pilot has covered trading standards, environmental health, food safety, health and safety, fire, and licensing inspections.

3.34 After successful testing in Warwickshire and the London borough of Bexley, the Cabinet Office will now extend the Retail Enforcement Pilot to 70 local authorities to establish the viability and net benefits of a possible national roll-out. The Government is also looking at extending the pilot to cover animal health and welfare, fruit and vegetables, veterinary medicines, and rural payments inspections. If rolled out nationally, it is estimated that, for Trading Standards alone, the initiative could save business an estimated £10 million a year from reduced inspections and £7 million from reduced form filling.[12]

Implementing Hampton nationally

3.35 At the national level, the Government is now speeding up implementation of the Hampton recommendations and ensuring that good practice is shared. To achieve this, the National Audit Office (NAO) will work with the BRE, regulators and business to develop a process of external review of regulatory performance. The assessment process will focus on a regulator's adherence to the Hampton principles and encourage continuous improvement. All major regulators will be assessed by the end of 2007 (including the Health and Safety Executive, the Food Standards Agency, the Financial Services Authority, the Environment Agency and the Office of Fair Trading). Publication of the assessment reports will increase accountability and transparency.

3.36 At Budget 2007, the BRE will also publish guidance on how regulators will pass the external review of regulatory performance. This will clearly set out the best practice on complying with the Hampton principles.

Data-sharing

3.37 The Hampton Review outlined the importance of data-sharing in order to reduce burdens on business. The BRE is leading work to outline the costs and benefits of different approaches to data sharing and to overcome the legal and technological barriers. This work complements Sir David Varney's review of of service transformation discussed in Chapter 6.

[12] These costs have been calculated using the Standard Cost Method (SCM), which the Government has introduced as a way of breaking down individual regulations into a range of manageable components and activities that can be consistently measured internationally. For more details, see www.cabinetoffice.gov.uk

Macrory Review of Penalties

3.38 Fundamental to a risk-based approach is the certainty that the majority of businesses, which are compliant, will receive a lighter touch with fewer inspections and forms. Meanwhile, rogue businesses, which repeatedly flout the law, will face quick, meaningful and proportionate penalties. Following the Hampton Review's recommendation that a comprehensive review of regulators' penalty regimes be undertaken, Professor Richard Macrory began his work in September 2005. The Review,[13] published in November, sets out a vision for a fit-for-purpose penalty regime, with a renewed focus on advice and education. The recommendations have been accepted in full by the Government and will create a level playing field for all businesses and ensure that there is no financial incentive for non-compliance. Regulators will only have access to the new toolkit of penalties when they have demonstrated to the satisfaction of the Prime Minister's Panel for Regulatory Accountability that they are compliant with the Hampton and Macrory principles.

3.39 The NAO and BRE external review of regulatory performance (outlined earlier in this chapter) will also assess regulators against the Macrory principles.

Measuring and reducing administrative burdens

3.40 The Government has been carrying out work to measure the total administrative burden on business in complying with government regulations, as a basis on which to set targets to reduce this burden. Eighteen government departments and regulators will publish their first simplification plans in December this year, in which they will outline simplification measures to reform and remove existing legislation, and will commit to reducing by 25 per cent the administrative burden from their regulations.

3.41 In early 2006, the Government established an online Better Regulation Portal. This provides business and others with an easy way to communicate their ideas on the reduction of red tape, with the assurance that they will receive a considered response within 90 working days. Over 300 suggestions have been received. To strengthen the transparency of the Portal, in early 2007 the Government will start making public all the ideas it receives and the government responses, unless the sender has made a request to the contrary.

Regulation of financial services

3.42 At the 2005 Pre-Budget Report, the Government announced a ten-point action plan for reforming wholesale and retail financial markets, which reflected the greatest concerns of businesses in relation to the burden of financial services regulation. Substantial progress has been made in enhancing the Financial Services Authority's (FSA) risk-based approach to regulation, including:

- broadening exemptions for employees: a response to the consultation on facilitating financial promotions in the workplace will be published shortly;
- introducing a Regulatory Reform Order to amend sections of the Financial Services and Markets Act 2000 relating to the regulatory functions of the FSA by removing restrictions, requirements, inconsistencies and anomalies that relate to how the FSA operates and thereby reduce burdens on industry: the draft Order will be laid before Parliament by the end of the year; and
- conducting a value-for-money review into the FSA, to be undertaken by the NAO. HM Treasury plans to lay a report before Parliament in the first half of next year.

[13] *Regulatory justice: sanctioning in a post-Hampton world*, Professor Richard Macrory, November 2006

European regulatory reform

3.43 The Government continues to address unnecessary regulation in Europe. The UK played a key role in the call by finance ministers in October 2006 for the European Commission decisively to reduce EU administrative burdens by immediately identifying specific pieces of legislation and taking prompt action to cut the burden they cause. The European Commission has now come forward with plans to measure and reduce administrative burdens in the EU and has proposed a Europe-wide reduction target of 25 per cent.

3.44 The UK will continue to work closely with the European Commission and the German Presidency to develop an action plan containing concrete proposals to tackle regulation in identified priority areas, and to ensure that the EU adopts an administrative burdens reduction target to match the UK's own ambition in this area. Additionally, the UK will make the case for regulations to be made and enforced with regard to risk, in line with the Hampton principles.

Davidson Review

3.45 The Government also needs to ensure that regulations stemming from Europe are implemented proportionately. In the 2005 Pre-Budget Report, the Chancellor asked Lord Neil Davidson QC to review the stock of EU-sourced legislation in the UK and identify measures where unnecessary regulatory burdens could be reduced or the system simplified. The Davidson Review found that unnecessary over-implementation was not extensive, but made some specific recommendations in its final report in November this year, as outlined in Box 3.5.

Box 3.5: The Davidson Review on implementation of EU legislation

Lord Davidson QC's report found that, while unnecessary over-implementation of European legislation may not be widespread in the UK, there are some areas of legislation where burdens could be reduced or the system simplified. Following consultation with government departments, regulators and external stakeholders, the Review has made specific simplification proposals in a range of areas including consumer sales, financial services, food hygiene training, transport and waste legislation. The simplification recommendations will benefit public UK businesses and the wider public by up to £240 million and £430 million a year respectively.

The Review has also identified factors – at the EU level and in the UK – that can contribute to over-implementation of European legislation. Building on recent and ongoing government reforms, the report makes recommendations further to improve the implementation process in the future, by updating the Cabinet Office's Transposition Guide, conducting regular post-implementation reviews, and changing the culture of implementing EU legislation, for instance, by improving communication between negotiating and implementing teams and between the Government and stakeholders. These reforms will help to ensure that the UK economy remains one of the most competitive in the world while maintaining necessary regulatory protections.

3.46 The Government welcomes the final report of the Davidson Review and accepts its recommendations in full. Government departments and regulators will work with their external stakeholders to ensure successful delivery of the recommendations, and the BRE will monitor progress on a regular basis. Government departments will provide an update on the delivery of the Davidson Review's specific simplification proposals in their 2007 simplification plans. HM Treasury has already committed to a consultation on reducing the scope of activity caught by the Insurance Mediation Directive to exclude freight forwarders.

Simplifying tax administration

3.47 To deliver faster productivity growth, which supports higher living standards, the Government will continue to modernise the tax system (as set out in Chapter 5) and reduce administrative burdens. This requires a strong, constructive relationship with business, so that all businesses contribute fairly, through the tax system, towards public services.

Review of HMRC links with large business

3.48 HM Revenues and Customs (HMRC) will continue to respond to the evolving needs of the corporate sector and will implement in full the proposals of Sir David Varney's *2006 Review of Links with Large Business*, published in November 2006.[14] The key proposals, outlined in Box 3.6, will deliver modern, responsive tax administration and an improved relationship between business and HMRC built on greater trust and transparency. Large business will benefit from a more cost-effective use of HMRC resources through the implementation of a risk-based audit approach, which is focussed on key risks to give business greater speed and certainty over the tax implications of commercial decisions.

Box 3.6: Review of HMRC Links with Large Business

The Review of HMRC Links with Large Business consulted extensively with business, representative and professional bodies. The outcomes that business and HMRC want to see are greater certainty, an efficient risk-based approach to dealing with tax matters, rapid resolution of issues, and clarity through effective consultation and dialogue. To deliver these outcomes, the review makes the following key recommendations:

- **introducing an advance rulings process, by the 2007 Pre-Budget Report, giving UK and international business earlier certainty on the tax implications of significant investment and corporate reconstruction projects;**
- **extending the existing clearances process, so that, by Budget 2008, HMRC will provide business with its view of the tax consequences of significant commercial issues within 28 days;**
- **implementing a risk-based approach to enquiries, by the end of 2007, making HMRC move responsive, as resources will be focussed on resolving contentious issues more efficiently and quickly;**
- **a comprehensive approach, implemented by the end of 2007, to the settlement of transfer-pricing enquiries within 18 months; and**
- **with effect from Budget 2007, making HMRC accountable for taking the business perspective into consideration in everything it does from implementing policy decisions to designing systems and processes.**

A Large Business Advisory Board, including senior business representatives, will be established to oversee delivery and HMRC will publish a detailed delivery plan by 31 March 2007.

Reducing administrative burdens

3.49 At Budget 2007, HMRC will report on progress towards meeting its stretching targets announced at Budget 2006 to: reduce the administrative burden on business in dealing with HMRC forms and returns by at least 10 per cent over five years; and reduce the administrative burden on compliant businesses in dealing with HMRC audits and inspections by 10 per cent over three years, and at least 15 per cent over five years.

[14] *2006 Review of Links with Large Business*, HM Revenue & Customs, November 2006

3.50 All businesses can benefit from simplified tax administration, but the gains to smaller businesses can be particularly significant because they can find the costs of compliance the most difficult to absorb. In November this year, HMRC published *Delivering a new relationship with business: HMRC's plans to deliver a better service for business by 2010-2011*. This demonstrates progress made since the creation of a single tax department in 2005; for instance, the short self assessment tax return for the smallest businesses has already reduced from 16 to 4 pages, the new form P46 (a form used when taking on a new employee who cannot produce their latest pay details) has been introduced as well as a new style self assessment statement. Box 3.7 provides an overview of the paper and HMRC's package of reforms designed to transform its relationship with business, and reduce further the administrative burden the tax system places on business.

Box 3.7: Simplifying tax administration for business

Delivering a new relationship with business: HMRC's plans to deliver a better service for business by 2010-2011 set out milestones for the introduction of new and improved services that will deliver the stretching targets, announced at Budget 2006, to reduce administrative burdens. Over the next four years, HMRC will:

- further reduce the burden of forms and returns: for instance, by introducing a redesigned VAT registration form from December 2006 to make registration easier and quicker for 225,000 businesses each year, and a new self assessment return in April 2008, halving the number of self-employment pages for 500,000 businesses;
- develop a single customer record, which will underpin single registration for all business taxes and enable the creation of a single business customer account, with consultation starting in 2007;
- link the enquiry window with the submission of the tax return, so that businesses can have their tax affairs settled sooner, with effect from 2008;
- provide a streamlined online environment for businesses to submit forms and returns and make payments, with delivery planned from 2008-09; and
- enhance services for agents and tax advisers, so that they can better support their clients and enable HMRC to target its activities more accurately on higher risk areas, with the first pilots starting in December 2006.

Supporting small businesses

3.51 Macroeconomic stability, fair and progressive tax administration and a risk-based regulatory framework are important preconditions for enterprise and job creation. These create the environment for new and growing businesses to raise their productivity and contribute to economic growth. However, small and medium-sized enterprises (SMEs) – particularly in disadvantaged areas – face disproportionate barriers in accessing finance and information. The Government is committed to addressing these market failures in the most effective and targeted way. The Government has already set out its reforms to finance support, introducing Enterprise Capital Funds (ECFs) and reforming the Small Firms Loan Guarantee. The policy priority now is to focus on delivery.

Enterprise Capital Funds

3.52 In order to support firms in accessing finance for growth, the Government has selected six ECFs since Budget 2006, with the second of these, the IQ Capital Fund, formally launched in November this year. This first round of ECFs will invest in: sustainable technology, life sciences, and high technology firms; firms at an early stage of development; and more generally in SMEs with high growth potential. **The Government has now invited**

bids for the selection of the second round of ECFs by 28 February 2007. The bidding process for this second round has been streamlined, making application to run the funds easier and cheaper for potential fund managers.

Small Firms Loan Guarantee scheme

3.53 The Small Firms Loan Guarantee scheme (SFLG) is an important means by which many small businesses access debt finance. Implementation of the Graham Review's recommendations has streamlined the operation of the SFLG, making it easier for lending institutions to use, and a more effective instrument.[15] Participating lenders now take full responsibility for the administration of the guarantee, speeding processes and providing a better service to their customers. The revised scheme is better aligned with market practice, and more focused on innovative products and those businesses facing the greatest difficulties in raising debt finance.

Rationalising business support

3.54 The Government recognises that the plethora of business support schemes available at local, regional and national levels can be hard for firms to navigate. Budget 2006 announced plans to rationalise business support by reducing the existing 3,000 schemes to no more than 100 by 2010, and, in doing so, ensure that they are complementary with private provision and targeted effectively at market failures. A strategy for meeting this 2010 target is being developed in time to inform the 2007 CSR.

3.55 The Department of Trade and Industry reviewed its business support products, taking their portfolio down from around 200 to just 10 larger and higher-impact products in 2004. Further changes include:

- the Department for Education and Skills' has simplified access to many of its workforce products within Train to Gain and will bring in services such as Investors in People to create an employer-focussed and employer-driven skills system;
- the Leitch Review, published on 5 December (and discussed later in this chapter), recommends that employer coalitions and regional skills partnership are merged into a series of employer-led Employment and Skills Boards – giving employers a single contact point to scrutinise local services;
- partnerships will also act as the focal point for mainstreaming the current range of local initiatives to improves employment and skills outcomes for disadvantaged groups, such as the Ambition pilots and Fair Cities, as they come to an end – providing a single point of reference for employers.

3.56 Box 3.8 sets out the progress RDAs have made in simplifying, and increasing the impact of, regional business support.

[15] *The Graham Review of the Small Firms Loan Guarantee*, HM Treasury, September 2004. Available at www.hm-treasury.gov .uk

Box 3.8: Regional development agencies and business support simplification

Responsibility for delivery of business support was devolved to the RDAs in March 2005, and regional government is responsible for around 40 per cent of business support schemes. RDA's commitment to delivering the 3,000 to 100 target in their regions is strong and they have already made significant progress in a number of areas. Specific achievements so far include:

- **positioning of Business Link as the primary access channel for publicly funded business support – RDAs including East of England Development Agency, East Midlands Development Agency and One NorthEast are integrating existing access channels into the existing Business Link offer, and are taking the opportunity to streamline delivery arrangements;**
- **rationalising initiatives – Yorkshire Forward is reducing all current business support products into six programmes – Enterprise, Best Practice, Innovation, International Business, Skills and Access to Finance. A number of RDAs, including South East of England Development Agency and Advantage West Midlands, will consolidate a number of duplicative regional access to finance schemes into a single customer-facing offer;**
- **rationalising new firm schemes – London Development Agency's new pan-London start-up and micro programme, Business London, replaces a number of previous separate schemes and at least 13 access channels. The North West Development Agency is also developing a new, better coordinated, start-up offer; and**
- **building on the strength of the national brands such as the Manufacturing Advisory Service (MAS) programme – the South West RDA is proposing to merge sector specific business improvement initiatives with the MAS programme.**

Local Authority Business Growth Incentive scheme

3.57 To create a direct financial incentive for local authorities to promote local business growth the Government introduced the Local Authority Business Growth Incentive (LABGI) scheme in April 2005. Local authorities receive a proportion of the increases in local business rate revenues to spend on their own priorities, in addition to the grant that they have already received in the local government finance settlement. In England, 278 local authorities received LABGI grants for 2005-06, totalling £127 million. Following its first year, the Government announced changes in September 2006 to simplify the scheme and increase the level of reward available to local authorities. With up to £1 billion to be spent over the three years to 2007-08, the Government anticipates that up to three times as much non-ring-fenced LABGI grant will be awarded to local authorities to spend on local priorities this year and next year. However, if business rate growth is significantly above or below forecast, the Government may have to scale LABGI payments up or down accordingly.

Enterprise in disadvantaged areas

3.58 Disadvantaged areas suffer from disproportionate barriers to business creation and growth. Markets in these communities tend to be smaller, more fragmented and less efficient, providing fewer opportunities for businesses to create wealth and employment. The Government is committed to tackling these market failures and creating a vibrant enterprise environment within disadvantaged areas.

Community Investment Tax Relief

3.59 In the *Social enterprise action plan*, the Government invited evidence from all interested parties on how the operation of the Community Investment Tax Relief and other incentives might be improved.[16] Details of how to submit evidence can be found on the Small Business Service's website.[17]

Local Enterprise Growth Initiative

3.60 The Local Enterprise Growth Initiative (LEGI), announced at Budget 2005, provides flexible, devolved investment in some of the most deprived areas to support enterprise and productivity. The second round of LEGI was launched in March this year. Regional and central government have undertaken a rigorous process of scrutiny to determine the bids most capable of making a targeted, sustainable difference in their communities. **Ten bids from fourteen local authorities in England have today been awarded £157 million over three years, subject to confirmation in the 2007 CSR**. This will boost the economies of some of the most deprived areas in England, through locally targeted, private sector supported solutions.[18] The Government will continue to work closely with local authorities with the highest levels of deprivation and lowest rates of enterprise formation to improve their capacity to bid in future LEGI rounds.

Creating an enterprise culture

Enterprise education

3.61 The continued growth and productivity of the UK economy will increasingly depend on the capacity of enterprising individuals and businesses to identify opportunities, develop innovative approaches to wealth creation and adapt to changing market circumstances. The Government is committed to building a stronger enterprise culture in the UK and is working to promote greater enterprise capability among young people in education. **To support meaningful business engagement with teaching and learning, the Government, in partnership with the British Chambers of Commerce, is creating 50 Young Chambers of commerce.** Young Chambers provide a framework that brings together local Chambers of Commerce, business, schools and pupils, to develop and take forward enterprise initiatives within individual schools. They will facilitate active business leadership and participation from local SMEs in enterprise education for pupils aged 14-19.

3.62 The 23 UK enterprise summer school pathfinders, announced in Budget 2006, have now been delivered by Young Enterprise. Their innovative approaches to extra-curricular learning have received good initial feedback from participants. Oxford University's evaluation of the scheme, to be published later this month, will examine the case for future investment.

Women and enterprise

3.63 US female entrepreneurial activity is two and half times higher than that of the UK, suggesting that there is significant untapped potential in the UK workforce. The Government recently appointed Glenda Stone, Chief Executive of Aurora, and Pam Alexander, Chief Executive of South East England Development Agency, as co-chairs of the Women's Enterprise Taskforce. The Taskforce will report in 2007 on the priorities for developing women's enterprise in the UK, including the evaluation of the regional Women's Enterprise Unit pilots.

[16] *Social enterprise action plan: scaling new heights*, Cabinet Office, November 2006. Available at www.cabinetoffice.gov.uk

[17] Available at www.sbs.gov.uk

[18] The successful bids are: Blackpool; Doncaster, Liverpool and Sefton, North East Lincolnshire, Norwich, Leeds, Pennine Lancashire (Blackburn, Darwen, Pendle, Burnley, Hyndburn), Redcar and Cleveland, Sheffield, Wansbeck.

SCIENCE AND INNOVATION

3.64 In a competitive global economy, innovation and the successful exploitation of creative ideas is increasingly important to business success, productivity and long term economic growth. The Government has an important role to play enabling an innovation system to thrive, so that creative ideas can be carried through to new products and services. The Government has taken action to invest in the science base, strengthen links between business and the research base, incentivise research and development (R&D), and ensure an attractive regulatory and investment environment.

3.65 In July 2004, the Government set out its ambition to increase public and private investment in R&D, so that it reaches 2.5 per cent of Gross Domestic Product (GDP) by 2014. The *Science and Innovation Investment Framework 2004-2014* sets out the Government's framework for achieving this target, and its long-term vision for UK science and innovation policy.[19] The second annual report, published in July 2006, showed that good progress has been made on key indicators for implementing the framework.[20] The Government is committed to ensuring the UK remains at the forefront of research globally and remains a location of choice for research-intensive firms. The Government therefore welcomes the Cooksey Review of Health Research and the Gowers Review of Intellectual Property (IP), detailed in this chapter, which identify areas where the UK can capitalise on its strengths, setting out a strategic vision for health research and an IP system fit for the 21st century.

Excellent Research

Cooksey Review of Health Research

3.66 At Budget 2006, the Government announced its intention to create a single fund of at least £1 billion and more effective structures to support world-class health research in the UK, aligning research priorities more closely with wider health objectives, building on scientific progress to date, and translating the results of research into economic and patient benefit. It appointed Sir David Cooksey to lead a review of health research.

3.67 The Cooksey Review, published today, recommends a more strategic approach to the planning, funding and delivery of health research. Amongst its recommendations, set out in Box 3.9, the Review proposes establishing an Office for Strategic Coordination of Health Research (OSCHR) to enhance the coordination of health research in the UK and ensure more coherent funding arrangements.

[19] Available at www.hm-treasury.gov.uk

[20] Available at www.dti.gov.uk

Box 3.9: The Cooksey Review of Health Research

The Cooksey Review recommends that a new Office for Strategic Coordination of Health Research (OSCHR) be established to create a more strategic approach to health research. This will bring together the health research budgets of the Medical Research Council (MRC) and the Department of Health (DH), while retaining two separate organisations, in order to:

- **set the Government's health research strategy, taking into account the advice, priorities and needs set out by the National Institute of Health Research (NIHR), the MRC and the National Health Service (NHS);**
- **set the budget required to deliver the health research strategy and the objectives for the DH and the MRC, including the distribution of the research budget between the NIHR and the MRC;**
- **monitor the delivery of the health research strategy against objectives, to report to ministers and Parliament on its progress, and to advise ministers on the effectiveness of maintaining two separate public bodies; and**
- **encourage a stronger partnership with the health industries and charities.**

The Government is committed to making the UK the best place in the world to undertake health research and develop new drugs. The review makes recommendations to improve the economics of drug development in the UK by improving speed to market, while allowing more rapid assessment of a drug's safety and efficacy. The OSCHR will use its understanding of the UK's health priorities to improve market signalling to the pharmaceutical and biosciences sectors. It will brand research projects, which could be in the public, private or third sectors, that it believes could address an unmet health need in the UK as "UK Priority Health Research Projects". The Review recommends that the status of "UK Priority Health Research Project" also be included as a criterion in the decision regarding the process by which medicines should be assessed, by the National Institute for Health and Clinical Excellence (NICE) – and its equivalents in the Devolved Administrations. The Review also proposes that the Government, regulators and industry create a new partnership to pilot a new drug development "pathway" for the benefit of all stakeholders: industry, government, the wider economy and patients. This pathway should enable:

- **more rapid discrimination between potential new therapies at earlier stages of drug development and earlier 'conditional licensing' of new drugs, enabling patients to access cost effective drugs faster;**
- **the earlier involvement of the NICE in the process of development to accelerate assessment of clinical trials and ensure their cost-effectiveness, creating more certainty for companies involved in drug development and improving speed to market;**
- **clearer processes for ensuring the NICE's initial assessments and recommendations for further research are followed-up more systematically; and**
- **the use of the NHS IT programme to ensure more rapid assessment of any emerging side-effects and efficacy over longer periods, resulting in improved safety for patients.**

Government response to Cooksey

3.68 **The Government welcomes the Cooksey Review and will take forward its recommendations.** The Government has appointed Professor John Bell, as Acting Chair of the OSCHR, to set out the health research strategy for the UK and put forward a joint bid from the NIHR and the MRC to the 2007 CSR to meet the objectives of the strategy. In addition, the

Government will appoint an Independent Adviser in the New Year to implement the Cooksey Review's recommendations for reforming the drug development pathway to improve speed to market for new drugs and enable more rapid assessment of the efficacy and safety of new drugs, and develop a "UK Priority Health Research Project" brand.

Stem cells

3.69 The UK Stem Cell Initiative reported back to the Government, at the 2005 Pre-Budget Report, on a strategy for the next decade of stem cell research in the UK. The first recommendation was for the Government to establish a public-private partnership (PPP) using stem cells to enhance pre-commercial aspects of drug development. Following extensive consultation with the pharmaceutical industry and research community, a task force led by the Association of the British Pharmaceutical Industry has backed the recommendation to establish a PPP. **The Government will work in partnership with industry to establish a consortium, which will develop the use of stem cells in the production of safer medicines and begin work with a series of pilot projects in 2007.**

Research Assessment Exercise

3.70 Building a national innovation system depends on the maintenance of a strong public research base. The UK research base is already highly competitive by international standards. In order to maintain the UK's world-class universities the Government intends that resource allocation should continue to be strongly focused on excellence in research, including curiosity-driven, user-focused, and collaborative research. The Government is strongly committed to the dual support system for university research, which provides institutions with the freedom to set strategic priorities for research, undertake blue skies work, and respond quickly to emerging priorities.

3.71 In recognition of the burden imposed on universities by the Research Assessment Exercise (RAE) the Government has consulted on options for reform. In line with the presumption made in Budget 2006, the 2008 RAE will go ahead as planned. However, the consultation made clear that there is overwhelming appetite for reform thereafter.

3.72 **This Pre-Budget Report sets out a new framework for research assessment and funding.** Further details of the new system are published today.[21] Responses to the consultation made clear that a single system should apply to all institutions and across all disciplines, but noted differences in the applicability of current metrics across disciplines. The Government agrees with this analysis and is developing an overarching framework within which the current applicability of metrics in different disciplines is accommodated:

- for science, engineering, technology (SET) and medicine a combination of research income, postgraduate research student data and a bibliometric indicator of quality will be used to assess research. The process will be overseen by seven advisory groups with representation from UK academics, research users and international advisors; and
- for all other disciplines, including mathematics and statistics, there will be a significantly reduced, light-touch peer review process informed by a range of discipline-specific indicators. This will be substantially less onerous for universities.

3.73 The outcomes from this process will be adjusted for research volume to produce a funding allocation. Data to support the new system will be collected for SET and medicine in the academic year 2009-10 with a gradually phased change to funding allocations between September 2010 and August 2014. For all other subjects, expert panels will be convened in 2013-14 to inform new funding allocations from September 2014.

[21] The consultation document, a summary of consultation responses and further details on the new system are available from www.dfes.gov.uk

3.74 In order to optimise the economic impact of research, the new system will provide greater rewards for user-focused research. In advance of the new system coming into effect, **the Higher Education Funding Council for England (HEFCE) will, from 2007-08, allocate £60 million of Quality-Related research funding a year, relative to the amount of research universities undertake with business.** HEFCE will be responsible for refining the details of the new system, including the bibliometric system and the light-touch peer review, in consultation with the university sector. It will report back to the Government in time for the 2007 Pre-Budget Report.

Building an innovation system

Supporting knowledge transfer

3.75 **The Department of Trade and Industry (DTI) is today publishing a booklet of case studies, *Making the Most of UK Science*, highlighting examples of excellent research collaboration and knowledge transfer.**[22] The case studies illustrate how the academic community and business in the UK have engaged with each other, risen to new challenges, and built upon their respective strengths, to produce innovative products and services that have had significant social and economic impact in the UK.

Public engagement

3.76 The Government's goal is for the UK public to be confident about the governance, regulation and use of science and technology – by both government and business – and to be actively engaged in scientific debate. To build on the progress made in this area through the Sciencewise Programme, **the Government will establish an Expert Resource Centre for Public Dialogue on Science and Innovation to assist all parts of government in enabling public debate on science and technology-related topics**. The Centre will develop and disseminate good practice on public dialogue across government and its non-departmental public bodies, resulting in a culture where public dialogue is seen as a fundamental part of science and technology policy development.

Sainsbury Review

3.77 The Chancellor has asked Lord Sainsbury to carry out a review to assess the responsiveness of the science and innovation system to the challenges and opportunities of globalisation, and take a forward look at what more needs to be done to ensure the UK's continued success in wealth creation and scientific policy-making. The Review will build on the Government's existing policy agenda, including the *Science and Innovation Investment Framework 2004-2014*, as well as the *Next Steps* for implementing the framework published alongside Budget 2006.[23] Lord Sainsbury will report to the Chancellor of the Exchequer and the Secretaries of State for Trade and Industry and Education and Skills in time for the 2007 CSR.

Business Research and Development

R&D tax credit

3.78 Strong R&D performance is fundamental to a high performing innovation system. **In November this year, HMRC launched specialist units dedicated to handling all R&D tax credit claims outside the Large Business Service.** These units will build links with the R&D community, and provide small firms with specialist support. The Government has also launched a promotional campaign, aimed at increasing the levels of awareness and understanding of the R&D tax credit. The Government has begun a dialogue with the European Commission over extending additional support to companies with between 250 and 500 employees.

[22] *Making the Most of UK Science*, OSI, November 2006. Available at www.dti.gov.uk

[23] Available at: www.dti.gov.uk

Gowers Review

3.79 In 2005, the Government asked Andrew Gowers to conduct a wide-ranging independent review into the UK's intellectual property regime to ensure that it is supporting UK innovation and the creative industries in a time of rapid global economic change and increased global competition. **The Gowers Review of Intellectual Property (IP) reports its recommendations to the Government alongside this Pre-Budget Report, setting out a vision of an IP system that is fit for the 21st century.** The Review has considered the challenges of globalisation and technological change, and sets out a strategic vision of a system that is balanced, coherent and flexible, ensuring that the operations of the system work for businesses and consumers.

3.80 The Gowers Review argues that, faced with the twin challenges of profound global and technological change, innovation has never been more important to economic competitiveness in the UK, and that an effective IP regime is essential to support that innovation and investment. This requires that IP rights must be effectively enforced to protect and promote innovation and ensure that businesses benefit from their own creativity. It also requires that businesses and innovators be appropriately supported in their use of the IP system. IP rights must also be balanced, so that, while ideas are protected, future innovation is not stifled. The Review's recommendations are set out in more detail in Box 3.10.

Box 3.10: Gowers Review of intellectual property

The Gowers Review sets out reforms to ensure the UK's IP system is fit for the digital age.

With the music industry losing as much as 20 per cent of annual turnover to piracy and counterfeiting the Review recommends strengthening enforcement through:

- **new powers and duties for Trading Standards to take action against copyright infringement;**
- **the recognition of IP crime as an area for police action in the National Community Safety Plan;**
- **tougher penalties for online copyright infringement – with a maximum 10 years imprisonment;**
- **lowering the costs of litigation – by using mediation and consulting on the use of fast-track litigation. The Review acknowledges that prohibitive legal costs affect the ability of many to defend and challenge IP; and**
- **consulting on the use of civil damages as a deterrent for IP infringement.**

To support businesses using IP rights, the Review recommends:

- **restructuring the UK Patent Office as the UK Intellectual Property Office to provide greater support and advice for businesses using IP domestically, with business representatives sitting on a new independent Strategic Advisory Board for IP Policy, advising the Government; and**
- **improving support and advice internationally – including in India and China – to enable UK businesses to protect their investment around the world.**

To ensure the correct balance in IP rights, the Review recommends:

- **ensuring the IP system focuses resources on tackling genuinely illegitimate activity. The Review recommends introducing a 'private copying' exception to enable users to format-shift content;**
- **enabling access to content for libraries and education establishments – to ensure that the UK's cultural heritage can be adequately stored for preservation and accessed for learning. The Review recommends clarifying exceptions to make them fit for the digital age; and**
- **that the European Commission does not change the *status quo* and retains the 50 year term of copyright protection for sound recordings and performers' rights.**

Government response to Gowers

3.81 **The Government welcomes the Gowers Review and will take forward those recommendations for which it is responsible.** The Government firmly believes in the need for strong enforcement of IP rights to support the UK's creative industries. **The Government is therefore today endorsing the full Gowers enforcement package to tackle piracy and other IP infringement and is providing Trading Standards with an additional £5 million in 2007-08 in order to support the implementation of their new powers to tackle copyright infringement.** To ensure that IP policy is strategically formulated in the future, the Government also supports the creation of an independent Strategic Advisory Board for IP policy. This Board will receive £500,000 from the Patent Office to commission research on emerging IP trends. The Government notes the recommendation to the European Commission on copyright term.

Supporting creativity in business **3.82** Creativity is fundamental to innovation. Following the publication of the Cox Review of Creativity in Business in December 2005,[24] the Government is taking forward its response to support UK business innovation, in the context of increasingly competitive global markets. The "Designing Demand" programme, which will help firms to use design to drive innovation, has been successfully launched in the South East, West Midlands and South Yorkshire regions, with the programme due to start in North East and South West by spring 2007. Between 2006 and 2010 it is envisaged that over 6,000 companies will access this support in the strategic use of design and creativity to change the direction of their business. A panel of distinguished figures from the arts, science, technology and education has been set up to oversee the planning of a National Centre in London, with the London Development Agency taking responsibility for the London hub.

Higher education centres of excellence **3.83** Higher education institutions (HEIs) also play an important role in nurturing business innovation. Following the call from the Higher Education Funding Council for England (HEFCE) for bids to establish Centres for Excellence for multi-disciplinary courses, HEIs are developing new approaches to teaching and learning to develop creativity and entrepreneurialism. It is expected that HEFCE will fund around six additional developments to explore major new aspects of the Cox agenda. These projects will work across institutions and cover a variety of sectors, including services, health, environment, and communication, and will explore the development of creative leaders, world class designers, engineers, scientists and executives.

Science Forum **3.84** The UK Science Forum is a high-level forum between government, business leaders and academics, set up to support the UK's R&D and innovation agenda. In July 2006, the Forum presented its findings to the Government on a number of key issues including science, technology, engineering and mathematical (STEM) skills, the role of public procurement, joint programmes and projects between industry and government, and public attitudes to science. The Government has committed to undertake an analysis of the R&D performed by leading R&D businesses in the UK, exploring the factors influencing their location decisions and their plans to invest in the UK in the future. This analysis will contribute to evidence informing future policy decisions.

SKILLS

3.85 Workforce skills are key to the UK's capacity to respond flexibly to new challenges in a changing global economic environment. A skilled workforce enables firms to increase their productivity by improving working practices and enhancing innovation, as well as driving improvements in social justice. The UK's skills profile is improving, with more people gaining qualifications at all skill levels. However, the large stock of workers with low or no skills continues to act as a barrier to productivity growth and reinforces inequalities.

Leitch Review of Skills **3.86** In the 2004 Pre-Budget Report, the Government commissioned Lord Leitch to identify the UK's optimal skills mix in 2020 to maximise economic growth, productivity and social justice, and to consider the policy implications of achieving a world-class skills base. The final report, *Prosperity for all in the global economy – world class skills,* was published on 5 December this year.[25] It sets out a compelling vision, recommending that the UK commit to becoming a world leader in skills by 2020, benchmarked against the upper quartile of OECD countries. This requires doubling attainment at most levels. Stretching objectives for 2020

[24] *The Cox Review of Creativity in Business: building on the UK's strengths*, HM Treasury, December 2004. Available at www.hm-treasury.gov.uk

[25] The full document is available online at www.hm-treasury.gov.uk

include ensuring that: 95 per cent of adults have basic skills; more than 90 per cent of the workforce are qualified to at least level 2; there is a shift the balance of intermediate skills from level 2 to level 3 qualifications; and that more than 40 per cent of the adult population have qualifications at level 4 and above. More details are set out in Box 3.11.

Box 3.11: The Leitch Review of Skills

The Leitch Review sets out how the UK should raise its ambitions on skills, by committing to stretching objectives for 2020:

- **95 per cent of adults to achieve the basic skills of functional literacy and numeracy, an increase from levels of 85 per cent literacy and 79 per cent numeracy in 2005;**
- **exceeding 90 per cent of adults qualified to at least level 2, an increase from 69 per cent in 2005. A commitment to go further and achieve 95 per cent as soon as possible;**
- **shifting the balance of intermediate skills from level 2 to level 3. Improving the esteem, quantity and quality of intermediate skills. This means 1.9 million additional level 3 attainments over the period and boosting the number of Apprentices to 500,000 a year; and**
- **exceeding 40 per cent of adults qualified to level 4 and above, up from 29 per cent in 2005, with a commitment to continue progression.**

The Review makes a number of recommendations to help the UK meet these stretching objectives, including:

- **routing all public funding for adult vocational skills in England, apart from community learning, through Train to Gain and Learner Accounts by 2010;**
- **strengthening the employer's voice, creating a new Commission for Employment and Skills, boosting the role of Sector Skills Councils, and increasing employer engagement and investment in skills;**
- **launching a new Pledge for employers voluntarily to commit to train all eligible employees up to level 2 in the workplace. In 2010, review progress of employer delivery – if the improvement is insufficient, introduce a statutory entitlement to workplace training at level 2 in consultation with employers and unions;**
- **increasing people's aspirations and awareness of the value of skills to them and their families, through a high profile, sustained awareness programme including better careers guidance; and**
- **creating a new integrated employment and skills service, based upon existing structures, to increase sustainable employment and progression with better intergration of jobs and skills.**

Government response to Leitch

3.87 **The Government welcomes the Leitch report and its analysis of the growing importance of skills in a modern economy.** The report identifies worsening employment rates and low social mobility for the poorly qualified, despite the UK's recent strong economic performance and narrowing of the productivity gap with key comparator countries. Improvements in all these areas are increasingly driven by skills. The long-term challenge for the UK is to increase its prosperity through higher productivity and employment at a time when the global economy is changing rapidly. These global changes are increasing the number of high skilled jobs and increasing skills demands within most existing jobs.

3.88 The Government accepts the higher skills ambitions for 2020 set out in the Leitch Review. The Government is already investing heavily in skills to deliver the current set of challenging skills targets. Achieving these targets is a precondition for any higher ambitions. They will set the foundation from which to build. The Government will consider how best to achieve the Leitch ambitions and implement its recommendations, alongside the level of resources it will allocate to them, as part of the 2007 CSR process.

3.89 The Government accepts the principles the Leitch Review recommends to underpin the delivery of the world-class skills ambition. There must be a shared responsibility for delivering the ambition. Employers, individuals and the Government must all improve their efforts and investment. The Government is committed to investing where there are market failures, with employers and individuals making a larger contribution where they gain the greatest private returns. The focus must be on economically valuable skills that deliver returns for employers and individuals. The skills system must be fully demand-led and focused on the needs of employers and individuals. Reforms should also build on existing structures through simplification, rationalisation and better performance management.

Employer engagement in skills

3.90 Employers have an important role to play in securing world-class skills in the UK, raising their investment in skills at all levels and using skills effectively. The Government welcomes the investment in training that employers have made, and their involvement in existing skills initiatives. The Leitch Review sets out recommendations for shared action from the Government and employers – a 'something for something' approach – that ties greater rights to increased responsibility. This approach recommends that employers take more responsibility to offer time off, in return for more influence over the type of training available, and that the Government takes more responsibility to reform and invest in training provision. At the heart of this deal is the Government's commitment, through Train to Gain, to ensure all workers have a basic platform of skills.

Train to Gain

3.91 Since April 2006, the Government has been rolling out a new national service for employers – Train to Gain. This provides firms with free, flexibly delivered training in the workplace for their low-skilled employees. In return, firms give their employees time off to undertake and complete training. This innovative approach is based on the lessons learned from Employer Training Pilots, which were launched in September 2002 and completed recently. Evaluations of the Employer Training Pilots have shown the positive impact of the pilots on both employers and learners in terms of satisfaction and workplace performance improvements. Over 90 per cent of employers were satisfied with the pilots overall. As described in Chapter 4, the Leitch Review makes a number of recommendations for integrating skills and employment services, with Train to Gain playing an important role in helping to increase sustainable employment and progression. The Train to Gain model has clearly been a successfully piloted and provides a solid foundation from which the Government can start work towards the Leitch ambitions.

Government Envoy for Skills

3.92 The Government also accepts the need for a strong, coherent employer voice at the heart of the skills system, delivered through the new Commission for Employment and Skills, recommended by the Leitch Review. In advance of the creation of the Commission, Sir Digby Jones has agreed to take on the role of the Government's Skills Envoy, working with all employers to help build a national consensus about the need to work together to improve the UK's skills.

Skills for young people

3.93 The Government has introduced a number of measures to encourage all young people to take part in some form of education or training up to the age of 19. Despite progress in recent years, the UK ranks among the lowest performing OECD countries in terms of post-16 participation.

3.94 The 14-19 Education and Skills White Paper, published in February 2005, set out the next steps the Government is taking to tackle this problem, including the introduction of 14 specialised diplomas in broadly vocational areas by 2013. The content of the first five Specialised Diploma subjects (ICT, health and social care, engineering, creative and media and the built environment) has recently been published.[26]

[26] The content for each of the first five Diploma lines is available on the Diploma Development Partnership websites.

3.95 Since April 2006 the Government has been piloting new Learning Agreements. These are aimed at 16 and 17 year olds who are in work but not receiving accredited training, to ensure they undertake appropriate learning. **The Government will now consider extending these pilots, to enable a greater number of people to benefit.** Building on the existing statutory right to paid time off to train or study for this group, the pilot is testing the effectiveness of formal learning agreements, financial incentives and wage compensation for young people and their employers when engaging in training. Chapter 5 sets out a number of new measures aimed at raising post-16 participation in education and training.

STEM Skills

3.96 To support the UK's ambition to move to a higher level of research and development intensity, it is crucial to ensure that the UK has the right stock and flow of skilled scientists, technologists, engineers and mathematicians (STEM). At Budget 2006 the Government announced further measures to improve the skills of science teachers, the quality of science lessons and increase progression to A-level sciences. In October this year, the Government published a report on STEM skills,[27] which announced the formation of a new high-level STEM strategy group, led by the Department for Education and Skills with the involvement of external stakeholders, to encourage a more coherent approach for STEM across government. The group will make recommendations to ministers about national STEM priorities and related matters such as delivery arrangements and evaluation. It will meet three times each year, following its first meeting in October. John Holman has been appointed National STEM Director, to drive delivery forward.

INVESTMENT

3.97 Alongside ensuring open and flexible markets, investing in essential infrastructure to support business growth is key to continuing to raise the UK's productivity performance. Evidence suggests the UK has historically had low levels of fixed investment, including in infrastructure such as housing and transport, compared with leading OECD countries.[28] The Government has made good progress in tackling this under-investment in recent years. This Pre-Budget Report sets out key measures to build on these recent increases in investment, through important reforms to the planning system, housing supply and transport system.

Investing in infrastructure

Barker Review of Land Use Planning

3.98 In 2005, Kate Barker was asked by the Government to conduct an independent review of the land use planning system in England. The terms of reference asked her to consider how, building on recent reforms, the planning system could better support economic growth in the context of delivering its wider sustainable development goals. An interim report was published in July 2006, highlighting the ways in which the planning system can impact on productivity growth. These included the transaction costs associated with uncertainty and planning delays, and the potential economic impacts of land supply restrictions, including on occupation costs. It welcomed the progress that had been made, but noted that further changes were needed to support competition and encourage sustainable economic growth.

[27] The full document is available online at www.dfes.gov.uk

[28] For instance, as set out in *Productivity in the UK 6: Progress and new evidence*, HM Treasury, March 2006

Box 3.12: Barker Review of Land Use Planning

The final report of the Barker Review of Land Use Planning was published on 5 December 2006. It set out a range of recommendations for improving the speed, responsiveness and efficiency of the planning system, while ensuring it delivers its economic, social and environmental objectives, including:

- **streamlining policy and process through reducing policy guidance, unifying consent regimes and reforming plan-making at local level so that future development plan documents can be delivered in 18-24 months rather than three or more years;**
- **updating national policy on planning for economic development (PPS4), to ensure that the benefits of development are fully taken into account in plan-making and decision-taking, with a more explicit role for market and price signals;**
- **introducing a new system for dealing with major infrastructure projects, based around national Statements of Strategic Objectives and an independent Planning Commission to determine applications;**
- **promoting a positive planning culture within the plan-led system, recommending that when the plan is indeterminate, applications should be approved unless there is good reason to believe that the economic, social and environmental costs will exceed the respective benefits;**
- **in the context of the Lyons Inquiry into Local Government, to consider enhancing fiscal incentives to ensure a more efficient use of commercial property and the redevelopment of vacant and derelict brownfield land;**
- **a more risk-based and proportionate approach to regulation, with a reduction in form-filling, including the introduction of new proportionality thresholds;**
- **removing the need for minor commercial developments that have little wider impact to require planning permission (including commercial micro-generation);**
- **improving skills, and ensuring sufficient resources for planning, linked to improved performance, including consulting on raising the £50,000 fee cap and allowing firms to pay for additional resources to speed up applications;**
- **reducing delays at appeals and call-in, with a new planning mediation service to reduce demand for appeal, and a 50 per cent reduction in the volume of Secretary of State call-ins; and**
- **ensuring that new development beyond towns and cities occurs in the most sustainable way, by encouraging planning bodies to review their greenbelt boundaries and take a more positive approach to applications that will enhance the quality of their greenbelts.**

3.99 The final report of Kate Barker's Review of Land Use Planning (see Box 3.12) makes clear that planning is a valued and necessary activity that can deliver positive economic outcomes, alongside important social and environmental objectives. However, it concludes that the context for the planning system is becoming ever more challenging and therefore recommends further wide-ranging reform, building on recent changes and the plan-led approach, to ensure that the planning system supports sustainable economic growth in a global economy.

Planning major infrastructure

3.100 The Eddington Transport Study recommends reform to the process of planning for major transport infrastructure (see Box 3.13). Kate Barker's Review has considered these proposals in a wider planning context and recommends comprehensive reform of the planning of major infrastructure projects in relation to transport, energy, water supply and waste, based on the same principles.

3.101 The Government believes that these recommendations on planning for infrastructure could play a significant role in ensuring the UK's competitiveness and delivering the Government's objectives on climate change, the environment, and energy security, through improving the speed, certainty and transparency of the planning process for major infrastructure. Key elements of the proposed reforms are that:

- the primary role of ministers would be to set national policy statements for major infrastructure development, taking full account of economic, social and environmental considerations, following full consultation;
- there would be a presumption in favour of development for major infrastructure proposals so long as they are consistent with national policy statements, and compatible with EU law and the European Convention on Human Rights;
- an Independent Planning Commission would be established to manage inquiries and determine individual applications for major schemes in England;
- local consultation would be carried out by the applicant at the pre-application stage and inquiries and decisions would have regard to local considerations;
- consent regimes would be rationalised to eliminate duplication and overlap and to treat major projects as a whole; and
- there would be a clear framework for statutory rights to challenge at key stages in the process.

3.102 **The Government welcomes Kate Barker's report which it will take forward, and agrees with her overall analysis. The Government will set out in a White Paper, in spring 2007, its proposals in response to her recommendations for improving the speed, responsiveness and efficiency in land use planning, and for taking forward Kate Barker's and Rod Eddington's proposals for reform of major infrastructure planning.** In the meantime, the Government is interested to hear views including on how the major infrastructure proposals could be implemented and made to work in practice.

3.103 Planning is devolved in Scotland, Wales and Northern Ireland. The Government will continue to work with the Devolved Administrations in developing reforms to ensure that the planning systems in the UK operate effectively alongside each other.

Tax incentives for brownfield land

3.104 Recognizing that previously used land is often more costly to develop than greenfield sites, the Government introduced a 150 per cent corporation tax relief in 2001 to give extra help with the costs of decontamination. Landfill tax also includes an exemption for waste removed from contaminated land. Following the recommendation of the Barker Review of Land Use Planning, the Government intends to review these tax reliefs to ensure they are helping to deliver additional development and will be consulting on possible reforms in spring 2007 to enable any changes to be put in place alongside the proposed introduction of the Planning-gain Supplement, set out later in this chapter.

Business Premises Renovation Allowances

3.105 The Business Premises Renovation Allowances scheme will give 100 per cent capital allowances for the capital costs of bringing empty business properties back into use in disadvantaged areas and was enacted in 2005. The Government is continuing to seek state aid approval and remains committed to introducing the scheme as soon as possible.

Real Estate Investment Trusts

3.106 **This Pre-Budget Report announces a change to the Real Estate Investment Trusts (UK-REITs) regime, to be included in Finance Bill 2007, to make it easier for newly-established companies to join the regime.** This change will allow companies to enter the UK-REIT regime without meeting the requirement that at least 75 per cent of their business by assets and income consists of property rental activity, provided that they meet this condition within one year of entry. The entry charge of 2 per cent of the gross market value of investment properties will be levied at the end of this first year, on the value of properties held at that point. HMRC will also shortly publish information on a number of technical changes to be made in Finance Bill 2007, to ensure that the regime runs smoothly.

Investing in housing

Investing in housing supply

3.107 Meeting housing need is vital for the UK's future economic prosperity and social success. *The Government's Response to Kate Barker's Review of Housing Supply*, published alongside the 2005 Pre-Budget Report,[29] sets out a package of measures to increase housing supply and improve affordability, including a target to raise the number of new houses being built to at least 200,000 net additions per year by 2016. Good progress is being made: data for the year until September 2006 shows 165,000 completions, a 25 per cent increase over the same period in 2001. However, predictions for demographic change indicate that new housing supply will need to rise further over the next decade.

3.108 The Government is therefore bringing forward further measures to increase and speed up the delivery of new, sustainable, housing. The publication of *Planning Policy Statement 3: Housing* (PPS3) will ensure that local and regional plans are more responsive to housing markets and prepare and release more land to meet future housing requirements.[30] Reinforcing this policy, 29 areas across the country have now been named as New Growth Points with the potential to contribute around 100,000 additional dwellings by 2016, an increase of around 32 per cent on previous plans for housing supply in these areas.

3.109 To support local authorities in meeting their housing targets, the Government plans to introduce a new Housing and Planning Delivery Grant on which it has recently consulted.[31] In addition, a new independent National Housing and Planning Advice Unit will begin work early in the new year, providing expert advice to regional planning bodies, allowing them to incorporate a better understanding of the relationship between housing supply and affordability.

Sustainable housing

3.110 To meet future economic, social and environmental challenges, it is vital that the UK builds more sustainable homes. To reduce the carbon impact of new development and to encourage environmentally sound housebuilding, the Department for Communities and Local Government will shortly publish the Code for Sustainable Homes. Building on the higher energy efficiency standards introduced earlier this year through building regulations, the Code will be accompanied by an ambition progressively to incorporate its standards on energy efficiency into future building regulations, thereby ensuring that, within a decade, all new homes are zero carbon. Chapter 7 sets out new measures to help achieve this ambition. Additionally, to ensure that the planning system plays its full role in tackling carbon

[29] *The Government's Response to Kate Barker's Review of Housing Supply*, HM Treasury and ODPM, December 2005

[30] *Planning Policy Statement 3: Housing (PPS3)*, DCLG, November 2006

[31] *Housing and Planning Delivery Grant: Consultation Paper*, DCLG, July 2006

emissions, the Government will shortly issue for consultation a new Planning Policy Statement on Climate Change. This will aim to integrate climate change considerations fully into every stage of the planning process.

Housing infrastructure

3.111 The Government is committed to ensuring that its ambitious plans for a step-change in housing supply are supported by the necessary investment in social, transport and environmental infrastructure. To address these issues, the Government has established a 2007 CSR Policy Review into Supporting Housing Growth.[32] The review has identified a number of key themes for further work, including:

- identifying the infrastructure implications of housing growth in different spatial forms and locations;
- possible adjustments to departmental priorities and allocation mechanisms to ensure more efficient and timely provision of infrastructure funding; and
- improving infrastructure planning and delivery at the local and regional level, including measures to improve the coordination and timeliness of delivery partners and mechanisms for front-funding the provision of infrastructure.

Shared Equity Task Force

3.112 Due to the long-term nature of investing in housing supply, the Government set up the Shared Equity Task Force to examine whether there were barriers preventing the development of shared equity products for households wanting to access home-ownership in the shorter-term. In its report, published today, the Task Force found that:

- there is currently a small, fragmented market in the provision of equity loans. Yet there are pension funds and others interested in investing in this market;
- the public-private partnership to develop the expanded Open Market HomeBuy scheme has already tackled a number of informational and regulatory barriers, as well as bringing major financial institutions into this market for the first time; and
- market provision is set to expand and the aspirations of those households closest to homeownership will increasingly be met by the market.

3.113 In response to the report, the Government will seek to extend the reach of the Open Market HomeBuy scheme to households on lower incomes, and will be launching a competition for lenders to join in a 2008-09 to 2010-11 round of the scheme. Taking together procurement gains, a stronger role for the private sector, and the numbers now expected to be assisted by the market, **the Government now expects over 160,000 households to access homeownership through private or public shared equity products by 2010, double original plans.**[33]

Surplus public sector land

3.114 The Government's response to the Barker Review of Housing Supply established a new, joint HM Treasury-Department for Communities and Local Government taskforce to examine cost-effective options for releasing more surplus public sector land to facilitate housing growth. **The taskforce has recommended a number of actions to accelerate the release of surplus public sector land for housing, including an increased ambition of 130,000 new homes to be delivered from existing and new sites over the next ten years,**

[32] See *The Government's Response to Kate Barker's Review of Housing Supply*, HM Treasury and ODPM, December 2005

[33] *Sustainable Communities: Homes for All*, ODPM, January 2005. Available at www.communities.gov.uk

further measures to support the work of English Partnerships in this area, an enhanced Register of Surplus Public Sector Land, and increased incentives for housing delivery. The Government will consider these recommendations as part of the 2007 CSR.

Progress on the Planning-gain Supplement

3.115 The proposed Planning-gain Supplement (PGS) aims to release increases in land value created by the planning process to help finance the infrastructure needed to support new housing and growth. Kate Barker recommended introducing PGS, alongside a revised planning obligations regime, in her review of housing supply, as an essential part of a package of reforms to incentivise the release of more land for development. The Government responded to Barker's recommendation, publishing a consultation paper on PGS alongside the 2005 Pre-Budget Report.[34]

Further consultation on PGS

3.116 **The Government will move forward with the implementation of PGS if, after further consultation, it continues to be deemed workable and effective.** In response to views expressed by consultation respondents on specific policy areas, the Government is today publishing consultation papers on elements of the design of PGS and the new approach to planning obligations:

- *Valuing Planning Gain: a Planning-gain Supplement consultation*, HM Revenue and Customs;
- *Paying PGS: a Planning-gain Supplement technical consultation*, HM Revenue and Customs; and
- *Changes to planning obligations: a Planning-gain Supplement consultation*, Department for Communities and Local Government.

3.117 Many respondents suggested that the Government consider alternative measures to capture land value, including the Optional Planning Charge and planning tariffs. Kate Barker's review of housing supply examined options for capturing value uplift and the Government has looked closely at these models. **The Government continues to believe that a workable and effective PGS, alongside a scaled-back planning obligations system, represents a fairer and more effective means of releasing land value to help finance infrastructure.**

Timetable

3.118 Given the need to allow markets sufficient time to adjust to the new regime, **the Government now proposes that a workable and effective PGS would not be introduced earlier than 2009**.

Rate

3.119 As proposed in 2005, **PGS would be levied at a modest rate across the UK** to generate additional revenue for investment in infrastructure at the local and regional levels while preserving incentives for development to come forward.

PGS and brownfield land

3.120 The Government consulted on whether a lower rate of PGS should be applied to brownfield land. Many respondents suggested that because lower values associated with brownfield sites would be reflected in PGS valuations, a lower brownfield rate would not

[34] Planning-gain Supplement: a consultation, HM Treasury, HM Revenue and Customs and the Office of the Deputy Prime Minister, December 2005

encourage regeneration. The Government agrees with this assessment, but will continue to examine this issue and whether other instruments could better create incentives for regeneration. **The Government intends to review certain tax incentives for the development of brownfield land** (as discussed earlier in this chapter).

Scope

3.121 Maintaining a broad scope with a wide base would enable PGS to be levied at a modest rate with a reduced risk of creating economic distortions or avoidance opportunities. **The 2005 consultation proposed that PGS apply to residential and non-residential development but that home improvements would be exempt from the levy. This remains the proposed scope of the levy. The Government is still considering thresholds for small-scale non-residential development.**

3.122 The application of PGS and a revised planning obligations system to major infrastructure projects, to public sector works, to minerals and waste consents and to non-Town and Country Planning Act consents remains under review.

Revenue allocation

3.123 The Government committed at Budget 2006 to recycle a significant majority of PGS revenues back to the local authority area in which the revenues derived. The Government now proposes that at least 70 per cent of PGS revenues would be hypothecated for local infrastructure priorities and would be returned to the local authority area in which they were generated. **Remaining PGS funds would be returned to the regions to help finance strategic infrastructure projects.**

PGS and the Devolved Administrations

3.124 PGS will apply across the UK but because it is essentially a local measure, **all PGS revenues generated in the Devolved Administrations would be returned to the country in which they were generated. The use of PGS funds in the Devolved Administrations would be determined by the administrations** and would not be subject to many of the conventions prescribed for the use of PGS revenues in England, although it is proposed that PGS revenues should be dedicated to infrastructure throughout the UK. The Government will continue to engage with the Devolved Administrations on this and other interactions with devolved policy areas.

Local infrastructure delivery

3.125 PGS revenue allocation will need to be consistent with the 2007 CSR Review into Supporting Housing Growth (as discussed earlier in this chapter). Robust local planning is critical to the efficient and effective delivery of infrastructure. **The Review is exploring options for improving infrastructure delivery planning at the local and regional level.** PGS revenues would be used, alongside scaled-back planning obligations and other revenue streams, to fund priorities set out in infrastructure plans. At the local level, the use of PGS funds could also be subject to the new performance management framework set out in the recent Local Government White Paper.[35]

Transitional arrangements

3.126 **Transitional arrangements will aim to ensure that development already formally in the planning process would not be subject to PGS.** The Government proposes that for development where planning permission was granted before an appropriate appointed day in the future, including for outline planning permissions, PGS would not apply. There will be dialogue with stakeholders on transitional arrangements before further announcements are made.

[35] *Strong and prosperous communities – The Local Government White Paper* DCLG (2006)

Legislation **3.127** **The Government will shortly introduce a preparations bill to Parliament** providing HMRC with the authority to build the systems necessary to administer PGS, if enacted. Further announcements on PGS are expected in spring 2007.

Investment in transport infrastructure

3.128 Transport infrastructure supports the efficient and flexible functioning of the economy, and plays a vital role in equipping the UK to respond to globalisation. It facilitates the movement of goods and people, encourages business investment, influences individuals' location decisions, supports social objectives and public services, and benefits consumers through lowering the cost of goods and services and increasing the variety available to them.

Eddington Transport Study **3.129** Sir Rod Eddington's Study, published on 1 December this year, examined how long-term transport decisions can impact on the UK's economic growth and concluded that transport has a pivotal role in supporting the UK's future success. A 5 per cent reduction in travel time for all business and freight travel on the roads would generate around £2.5 billion of cost savings – some 0.2 per cent of GDP. The Study reaffirms the importance of investment in transport to the continued success of the UK economy in the global marketplace. The Study finds that the UK is well connected and that much of the transport system works well. The study also demonstrates a changing context and identifies the challenge of the significant and growing strain the UK's economic success places on key points within the transport system, with a serious risk that congestion, crowding and unreliability will reduce future productivity growth. At the same time, the Study recognises the importance of improving the environmental impact of the transport system.

3.130 With long-term guidelines improving the certainty of future funding, and dividends working through from effective spending control (for instance, the progress on delivering Network Rail's 31 per cent efficiency target), new opportunities have been created to meet the challenge. The Study underlines the need for major reforms to the planning, funding and delivery of transport interventions if sustainable returns from any new investment are to be maximised and opportunities exploited. Box 3.13 sets out the Study's recommendations.

Box 3.13: Eddington Transport Study

Based upon new and existing empirical research, the Eddington Transport Study demonstrates a compelling link between transport and economic growth and productivity, and supports a strong case for continued investment in transport. The best schemes offer returns in the region of £5-£10 for each £1 invested. The Study finds that the UK is well-connected and that much of the transport system works well (for example, logistics companies can deliver to over 75 per cent of the UK population for their West Midlands hubs in a half-day truck journey). However, it also finds that sustained economic success and the growth in transport demand has put some parts of the system under strain and that, without action, the situation will worsen. To address these challenges, Sir Rod Eddington has made the following five key recommendations:

- **to meet the changing needs of the UK economy, the Government should focus policy and sustained investment in improving the performance of existing transport networks, in those places that are important for the UK's economic success;**
- **over the next 20 years, the three strategic economic priorities for transport policy should be: congested and growing city catchments, key inter-urban corridors, and the key international gateways that are showing signs of increasing congestion and unreliability. These are the most heavily used and economically significant parts of the network;**
- **the Government should adopt a sophisticated policy mix to meet both economic and environmental goals. Policy should get the prices right (especially congestion pricing on the roads and environmental pricing across all modes) and make the best use of existing networks. Reflecting the high returns available from some transport investment, based on full appraisal of environmental and social costs and benefits, the Government, together with the private sector, should deliver sustained and targeted infrastructure investment, in those schemes that demonstrate high returns, including smaller schemes tackling pinch points;**
- **the policy process needs to be rigorous and systematic: start with the three strategic economic priorities, define the problems, consider the full range of modal options using appraisal techniques that include full environmental and social costs and benefits, and ensure that spending is focused on the best policies; and**
- **the Government needs to ensure the delivery system is ready to meet future challenges, including through reform of sub-national governance arrangements and reforming the planning process for major transport projects, providing greater clarity about government policy through strategic statements of transport objectives, and by introducing a new Independent Planning Commission to take decisions on projects of strategic importance.**

3.131 The Government agrees with Rod Eddington's strategic analysis. It will take steps to implement his advice, covering strategy, processes and delivery, while aiming to improve transport's environmental performance and taking account of the Government's social objectives. In this context, the Government is committed to reforming its transport strategy, including:

- reviewing the implications for the 2007 CSR, publishing as outputs a framework and evidence base for decision-making over the medium term; an analysis, to be updated regularly, of the priority areas nationally where transport interventions should focus to unblock constraints to growth; developing and appraising a full range of potential solutions (including better use of existing networks, and targeted investment) and prioritising those options with the best value-for-money returns; and a refreshed research and evaluation strategy;

- developing the strategy on pricing: setting out early plans to enable widespread road pricing to be implemented within the next ten years (i.e. by 2016), if it can be done so in an affordable way which preserves the potential net gains to society; including within this key decision points; timely updating of these plans; and
- developing further the strategy to ensure that transport prices reflect the costs of carbon emissions and other environmental externalities, for instance, through taxation, regulation and trading mechanisms, as recommended by the Stern Review of the Economics of Climate Change.

3.132 The Government is committed to reforming the development of supporting processes, including:

- reviewing processes as part of the 2007 CSR so that resources are allocated taking account of options across modes and giving priority to cost-effectiveness in delivering objectives;
- developing appraisal of transport projects: by April 2007, it will better reflect reliability, freight and agglomeration benefits; by March 2008, it will capture additional economic and environmental benefits; by March 2008, scope for further improvements will be identified, drawing on evaluation studies; and
- adopting immediately a set of planning scenarios which include the significant possibility of widespread road pricing by 2016, and issuing guidance on the implications by April 2007.

3.133 The Government is also committed to reforming delivery, including:

- considering proposals to reform planning for transport infrastructure as part of wider proposals for planning reform following the Barker Review of Land Use (see Box 3.11); and
- taking forward Eddington's analysis of sub-national governance in the 2007 CSR.

3.134 The Department for Transport will report on progress in taking forward the measures, and its further consideration of the new evidence and analysis presented by the Eddington Transport Study, in the course of 2007. As discussed in Chapter 6, the Government has asked Sir Michael Lyons to consider the implications of the Eddington Transport Study, as well as the reviews by Kate Barker and Lord Leitch, for the role and funding of local government, ahead of publishing his final report.

The UK as a competitive centre for global investment

Strategy for promoting the UK

3.135 The Government recognises the importance of marketing the UK as a place to invest, to enable the UK to seize the opportunities presented by globalisation. In July this year, the Government published the new five-year strategy for marketing the UK economy internationally: *Prosperity in a changing world*.[36] This strategy sets out the steps that the Government will take to achieve a step-change in its efforts to attract high quality inward investment and promote UK businesses. These efforts will be more focused towards where the greatest opportunities lie, in high growth emerging markets and R&D-intensive sectors.

[36] Available at www.ukinvest.gov.uk

UK Trade and Investment

3.136 UK Trade & Investment (UKTI) is responsible for coordinating and driving the strategy. Progress has been made on a number of fronts. Resources have already been reprioritised to reinforce the UK's presence in China, India and 14 other emerging markets. UKTI is rolling out its new R&D programme. In October this year, a cross-Government group on marketing the UK economy was established to improve coordination of the Government's activities. Chaired by UKTI and including the Regional Development Agencies and Devolved Administrations, this group will meet quarterly to agree a coordinated programme of work. UKTI's reorganisation is underway to raise its profile as a skilled, professional and enterprising organisation. In the UK, UKTI's marketing expertise has been reinforced to strengthen its approach to marketing the UK as a place to do business. UKTI will market the UK business proposition as a unique "springboard for global growth", supported in particular by its international connections, creative talent, and business-friendly environment.

International Business Advisory Council

3.137 In March this year, the Chancellor established the International Business Advisory Council (IBAC). The IBAC will advise the Government on how the UK can rise to the challenge of globalisation, promote itself as one of the key locations of choice for international business investment in high value-added activity, and work with international partners to pursue a less protectionist world. Its inaugural meeting took place on 17 November 2006. The Government also hosted a Business Advisory Summit in November with over seventy Chairs and CEOs from many leading UK companies. The Government strongly welcomes this engagement with business on the challenges of globalisation, particularly in the areas of trade, economic flexibility and education.

Financial services

3.138 London is the world's leading international financial centre; its scope, scale and internationalism is unparalleled and the Government's objective is for it to be even more successful in an integrated global economy. The business services and finance sector is the largest sector of the UK economy, accounting for around a third of total activity. As Europe's leading financial centre, London also acts as Europe's gateway to global financial markets. This means the UK is in a strong position to benefit from opportunities presented by continuing global economic growth and integration, particularly in emerging markets such as China and India.

3.139 The Government committed, in Budget 2006, to establishing a High-Level Group, with senior representatives from across the financial sector, to develop a strategy to enhance the UK and the City of London's international competitiveness. Following their inaugural meeting in October this year, the Government agreed to take forward substantive proposals in a number of key areas, as set out in Box 3.14. The High-Level Group will also monitor UKTI's progress in promoting the UK-based financial sector overseas.

Box 3.14: High-Level Group on the City of London's international competitiveness

On the basis of extensive discussions held between HM Treasury and practitioners across six sectors – banking, insurance, capital and derivative markets, asset management, legal services and accountancy – the High-Level Group met for the first time in October to consider how the Government and the financial services sector can continue to work in partnership to ensure the continued global success of the UK-based financial sector. The Government agreed to take forward proposals to:

- **maintaining cutting edge principles-based regulation – the Government set out proposals to reduce administration burdens of regulation, to take further action against unnecessary gold-plating and agreed to examine, with the Financial Services Authority, whether the regulatory regime might be lightened for insurance services with lower consumer detriment or systemic risk;**
- **modernising the wholesale insurance market – Lord Leven, Grahame Millwater and Andres Kendrick will work together to support the timely delivery of the reform stage being set by the Market Reform Group and, in parallel, the Government will examine the business environment for the wholesale insurance sector;**
- **boosting professional financial skills in London – the Chancellor asked Teresa Sayers and the Financial Services Skills Council to undertake research on financial skills gaps. At the same time, HM Treasury, together with industry, will examine a proposal for a centre for regulatory expertise that would provide teaching and research; and**
- **promoting, in a new joined up strategy, the UK based financial sector in high growth overseas markets – bringing a more strategic approach and better coordination of the efforts of public and industry bodies. UKTI, which will be responsible for coordinating the strategy, will allocate additional resources to the promotion of financial services, with dedicated diplomatic staff and tailored promotional strategies in key overseas markets, including China and India.**

Work is also being taken forward on a number of broader issues affecting the financial and business services sector, including migration, and the findings of the reviews reporting at this Pre-Budget Report, including those by Sir David Varney, Lord Davidson, Sir Rod Eddington, Lord Sandy Leitch, and Kate Barker (all discussed earlier in this chapter). The next meeting of the High-Level Group will be chaired by the Chancellor in May next year, where progress on these issues will be reviewed.

3.140 Modern financial business places great importance on a tax system that is coherent and consistent, delivering both the clarity needed in handling fast moving financial transactions in a global environment, and the necessary flexibility to accommodate innovation that is a hallmark of the financial markets. In meeting these objectives, the Government will ensure that the corporate tax system continues to reflect the commercial and economic realities of the financial sector.

3.141 This Pre-Budget Report announces proposals that take forward this work in the areas of life insurance, general insurance, exchange traded funds, offshore funds and securitisation, with the objectives of modernisation and simplification, and reducing barriers to market developments, set out further in Chapter 5. These measures have been developed in consultation with business, a key theme of *HMRC's 2006 Review of Links with Large Business*, discussed earlier in this chapter. The financial sector contains many of the UK's largest businesses and will therefore be a very important player in taking forward this agenda. Consultation is continuing with business in a number of areas, including insurance and the impact of the Markets in Financial Instruments Directive on Stamp Duty relief.

4 INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

The Government's long-term goal for the labour market is to achieve employment opportunity for all – the modern definition of full employment. This means that everyone should be given appropriate support and advice to enable them to find and retain a job, with the opportunity to gain skills and experience, thereby helping to meet the productivity challenge. This chapter describes the further steps the Government is taking towards the attainment of employment opportunity for all. They include:

- **extending the support offered to lone parents who move into work** by maintaining the In-Work Credit in the current pilot areas for a further six months;
- **improving the Jobseeker's Allowance intervention regime** by offering expert work-search support at the new claim stage, and extending the Job Grant of £100 (£250 to claimants with children) to 18-24 year old jobseekers;
- **improving enforcement of the National Minimum Wage by increasing by 50 per cent the resources allocated to tackle non-compliance and raising penalties for the seriously non-compliant;**
- **providing funding to improve the administration of Housing Benefit and to raise awareness that Housing Benefit is available to those in work;**
- **taking forward measures to simplify and reduce error in the benefits system;** and
- **raising the earnings disregard to Housing Benefit and Council Tax Benefit in line with indexation to £15.45 in April 2007,** ensuring that claimants gain from increases in the rate of Working Tax Credits.

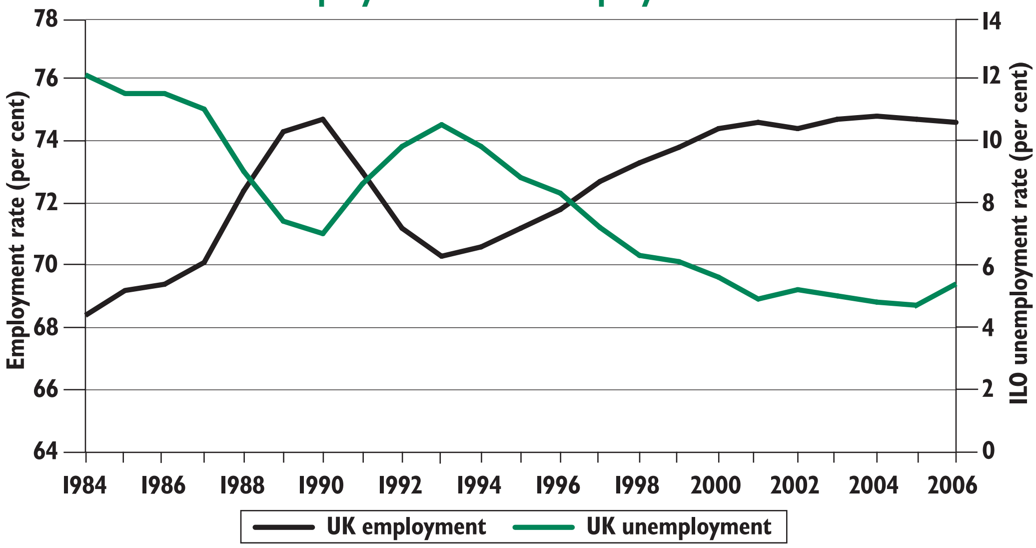
Government's employment objective

4.1 The Government's long-term objective for the labour market is to realise employment opportunity for all – the modern definition of full employment. There has been considerable progress on this objective, particularly in those areas and among those groups of people who had previously been most disadvantaged. The Government aims to go further, however, and has set a long-term aspiration for an employment rate equivalent to 80 per cent of the working-age population. This will involve reaching out to the hardest to help, moving people from inactivity to labour market participation and encouraging more individuals to take personal responsibility to move from welfare to work.

Labour market performance

4.2 Employment in the UK reached 29 million for the first time in 2006. This is the highest figure since comparable records began in 1971. The working age employment rate is now 74.5 per cent, up from 72.7 per cent in 1997. Chart 4.1 shows the UK employment and unemployment rates over time.

Chart 4.1: UK employment and unemployment rates



Source: LFS seasonally adjusted annual averages.

4.3 The International Labour Organisation unemployment rate is 5.6 per cent, down from 7.2 per cent in 1997. While the unemployment rate has risen slightly over recent months, this should be seen in the context of the sustained decline of the past decade and the steady growth in the numbers of people entering the labour market. The UK unemployment rate remains significantly below the EU average of 8 per cent.

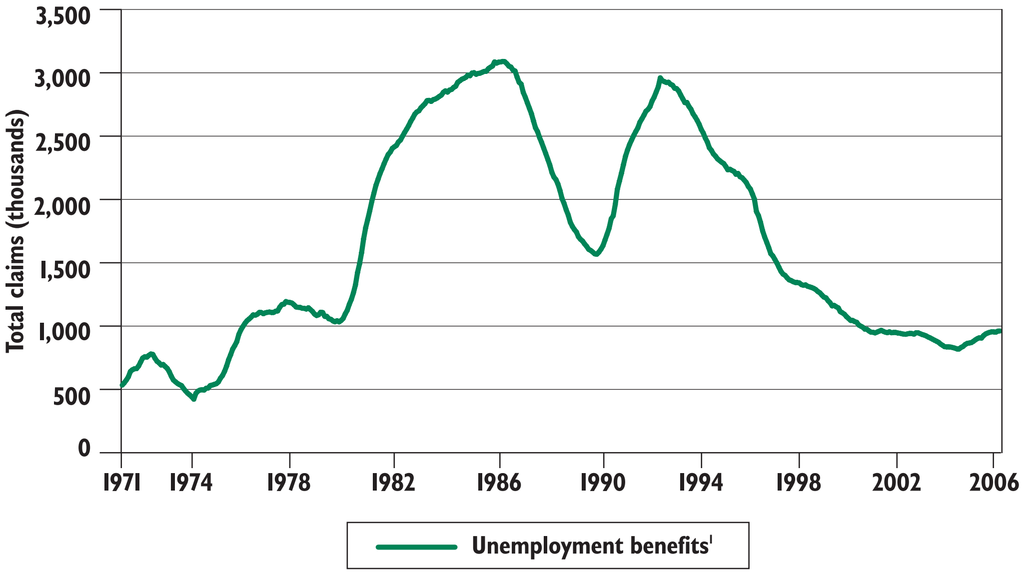
Inactivity

4.4 The counterpart of a rise in both employment and unemployment over recent months has been an ongoing fall in inactivity, especially among people with a health condition or disability. The working age inactivity rate decreased by 0.3 percentage points over the year to July – September 2006, with 75,000 people moving out of inactivity and into the labour market.

Working age benefits

4.5 The number of people who claim Jobseeker's Allowance (JSA) has been reduced by over 42 per cent since 1997, from 1,662,600 in April 1997 to 961,300 in October 2006. As Chart 4.2 shows, the claimant count has now remained below 1 million for 69 consecutive months; the longest period since the 1970s.

Chart 4.2: Unemployment benefit recipients since 1971



[1] Unemployment Benefit (before October 1996) and Jobseeker's Allowance (from October 1996).
Source: ONS seasonally-adjusted monthly claimant count.

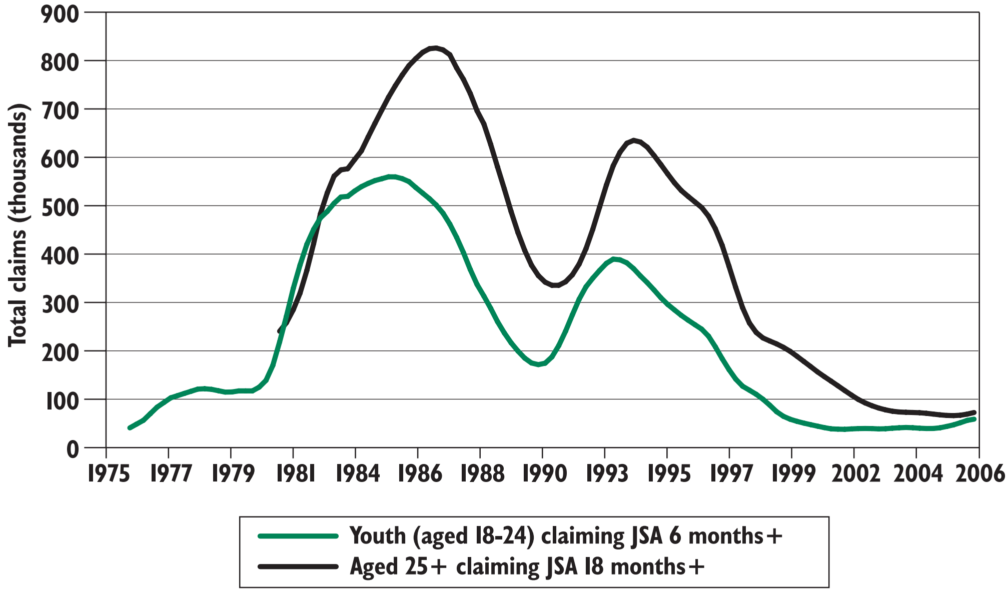
4.6 The fall over the past decade in the number of JSA claimants has been accompanied by a decline in the number of people claiming Income Support and, more recently, incapacity benefits.[1] In total, there are now 1 million fewer people of working age who are out of work and claiming benefits than there were in 1997. As well as its positive effect on individuals, the reduction in benefit claims has had a noticeable impact on government spending, with the cost of benefits for the unemployed alone now being £5 billion lower in real terms than in 1996-97.

DELIVERING EMPLOYMENT OPPORTUNITY FOR ALL

New Deal **4.7** Since the New Deal was introduced in 1998, nearly 694,000 young people and over 272,000 adults have gained a job through the programme. The New Deal has contributed to a reduction in the number of long-term unemployed, as Chart 4.3 illustrates.

[1] The current system of incapacity benefits includes: Incapacity Benefit, Income Support on the grounds of incapacity and Severe Disablement Allowance.

Chart 4.3: Long-term claimant count for young people and adults



Source: DWP (before April 1994) and ONS (from April 1994). Claimant count (4 point moving average).

4.8 Independent evaluations have repeatedly highlighted the New Deal's success and cost effectiveness. The National Institute of Economic and Social Research (NIESR) concluded in 2000 that the level of long-term unemployment would have been twice as high without the New Deal for young people (NDYP), and that the economy as a whole is richer by £500 million as a result of NDYP.[2] More recent studies show that: NDYP has significantly increased exit rates from unemployment in all regions;[3] overall youth unemployment has been reduced by between 30,000 and 40,000;[4] young men are now 20 per cent more likely to find work as a result of the NDYP;[5,6] and the social benefits of NDYP outweigh the costs.[7]

Flexibility

4.9 The degree of flexibility in the labour market helps to determine the speed and efficiency with which individuals, firms and markets are able to respond to shocks. A flexible and efficient labour market has the ability to adjust to changing economic conditions in a way that maintains high levels of output and employment, minimizing the cost of adjustment and maintaining economic stability. The Government's labour market policies are intended to advance flexibility and fairness together, ensuring that everyone in society has the support they need to achieve their full potential in a dynamic, global economy. This chapter reports on the progress the Government has made to increase and enhance flexibility in the labour market.

[2] *The New Deal for Young People: implications for employment and the public finances,* NIESR, December 2000.

[3] *How well has the New Deal for Young People worked in the UK?* McVicar and Podivinsky, Northern Ireland Economic Research Centre, April 2003.

[4] *New Deal for young people: evaluation of unemployment flows,* D. Wilkinson, Policy Studies Institute, 2003.

[5] *Evaluating the employment impact of a mandatory job search program, Blundell, R., Costa Dias, M., Meghir, C., Van Reenen, J., in Journal of the European Economic Association,* June 2004.

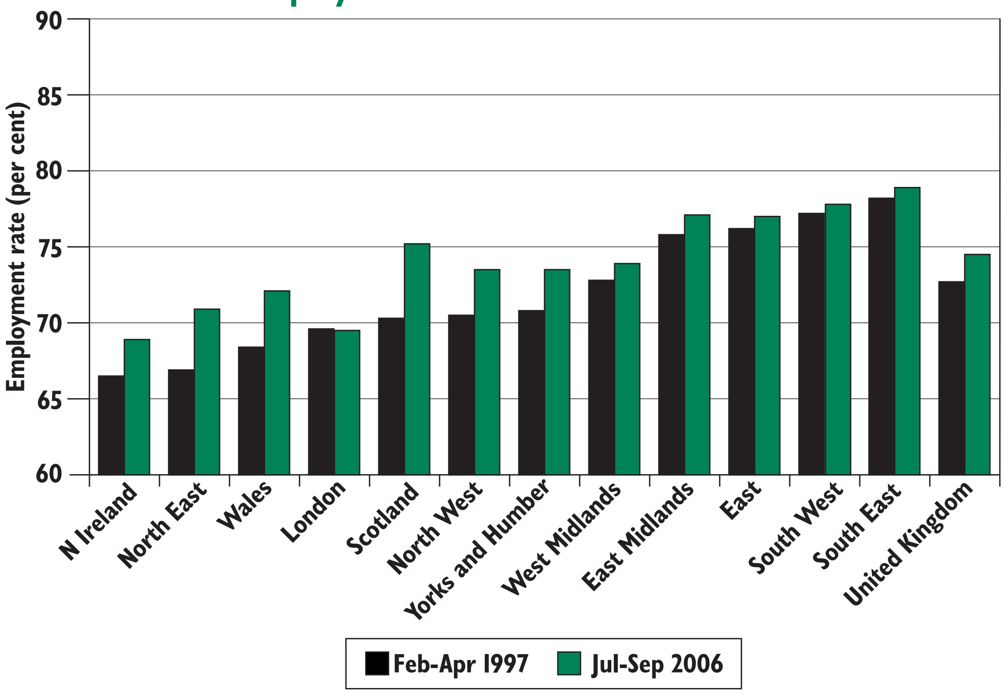
[6] *Active labour market policies and the British New Deal for unemployed youth in context, Van Reenan, J, in Seeking a premier league economy,* Blundell, R., Card, D., and Freeman, R., (eds) University of Chicago Press, June 2004.

[7] Ibid

Regional performance

4.10 The benefits of improved labour market performance have been spread widely across the country. In every region, with the exception of London, employment rates today are higher than in 1997, as shown in Chart 4.4. A technical note reporting on the Government's progress in delivering its regional economic performance Public Service Agreement is being published alongside this Pre-Budget Report.[8]

Chart 4.4: Employment rates across the UK



Source: LFS seasonally adjusted averages.

London

4.11 The reasons for London's labour market performance were considered in *Employment opportunity for all: Analysing labour market trends in London,*[9] published alongside Budget 2006. This analysis showed that London's lower headline employment rate largely (though not entirely) reflects differences in the composition of London's population compared with the rest of the UK. However, living in London, and especially in Inner London, is associated with a higher risk of labour market exclusion for lone parents and those with low skills. Why this should be the case remains unclear, and work is ongoing to understand the reasons.

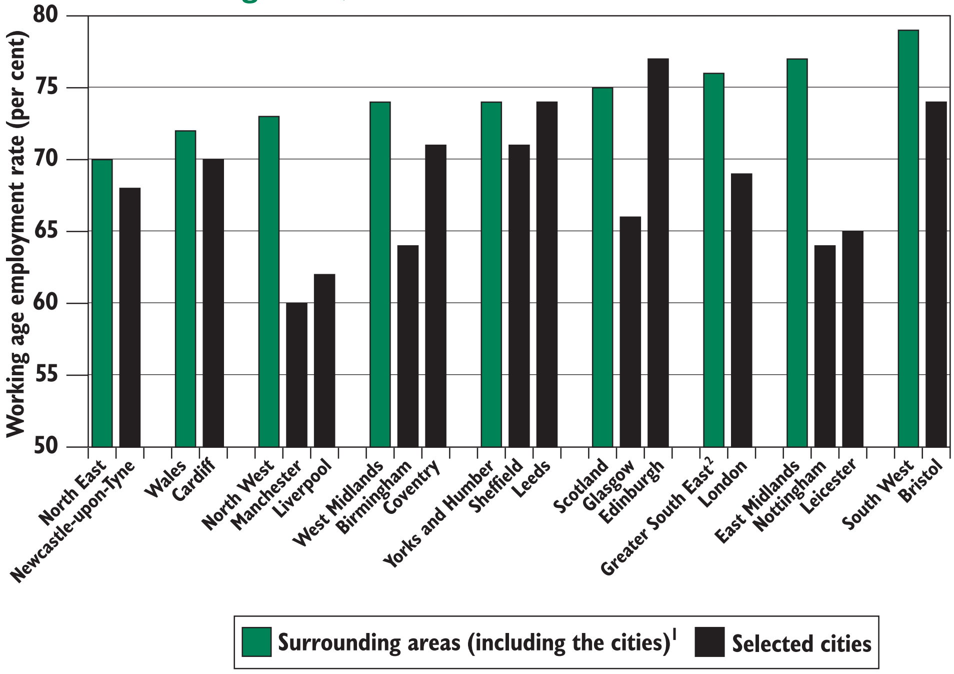
Cities

4.12 London is both a city and a region; and as Chart 4.5 demonstrates, the employment rate in London is below that of the area that surrounds it. This pattern is reflected elsewhere in the UK, with the employment rate in a city usually lower than that of the surrounding area.

[8] *Regional Economic Performance: Progress to date*, HM Treasury, DTI, DCLG, December 2006

[9] HM Treasury, 2006

Chart 4.5: Employment rates in selected GB cities and surrounding areas, 2005



Source: Labour Force Survey for countries and regions; Annual Population Survey for cities.
[1] Either regions, group of regions or countries.
[2] The Greater South East area includes the Government Office Region of the South East, East of England and London.

4.13 Local labour markets differ by sectoral mix, geographical reach and mobility of their labour force. It is therefore important that solutions to local needs are developed using local knowledge. Box 4.1 describes the steps that are being taken to integrate labour market and human capital investment strategies at the local level.

Box 4.1 Integrating labour market and human capital investment strategies at the local level

Helping the most disadvantaged people to find work and stay in work requires the coordinated efforts of local partners. Those furthest from the labour market need help with jobsearch support, training in basic employability skills to overcome initial barriers to work, and ongoing vocational training to ensure that they can thrive in work. A number of initiatives have been established to bring Jobcentre Plus, training providers and employers, along with local authorities and other partners, together to ensure that people get the end-to-end help they need.

As announced by the Secretary of State for Work and Pensions in July 2006, consortia consisting of Jobcentre Plus, local authorities, training providers, employers, the third sector and other partners will establish strategies for helping the most disadvantaged people in fifteen Cities Strategy pilot areas. The consortia will coordinate delivery of employment and training, with flexibility to pool their resources, set local targets and deliver support that better meets the needs of their local communities.

The three Fair Cities pilots, meanwhile, bring together training providers, Jobcentre Plus and employers to design pre-work training and support for disadvantaged people in areas with high ethnic minority populations so that they meet the skill needs of local employers.

Building on this experience, the Leitch Review of Skills, published on 5 December 2006, highlights the importance of ensuring that people receive an integrated employment and skills service that helps them move into work, stay in work and progress in work. The review sets out a number of measures that will deliver this, as discussed in Chapter 3.

EXTENDING EMPLOYMENT OPPORTUNITY TO ALL

People with a health condition or disability

4.14 Of the nearly 5.6 million people of working age with a health condition or disability, only around half are in employment. Ensuring that many more are able to take up the opportunity to work is central to achieving the Government's long term employment rate aspiration, and requires the reduction and removal of the barriers that prevent individuals in this group from finding, remaining in and progressing in work.

Growth in incapacity benefits claims

4.15 During the 1980s and early 1990s, the welfare system did little to support people with a health condition or disability back to work. As a result, many people drifted into long-term benefit receipt, despite the fact that as many as 90 per cent of people expect to get back to work when they start a claim for incapacity benefits. As a consequence, the number of incapacity benefits claimants in the UK more than trebled between the early 1980s and mid 1990s, despite ongoing improvements in general health and life expectancy.

Support for a return to work

4.16 For many incapacity benefits claimants, a return to work is possible with appropriate help and support. Reforms to the system of support mean that incapacity benefits claimants now receive active encouragement and support via a variety of means to plan their return to work, including:

- ensuring that incapacity benefits claimants have access to early and ongoing work focused advice from Jobcentre Plus;
- helping disabled people to identify and move into employment. By May 2006, the New Deal for disabled people (NDDP) had helped over 116,000 disabled people into work;
- tackling discrimination against disabled people through the Disability Discrimination Act 2005 and improving their opportunities to participate in society, as discussed in Chapter 5; and
- ensuring that work pays through the Working Tax Credit and National Minimum Wage.

Pathways

4.17 The Government's Pathways to Work pilots are providing additional support to help incapacity benefits claimants to return to work. These pilots are testing a new framework that combines ongoing mandatory contact with highly skilled Personal Advisers at Jobcentre Plus, and high quality employment, health and financial support. The OECD has described Pathways to Work as a "considerable success",[10] and this is demonstrated by:

- a significant increase in off-flows from incapacity benefits after six months of a claim, as shown in Chart 4.6.[11] Independent evaluation by the Institute for Fiscal Studies[12] has confirmed this effect, finding an 8 percentage point increase in people leaving benefits in Pathways areas compared to matched non-Pathways areas ten and a half months after an initial enquiry to claim benefits;
- over 25,000 job entries through the Pathways to Work pilots by February 2006;
- following the initial Work Focused Interview (WFI), over 21 per cent of claimants have taken up elements of the Choices package,[13] with over 8,000 referrals to the new Condition Management Programmes; and
- nearly 10 per cent of participants in the pilots are longer-term claimants who were not required to participate in the programme, but volunteered to take part after hearing about the support on offer. In February 2005, the Government extended a mandatory WFI regime to some existing claimants, alongside a new Job Preparation Premium of £20 per week to encourage steps towards finding work.

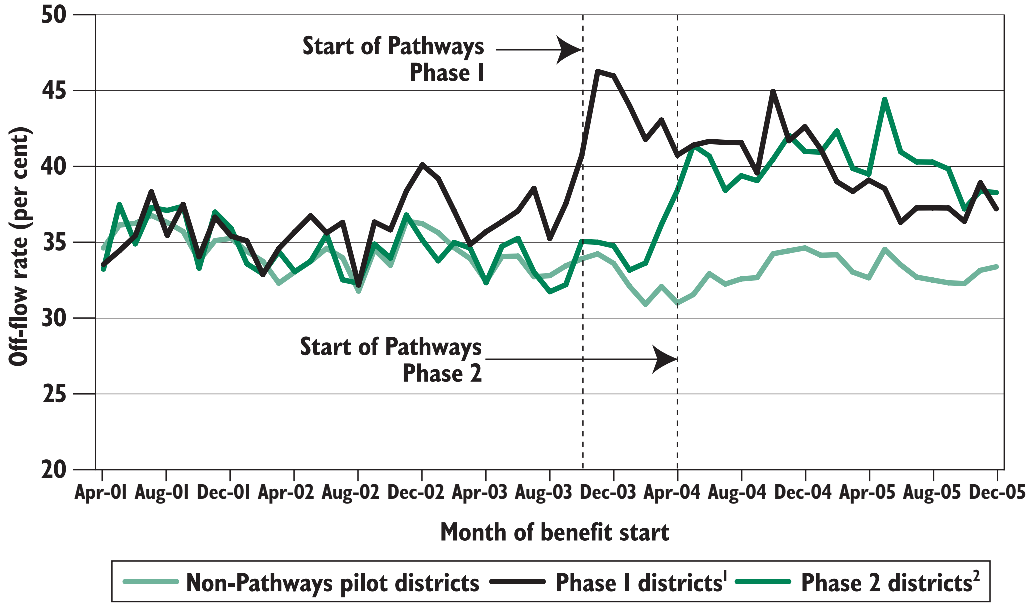
[10] *Economic Survey of the United Kingdom,* OECD, 2005.

[11] The off-flow rates presented are produced from the Working Age Statistical Database (WASD). WASD does not include a proportion of short-term incapacity benefit claims, therefore the off-flows presented will be lower than actual rates. However, trends over time will be consistent.

[12] *Early quantitative evidence on the impact of the Pathways to Work pilots*, Institute of Fiscal Studies, on behalf of the Department for Work and Pensions, June 2006.

[13] The Choices package is a range of provision aimed at improving labour market readiness and opportunities. This includes NDDP and the Condition Management Programmes.

Chart 4.6: Six month off-flows from incapacity benefits



[1] *The three phase 1 districts are: Bridgend, Rhondda, Cynon and Taff; Renfrewshire, Inverclyde, Argyll and Bute; and Derbyshire.*
[2] *The four phase 2 districts are East Lancashire; Essex; Gateshead and South Tyneside; and Somerset.*
Source: Department for Work and Pensions.

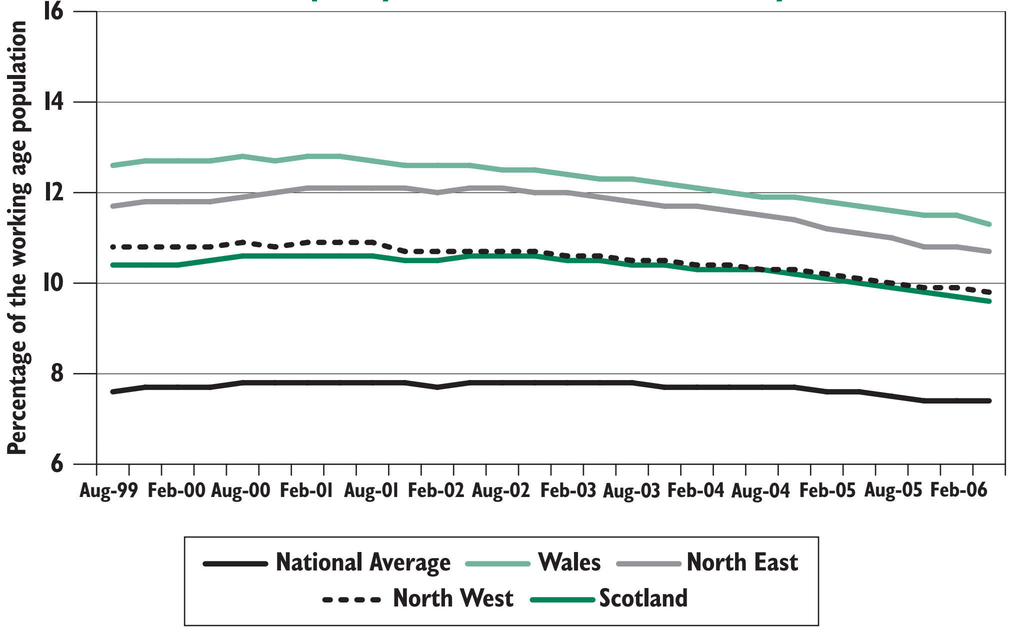
Changes in caseload

4.18 These reforms have started to change the attitudes and expectations of incapacity benefits claimants. The longstanding rising trend in the number of claimants has stopped and the caseload is now beginning to fall. Annual inflows to the benefits have fallen by a third since the mid 1990s, and the total number of incapacity benefits claimants in May 2006, at 2.69 million, was over 50,000 lower than the previous year.

Trends in claims by area

4.19 As Chart 4.7 shows, the incapacity benefits claimant rate is falling fastest in the areas where it was highest during the 1980s and 1990s. The total number of incapacity benefits claimants in Wales, the North East, the North West and Scotland has decreased by almost 100,000 in the last five years. These areas have also seen particularly strong increases in their employment rates since 1997, as seen in Chart 4.4. At the same time, however, the average duration of claims for incapacity benefits has increased, as has the proportion of claimants citing mental health conditions as the primary cause of their incapacity. Notwithstanding recent and considerable success, there is more to be done.

Chart 4.7: Incapacity benefits claimant rates[1] by area



[1] *Incapacity benefits caseloads as a percentage of the working age population.*
Source: Department for Work and Pensions client group analysis of the working age – percentage of working age population.

4.20 To inform the 2007 Comprehensive Spending Review, a number of long-term policy studies have been launched. Among them is a study of mental health and employment outcomes, and Box 4.2 sets this out in more detail.

Box 4.2 Review of Mental Health and Employment Outcomes

Budget 2006 announced a review of the policies needed to improve mental health and employment outcomes. The Government recognises that too many people of working age are excluded from work when, with proper help and support, it should be possible for them to find or remain in work, benefiting both their health and the wider economy. Individuals with mental health conditions are less likely to be employed and more likely to be economically inactive than those without mental health conditions. Nearly 40 per cent of all Incapacity Benefit (IB) claimants report a mental health condition as their main health issue and remain on IB for longer than with almost any other health condition.

Since 1997 much has been done to reform the help and support offered to people of working age with a health condition or disability to remain in or return to work. It can, however, be difficult to determine the impact of the different interventions currently available for this group on individuals with a mental health condition. Emerging evidence and consultation with stakeholders and service users suggests that more could be done, both to reduce and to remove the particular barriers that can prevent people from finding, remaining in and progressing in work. More could also be done to support the development of effective evidence-based interventions that individuals with mental health conditions need to achieve their full potential.

Building on the research and consultation already undertaken, the review is considering a number of areas and issues where appropriate responses focused around the key challenges of prevention, remaining in work and rehabilitation to return to work may be appropriate, including:

- **incentivising better national and local level delivery of services, including improved coordination between healthcare and employment services;**
- **working with primary care professionals to recognise employment as an effective part of the rehabilitation process for some people with mental health conditions;**
- **raising awareness of mental wellbeing among employers and employees and improving the 'signposting' of support and advice when needed;**
- **developing the current evidence base on the potential of psychological therapies, such as Cognitive Behavioural Therapy, to improve employment outcomes for people with mental health conditions;**
- **developing flexible, tailored help and support for individuals to tackle the variety of barriers which can prevent them from returning to work; and**
- **enhancing the role and contribution of the third sector in supporting people with mental health conditions to remain in or return to work.**

Welfare Reform Bill

4.21 Building on Pathways to Work, the Welfare Reform Bill, presented to Parliament in July 2006, is a key part of the Government's welfare reform programme. The Bill's main provision is for the introduction of a new, integrated and simplified Employment and Support Allowance (ESA), to replace the current system of incapacity benefits for new claimants from 2008. The success of the Pathways to Work pilots has demonstrated that, with the right help and support, many people on incapacity benefits can move back into work.

Employment and Support Allowance

4.22 The new ESA will have a clearer balance of rights and responsibilities than the current system. For most people full receipt of the new benefit will require: attendance at Work-Focused Interviews; an agreed action plan; and, as resources allow, engagement in work related activity. People with the most severe health conditions and disabilities will be supported by ESA at a higher level with no requirement for work related activity, although they will still be able to take up programme support on a voluntary basis. The Personal Capability Assessment, the eligibility test conducted at the start of an Incapacity Benefit claim, will be changed so that it focuses on what someone can do, not what they cannot. People will not be entitled to move onto higher levels of benefit until they have satisfied the eligibility test.

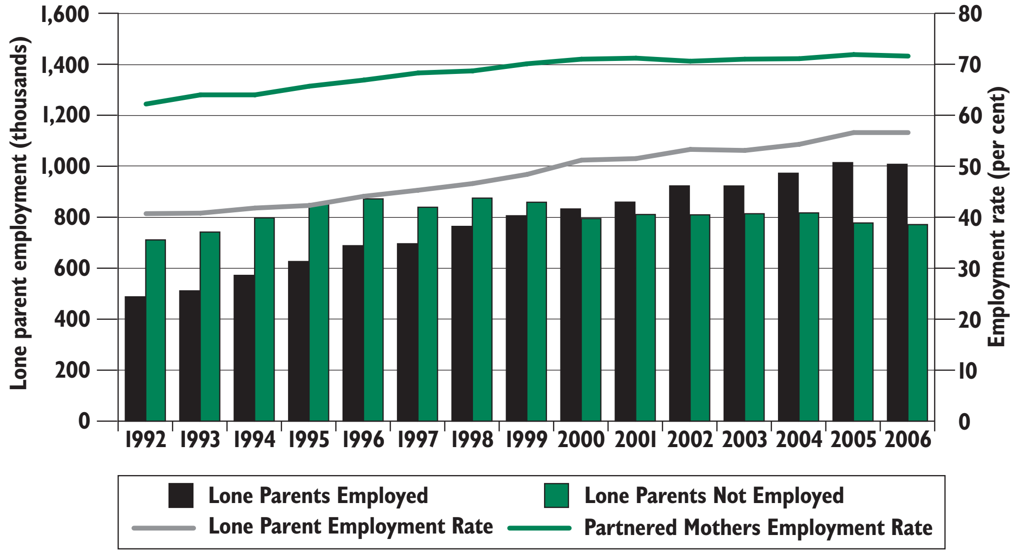
Lone parents

4.23 Worklessness remains a key cause of child poverty. Although there are now 440,000 fewer children in workless households than in 1997, there are still 1.7 million children living in households where no one works. Of those children living in a workless household 68 per cent live in a lone parent household. Helping lone parents move into work is therefore a central part of the Government's strategy – set out in Chapter 5 – to halve child poverty by 2010, on the way to eradicating it by 2020. The Government is committed to ensuring that lone parents receive a full range of support to enable them to move into work, thereby helping to improve the life chances of both themselves and their children.

Lone parent employment

4.24 Since 1997, the number of lone parents claiming Income Support has decreased by over 200,000; over 1 million lone parents are now in work. As Chart 4.8 shows, the lone parent employment rate remains at a record high of 56.6 per cent, an increase of 11.3 percentage points since spring 1997. The lone parent employment rate has also risen faster than that of partnered mothers; since spring 1997 the gap in the employment rates has narrowed from 22.9 to 14.9 percentage points.

Chart 4.8: Lone parent employment



Source: Department for Work and Pensions, Household Labour Force Survey, not seasonally adjusted annual spring quarters.

New Deal for Lone Parents **4.25** Evaluation suggests that the support introduced by the Government since 1997 has been a significant reason for the rising lone parent employment rate, with Government policies accounting for about half of the gains.[14] Steps have been taken to ensure that work pays through the introduction of policies such as Working Tax Credits and the National Minimum Wage, and that childcare provision is affordable and accessible.

4.26 Active labour market policies are delivered by trained Personal Advisers, who provide a comprehensive package of individualised support through Jobcentre Plus. The New Deal for lone parents (NDLP) has so far helped over 470,000 lone parents into work. Further independent evaluation suggests that participating in NDLP doubles an individual's chances of finding employment.[15]

Support for flexible working **4.27** Workplace rights have also been enhanced, and flexible working practices are increasingly being adopted by employers. Almost a quarter (22 per cent) of parents with children aged under six have requested flexible working since the law was introduced,[16] and over 80 per cent of such requests have been granted.[17] Maternity pay and child benefits have increased and childcare provision continues to be strengthened, providing the opportunities to better balance work and family life, and to ensure more lone parents make a move out of poverty. The ten year strategy for childcare, published alongside the 2004 Pre-Budget Report, sets out the Government's objective of high-quality, affordable childcare for all parents who need it. The Childcare Act 2006 creates the legislative framework for the strategy, including the introduction of a new duty for local authorities to work with childcare providers to secure sufficient childcare supply in their area.

New Deal Plus **4.28** The New Deal Plus for lone parents (NDLP+) pilots, launched at the end of April 2005 in five Jobcentre Plus areas, bring together all current lone parent initiatives to provide a coherent package of support. The package includes a range of financial incentives, including the In-Work Credit and the worksearch premium, as well as enhanced Personal Adviser support to help ensure that lone parents understand the gains to work through a "better off" calculation and are encouraged to make a move into sustainable employment. As announced in the 2005 Pre-Budget Report, NDLP+ was extended to two further Jobcentre Plus districts in Scotland and Wales[18] and will run until April 2008.

Work Focused Interviews **4.29** The Government is continuing to extend and develop the support offered to lone parents. Work Focused Interviews (WFIs) have proved effective in conveying the benefits of work and encouraging people to move onto NDLP. As announced in Budget 2006, six-monthly WFIs will be rolled out from April 2007 to lone parents with a youngest child aged under 14. This will mean that all lone parents will receive a WFI at least every 6 months.

Work Related Activity Premium **4.30** The Government also recognises that regular contact with a Personal Adviser may not be sufficient to encourage lone parents to return to work. The Department for Work and Pensions (DWP) will pilot a Work Related Activity Premium (WRAP) from April 2007, to incentivise lone parents who have been on benefit for over 6 months and whose youngest child is aged over 11 to move closer to the labour market. Lone parents will be able to receive £20 per week if they take steps towards preparing for work.

[14] *Welfare Reform and Lone Parents Employment in the UK,* CMPO working paper no 72, Gregg and Harkness, 2003

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

[16] *2nd Worklife Balance Survey* (Employment Relations Research Series), DTI, 2005.

[17] *Executive Summary of 3rd Worklife Balance Survey* (Employment Relations Research Series), DTI, 2006.

[18] Edinburgh; Lothian and Borders, and the former Cardiff and Vale sites within the new SE Wales district.

In-Work Credit **4.31** The Government recognises that work incentives may be affected by the higher costs of living in some areas of the country. Since April 2004, it has been piloting the In-Work Credit (IWC); a £40 a week payment for lone parents who have been on income support for more than 12 months, for their first 12 months back in work. The pilot areas, expanded in October 2005, now cover around 45 per cent of lone parents who have been on benefit for more than a year. **This Pre-Budget Report announces that the Government will extend the IWC in the current pilot areas until June 2007. This means that around 250,000 eligible lone parents will continue to benefit from improved financial gains to work.**

Partners

4.32 Over the past two decades, there has been a significant change in the way in which households organise their work. Between the 1970s and the early 1990s there was a decline in male employment from 92 per cent to a low of 75 per cent, while female employment increased from 56 per cent to 66 per cent. There was a significant shift away from single earning households, and towards a polarisation between 'work-rich' dual-earning households and 'work-poor' workless households, with the latter experiencing high levels of child poverty and social exclusion.

4.33 The Government's aim of reducing child and pensioner poverty and extending opportunity to all means that work-focused support is now provided to every workless adult. The introduction of WFIs in April 2004 for partners of benefit claimants ensures that they can benefit from help and advice on offer. The New Deal for partners (NDP) provides support and encouragement to partners of benefit claimants to acquire the skills and confidence they need to move into work. The NDP includes assistance with job search, advice on training and skills, and the identification and provision of support for registered childcare. Over 4,300 job entries have been recorded for partners who have either attended a WFI or joined NDP since April 2004.

Women returners

4.34 As well as focusing support on lone parents, over 90 per cent of whom are female, the Government has continued to take steps to increase opportunities for training and work for women. Around 70 per cent of the beneficiaries of the National Minimum Wage have been women. Additional Pension Credit entitlement is to be extended to those who have spent time out of the labour market due to caring responsibilities, many of whom will be women. The London Development Agency (LDA) pilot to understand barriers preventing women from returning to work is due to conclude in December 2006.

Women and Work Commission **4.35** In response to the Women and Work Commission's report,[19] in September 2006 the Government published the *Government Action Plan: Implementing the Women and Work Commission recommendations*. As announced in this document, some of the additional incentives the Government will be implementing include:

- a £500,000 programme to increase the number of senior and quality jobs that are available part time;
- funding for Sector Skills Councils, matched by employers in industries with skills shortages, to develop new ways of recruiting and training women, benefiting over 10,000 women;

[19] *Shaping a Fairer Future*, Women and Work Commission, February 2006.

- establishing a Women's Enterprise Task Force to provide high profile leadership to accelerate women's enterprise development throughout the UK; and
- increasing the number of pilots delivering level 3 skills (the equivalent of 2 A levels) by 50 per cent and focusing an additional pilot on women with low skills. This will contribute to the vision set out in the Leitch Review of Skills.

Unemployed people (Jobseeker's Allowance claimants)

Intervention regime

4.36 For most jobseekers, unemployment is a short-term state; over 60 per cent of people who make a claim to JSA move off benefit within the first 3 months. The financial support offered by JSA is conditional on claimants taking responsibility for moving back into employment quickly, and the intervention regime is designed to ensure that claimants fulfil this responsibility by monitoring their jobsearch activity, offering support, and if necessary, imposing sanctions. Effective delivery of the intervention regime is central to helping people move back into work as quickly as possible.

4.37 It is important that new jobseekers start to look for work as soon as they become unemployed, and that they are given the help they need to move back into work as quickly as possible. Jobcentre Plus is currently re-engineering the benefit claim process to ensure that claims are processed as quickly as possible. This also provides an opportunity to improve the focus on jobsearch. **This Pre-Budget Report announces that every new Jobseeker's Allowance claimant will be offered expert help with jobsearch, delivered through Jobseeker Direct, as soon as they contact Jobcentre Plus to make a claim.**

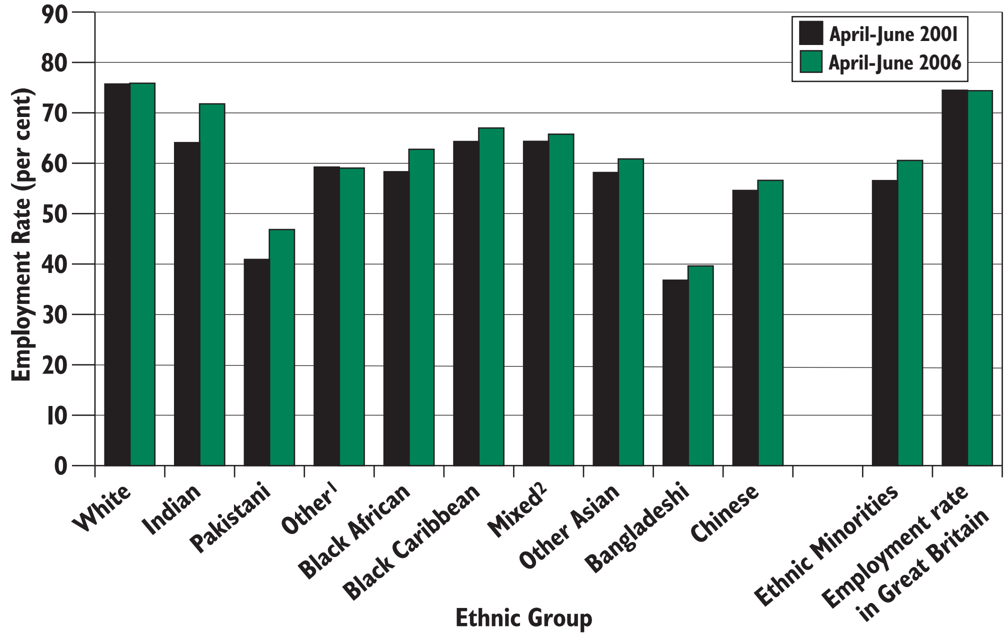
Job Grant

4.38 The transition into work can itself create immediate financial difficulties, at least until the first wage is received. Since 2004, a Job Grant of £100, or £250 to claimants with children, has been available to support those who move into employment after having been in receipt of benefit for 26 weeks or more. 80 per cent of JSA claimants move into employment before this point. The job grant is a single tax-free payment intended to cover the one-off costs of moving into work. Together with Housing Benefit and Council Tax Benefit run-on, which are available for the first four weeks of employment, the Job Grant helps to ensure people have a period of financial stability in the period between getting a job and receiving their first wage. JSA claimants aged 18 to 24 already receive intensive support through the New Deal for Young People after being unemployed for 26 weeks, but to date have not been eligible for the Job Grant. **This Pre-Budget Report announces that, with immediate effect, the Job Grant will be extended to JSA claimants aged 18 to 24 who have been receiving benefit for 26 weeks or more. This will provide up to £250 to help young people to meet the one-off costs of moving into work.**

Ethnic minority groups

4.39 A rising employment rate for ethnic minority groups, to just over 60 per cent in April-June 2006, means that the gap between this and the overall national employment rate continues to narrow, as Chart 4.9 illustrates. The New Deals, Employment Zones, Action Teams, Ethnic Minority Outreach, the Flexible Fund and Specialist Employment Advisers have together helped people from ethnic minority groups into over 227,000 jobs.

Chart 4.9: Ethnic minorities employment rates, spring 2001 and spring 2006



[1] *Other ethnic group comprises of the following groups from the Labour Force Survey: Other, Other White and Other Black.*
[2] *Mixed ethnic group comprises of the following groups from the Labour Force Survey: White and Black Caribbean, White and Black African, White and Asian and other mixed.*
Source: LFS not seasonally adjusted calendar quarters.

4.40 These positive overall trends mask distinct differences in the labour market performance of some groups. The national female employment rate is around 70 per cent, while the employment rate of women of Pakistani origin is 26 per cent and for women of Bangladeshi origin, 22 per cent. The average employment rate of women from other ethnic minority backgrounds is 51 per cent. The Government's response to such differences in experience and concentrations of worklessness is increasingly focused on ensuring that local employment and skills services respond to local needs and effectively direct help towards those who most need it.

Fair Cities

4.41 Announced in Budget 2004, Fair Cities pilots have been established in Birmingham, Bradford and Brent. They work with local employers and public sector partners to ensure disadvantaged people are ready for employment and have the skills that local employers demand. A full evaluation of the pilots will be carried out in 2008. The Government will look closely at the lessons they offer for delivering more effective services locally.

Business Commission

4.42 In the 2005 Pre-Budget Report, the Chancellor announced that he would ask a group of private sector leaders to advise on policies and practical measures to increase the recruitment, retention and progression of ethnic minorities in the private sector. The National Employment Panel's Business Commission, chaired by Gordon Pell, will submit its recommendations to the Chancellor in time for Budget 2007.

Extending Working Lives

Extending working lives

4.43 The Government is committed to ensuring that everyone who wishes to extend his or her working life should have the opportunity to do so. Evidence suggests that remaining in work can increase social inclusion and improve health. Raising employment among older people of working age will be a key element in realising the Government's long-term aspiration of an employment rate equivalent to 80 per cent of the working age population. In line with the European Employment Directive, the Government introduced legislation in October 2006 that outlaws age discrimination in employment and vocational training. The financial incentive to work, meanwhile, has been enhanced through the Working Tax Credit, which includes additional support for people over 50.

4.44 These measures have, in the context of a strong and stable economy, delivered impressive results. Since May 1997, the employment rate of people aged between 50 and State Pension Age has increased from less than 65 per cent to over 70 per cent. Furthermore, there are now nearly 1.2 million people over State Pension Age in employment. The increase in the UK female state pension age from 60 years to 65 years between 2010 and 2020 is expected to lead to significant growth in female labour market participation rates.

Helping people to stay in employment

Promoting retention

4.45 In a dynamic, flexible labour market, it is inevitable that some people who move into work will return to benefits or cycle between benefits and work. This does not, however, preclude a focus on reducing the number of those who return from work to benefits; around two thirds of new JSA claims, for example, are from people who have made previous claims for benefits.

4.46 While the probability of lone parents leaving work fell from 14 per cent in 1992 to around 10 per cent in 2003, lone parents are still more likely to leave their job than non-lone parents and single childless women.[20] The Employment Retention and Advancement (ERA) demonstration project, which focuses on promoting retention and advancement among lone parents, continues to be evaluated in six pilot areas. From 2003 to 2006, a group of lone parents on NDLP and in receipt of the Working Tax Credit for work of 16-29 hours per week have, alongside adults moving into work from the New Deal, been receiving individual support from an Advancement Support Adviser to assist them to:

- find suitable work;
- remain in work by avoiding some of the early pitfalls that sometimes cause new jobs to be short-lived; and
- progress in their jobs either through greater job security or better pay and conditions.

Additional financial incentives are also being evaluated including a retention bonus, cash payments for training and access to an emergency payment to overcome short-term barriers to retaining work.

[20] *Lone Parents cycling between work and benefits,* DWP research report 217, September 2004.

The role of skills

4.47 Both effective job-matching and ensuring that people have the opportunity to receive the training they need, are central to helping people remain in work and in the labour market. Jobcentre Plus already has an important role in helping benefit claimants get the basic employability skills they need to get a job in the first place. The basic skills and vocational training funded by the Learning and Skills Council is key to increasing people's productivity and helping them progress in work. This is particularly so where training that meets employers' specific needs is delivered in the workplace, as in Train to Gain. Jobcentre Plus and training providers hold the pieces of the jigsaw, but no single agency is currently responsible for putting them together.

New Deal for skills

4.48 The New Deal for skills has started to bring training providers, the Learning and Skills Council and Jobcentre Plus closer together to meet more effectively the needs of low-skilled benefit claimants. Skills Coaches have been introduced in Jobcentre Plus to provide advice on training needs and the Adult Learning Option is testing the impact of allowing benefit claimants access to full time training where a lack of skills is the main barrier to work. Jobcentre Plus can also contribute to promoting skills and progression by signposting employers to Train to Gain when securing jobs for people with low skills.

The Leitch Review of Skills

4.49 The Leitch Review of Skills, published on 5 December 2006, builds on this joint working and recommends that Jobcentre Plus, the Learning and Skills Council and training providers should together have responsibility for helping people get into work, stay in work, and progress in work. A joined-up approach to delivery is also central to delivering the Government's wider skills agenda, helping people to progress in the labour market by gaining the skills employers need. As described in Chapter 3, the review makes a number of recommendations to drive this forward, including the need for an integrated objective of employment retention and progression for Jobcentre Plus and training providers.

4.50 The Leitch Review recommends that employment and skills support should be integrated in order to provide seamless support from benefits to in-work training thereby enhancing employment progression, and that Employment and Skills Boards (ESBs) should be established to ensure joined-up support by delivery agencies. As part of its response to the Leitch Review, the Government will be reviewing the best way to ensure that a wide range of stakeholders are appropriately involved in the new arrangements. Sir David Varney's report, *Service Transformation*, described in Chapter 6, sets out recommendations for further reform to join up service provision across the public sector.

Delivering responsive and personalised support

Personalisation

4.51 Delivery of Welfare to Work support through Jobcentre Plus needs to combine a standard and appropriate level of service for everyone, with the flexibility for local managers and front line staff to direct extra support to those who need it most. Effective delivery also entails making best use of local delivery partners' resources to deliver the more holistic, intensive support which is needed to get the most disadvantaged clients into work. A recent report for DWP highlighted the importance of tailored Jobcentre Plus support for parents to enable progression in work and support the Government's child poverty target.[22]

Cities strategy

4.52 Those people furthest from the labour market tend to have multiple barriers to work, many of which go beyond the remit of Jobcentre Plus, such as poor skills, lack of transport to jobs, or ingrained assumptions that their potential as workers is not valued by employers. Overcoming these barriers requires a joined-up approach, involving the different delivery agencies, local authorities and local employers. The DWP Cities Strategy is a good example of this approach. In 15 areas, city-level consortia – consisting of Jobcentre Plus, local authorities,

[21] *Delivering on child poverty: what would it take?* Lisa Harker, November 2006

training providers, employers, the third sector and other partners – have set out their strategies for tackling the employment needs of disadvantaged groups in their areas. The Government is reviewing how best to give consortia discretion over national policy in order to deliver their strategies more effectively, while maintaining an appropriate degree of support for everyone and ensuring value for money.

Delivery by the private and third sector

4.53 Private sector and third sector organisations can bring a distinctive approach to service delivery, based on their specialist knowledge, experience and skills. Given flexibility to deliver personalised support based on individual needs, and paid on outcomes, private and third sector providers can make a real difference. Chapter 6 sets out measures to support third sector delivery of public services and the supplementary document *The future role of the third sector in social and economic regeneration: interim report,* detailed in Chapter 5, presents findings from consultation with the third sector on the range of roles the third sector plays in society, including in transforming public services.

4.54 Since 2000, the Government has been systematically testing the impact of opening up the design and delivery of labour market support to competition in the 13 Employment Zones, as well as in New Deal for Disabled People, and Action Teams. The Government will be increasing the focus on contestability with the roll-out of Pathways to Work to the remaining two thirds of the country being delivered primarily by the private and third sectors, and exploring ways to involve private and third sector organisations more fully in efforts to tackle worklessness at a local level.

REFORMING HOUSING BENEFIT

4.55 Over 4 million low income tenants receive help with their rent costs from Housing Benefit. It is important for Housing Benefit claims to be dealt with quickly and accurately, as this influences the mobility and employment choices of claimants. Effective delivery of Housing Benefit supports people into work and lifts children out of poverty. Therefore, the Government is reforming Housing Benefit by introducing administrative improvements, putting structural reform in place and streamlining and aligning benefits.

Administrative improvements

4.56 Government investment in local authorities' I.T. has led to considerable improvements in processing times. In the first quarter of 2002-03, local authorities took an average of 57 days to process a new Housing Benefit claim. By the first quarter of 2006-07 this had been reduced to an average of 36 days, with the 60 worst performing local authorities reducing their processing times by an average of 44 days over the same period. **The Government will make additional investment in this area to complete the roll-out of the National Performance Management Framework, which will allow local authorities to benchmark and track their performance. In addition, the Government will fund improved data transfer between DWP and local authorities.**

4.57 Spending on Housing Benefit has been rising in real terms since 2000-01. There have been a number of reasons for this, including above-inflation increases in private sector rents. While ensuring that tenants continue to receive appropriate levels of Housing Benefit, the Government is keen to reduce fraud and error in the administration of the benefit. Building on the considerable investment already made in this area, **this Pre-Budget Report announces funding to consolidate the Local Authority Housing Benefit data scan and I.T. matching service, which will deliver a streamlined and effective risk-based referral and interventions tool.**

Structural reform

4.58 The Government is introducing structural reform of Housing Benefit through the flat-rate Local Housing Allowance (LHA). LHA was first piloted in 9 local authorities from November 2003 and in a further 9 from April 2005 and is a simpler and more transparent way of administering Housing Benefit. The LHA rates are based on household size and the area in which the tenant lives, and are published monthly. This makes it easier for tenants to find out in advance how much rent can be covered by Housing Benefit, allowing them to make more informed housing choices. LHA is normally paid direct to tenants, rather than the landlord, thereby increasing financial inclusion and helping tenants develop budgeting skills as a step towards employment.

4.59 The Government has commissioned comprehensive independent evaluation of the LHA pathfinders, and has found that:

- overall, tenants are increasingly occupying suitably sized private rented accommodation, and are not moving to smaller accommodation to keep part of their LHA;
- the overall number of lettings has increased in a buoyant market and those landlords who leave the Housing Benefit market are being replaced by new entrants;
- around 91 per cent of claimants on LHA now have a bank or building society account, with a quarter of these saying that they opened the account specifically to have their LHA paid into; and
- the safeguards put in place to protect vulnerable customers are working well, with no evidence that the LHA has led to increased levels of arrears or increased numbers of evictions.

4.60 Subject to the successful passage of the Welfare Reform Bill, the Government will introduce the Local Housing Allowance across the private rented sector for all new Housing Benefit claimants and those who move house from April 2008.

Housing Benefit take-up

4.61 The latest statistics show a high take-up of Housing Benefit, with between 84 and 91 per cent of eligible people claiming.[22] However, recent research shows that there is low awareness that Housing Benefit is available to people who are working.[23] Therefore in order for Housing Benefit to act as a work incentive, it is necessary to raise awareness that the benefit is available and can contribute to in-work income. **This Pre-Budget Report announces a package of measures to raise awareness of Housing Benefit as an in-work benefit, including:**

- **providing awareness material to highlight the availability of Housing Benefit as an in-work benefit;**
- **working with local authorities and Housing Associations to promote financial inclusion; and**
- **working with Jobcentre Plus to develop improved in-work calculations for customers.**

[22] *Income Related Benefits, Estimates of Take-Up in 2004-05*, Department for Work and Pensions, 2006.

[23] *Housing Benefit and Council Tax Benefit as in-work benefits; claimants and advisors knowledge, attitudes, and experiences.* Department for Work and Pensions, September 2006.

Improving benefit delivery and accuracy

Simplification and error reduction

4.62 The vast majority of benefits (just under 98 per cent)[24] are paid correctly. The Government's strategy for reducing error in the benefits system is based on checking the accuracy of new claims, reminding customers and staff of their responsibilities, and identifying and correcting error which is already in the system. Simplifying the benefits system will also help to reduce error by making the system easier to understand and operate. **This Pre-Budget Report announces a review of the accuracy of all data held for Pension Credit claimants; the removal of Adult Dependency Increases (ADIs) in Carer's Allowance for new claims from 2010, aligning with the planned treatment of ADIs in state pensions and other benefits; and action to prevent and reduce error in JSA and IS payments.**

MAKING WORK PAY

4.63 The Government believes that work is the best route out of poverty and is committed to making work pay, by improving incentives to participate and progress in the labour market. Through the Working Tax Credit (WTC) and the National Minimum Wage, the Government has boosted in-work incomes, improving financial incentives to work and tackling poverty among working people.

National Minimum Wage

4.64 The National Minimum Wage guarantees a fair minimum income from work. In February 2006, the Government accepted the Low Pay Commission's recommendations to increase the adult rate to £5.35 from October 2006. The youth rate, for workers aged between 18 and 21, also rose to £4.45 from October 2006.

4.65 For the National Minimum Wage to be effective, British workers must not be undercut by illegal rates. The Government is therefore determined to ensure that the National Minimum Wage is properly enforced, in line with the Hampton principles outlined in Chapter 3, and that enforcement procedures adjust to the changing UK labour market. **The Government will therefore increase the resources devoted to National Minimum Wage enforcement by 50 per cent from April 2007, to raise the standards of enforcement by providing better, risk-based and targeted enforcement action.** This will include better information and advice for workers and employers, investigations of specific sectors thought to pose the greatest enforcement risks, joint working with other Government agencies and improved procedures for managing compliance investigations.

4.66 In January next year, responding to the Low Pay Commission's reports, the Government will also raise the penalties for the minority of employers who are persistently non-compliant, as well as taking criminal prosecutions in extreme cases.

Working Tax Credit

4.67 The WTC provides financial support on top of earnings for households with low incomes. In April 2006, 2.2 million working families and over 320,000 low income working households without children were benefiting from the WTC. Some 90,000 households were benefiting from the disabled worker element of the WTC, more than double the number who received support through its predecessor, the Disabled Person's Tax Credit.

4.68 **To ensure that people claiming Housing Benefit or Council Tax Benefit gain from the increases in the rates of WTC, this Pre-Budget Report announces that the earnings disregard in Housing Benefit and Council Tax Benefit will also be raised in line with indexation, increasing to £15.45 in April 2007.**

[24] DWP Resource Accounts 2005-06

Tackling the unemployment trap

4.69 The unemployment trap occurs when those without work find the difference between in-work and out-of-work incomes too small to provide an incentive to enter the labour market. Table 4.1 shows that, since the introduction of the National Minimum Wage in April 1999, the Government has increased the minimum income that people can expect when moving into work, thereby reducing the unemployment trap.

Table 4.1: Weekly Minimum Income Guarantees (MIGs)

	April 1999	April 2007	Percentage increase in real terms[2]
Family[1] with one child, full-time work	£182	£275	22%
Family[1] with one child, part-time work	£136	£215	27%
Single person, 25 or over, full-time work	£113	£178	27%
Couple, no children, 25 or over, full-time work	£117	£211	45%
Single disabled person in full-time work	£139	£222	29%
Single disabled person in part-time work	£109	£163	20%

Assumes single earner household, the prevailing rate of NMW and that the family receives the full entitlement of Family Credit/Disability Working Allowance or Working Tax Credit/Child Tax Credit.
Full-time work is assumed to be 35 hours. Part-time work is assumed to be 16 hours.
[1]Applies to lone parent families and couples with children alike.
[2]RPI growth is taken from HM Treasury's economic forecasts.

Tackling the poverty trap

4.70 The poverty trap occurs when those in work have limited incentives to move up the earnings ladder because it may leave them little better off. 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 benefits or tax credits.

4.71 The Government's reforms are ensuring that workers have improved incentives to progress in work. Table 4.2 shows that, as a result of these reforms, about 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, including low income working people without children. These financial incentives to progress in work will be supported by the focus on progression in the Leitch Review of Skills.

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

Marginal deduction rate[1]	Before Budget 1998	2007-08 system of tax and benefits
Over 100 per cent	5,000	0
Over 90 per cent	130,000	45,000
Over 80 per cent	300,000	165,000
Over 70 per cent	740,000	205,000
Over 60 per cent	760,000	1,680,000

[1] Marginal deduction rates are for working heads of 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 a disabled person.
Note: Figures are cumulative. Before Budget 1998 based on 1997-98 estimated caseload and take-up rates; the 2007-08 system of tax and benefits is based on 2004-05 caseload and take-up rates.

Funding for Welfare to Work

4.72 The Welfare to Work programme is delivered by DWP. When first established in 1997, the programme was funded from the excess profits of the privatised utilities. Since 2003-04, Welfare to Work has been increasingly funded from within DWP's own resources as the Windfall Tax receipts have been exhausted. The DWP Annual Report sets out expenditure plans and outturn information.

Table 4.3: Allocation of the Windfall Tax

£ million	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04[2]	2004-05[3]	2005-06[3]	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] *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.*

[3] *Figures are provisional for the years from 2004-05 to 2005-06.*

[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 to ensure that everyone can take advantage of opportunities to fulfil their potential. The Government's reforms of the welfare state reflect its aims of eradicating child poverty, supporting families to balance their work and family lives, promoting saving and ensuring security for all in old age. The Government is also committed to a modern and fair tax system that 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:

- **announcing that from April 2007, the value of the child element of Child Tax Credit will rise by £80 to £1,845 per year;**
- **from April 2009 additional support for all families, with every mother-to-be becoming eligible for Child Benefit from week 29 of their pregnancy, so that women will be up to £200 better off;**
- **an extension of the Warm Front programme, targeting 300,000 of the most vulnerable pensioner and other households, community by community;**
- **making Individual Savings Accounts (ISAs) permanent, beyond 2010,** to provide stability for savers and certainty for the industry. In addition, the introduction of a package of reforms to the ISA, designed to simplify the regime, will make it more flexible for savers and providers and further promote saving;
- **a package of measures responding to the consultation on the role of the third sector in social and economic regeneration,** including the establishment of a new £30 million Community Asset Transfer fund and the guarantee of three years of funding passed on to third sector organisations;
- **the establishment of an international research collaborative for the development sciences,** led by a high level steering board including leading scientists; and
- **further reforms to modernise the tax system and protect tax revenues,** including work to tackle avoidance.

5.1 The Government's aim is to promote a fair and inclusive society in which everyone shares in rising national prosperity and no one is held back from achieving their potential by disadvantage or lack of opportunity. The Government is committed to advancing fairness and flexibility together, so that all people, at all stages of life, can benefit from the UK's modern and dynamic economy.

SUPPORT FOR FAMILIES AND CHILDREN

5.2 The Government believes that every child, irrespective of background or circumstances, deserves the best start in life. To achieve this, since 1997, the Government's strategy has been to reform financial support for families with children, help parents into work and provide better public services for children and their families.

Eradicating child poverty

5.3 To ensure that every child gets the best start in life, the Government has set itself the goal of eradicating child poverty in a generation. This commitment has been underpinned by stretching targets to reduce by a quarter, and then by a half, the numbers of children living in relative low-income households.

Progress to date

5.4 In the 1980s and early 1990s, child poverty more than doubled. Since 1999, the Government has decisively reversed this upwards trend. Child poverty rates have fallen faster than in any other European country. Between 1998-99 and 2004-05, the numbers of children in relative low-income households fell from 3.1 million to 2.4 million, at the same time as average incomes grew by 2.4 per cent per year in real terms. Against a fixed income poverty line, 1.8 million children have been lifted out of poverty since 1996-97. And as the poorest families have seen their incomes rise, they have spent more on their children's needs,[1] and there are fewer families unable to afford key items such as new shoes and winter coats.[2]

5.5 The Government's first Public Service Agreement (PSA) target was to reduce the number of children in relative low-income households by a quarter between 1998-99 and 2004-05. Data released in March 2006 showed that this measure of poverty had fallen by 700,000, the equivalent of 23 per cent (before housing costs) or 17 per cent (after housing costs). These reductions represent a strong improvement and the Government remains committed to halving the numbers of children in poverty by 2010-11.

Halving child poverty

5.6 *The Child Poverty Review*[3] set out the Government's strategy for halving and eradicating child poverty, and the Government will continue to take this forward. Lisa Harker has conducted an external review for the Department for Work and Pensions (DWP) on how it can maximise its contribution to halving child poverty,[4] and her conclusions are currently being considered. This chapter also sets out steps to improve support for children and young people.

Financial support for families

5.7 Since 1997 the Government has radically reformed the way it provides support to families with children, recognising the benefits of a good start in life and that families with children face additional costs. This support is delivered through a combination of Child Tax Credit (CTC) and Child Benefit.

Increased support for families

5.8 Tax credits are the central component of the Government's programme of financial support for families and are reaching far more low- and moderate-income families than any previous system of income-related financial support, benefiting around six million families and ten million children. Figures published in March 2006 showed that in the first year of new tax credits (2003-04), 79 per cent of eligible families were claiming CTC, while the proportion of the money claimed was even higher, at 87 per cent. Some 89 per cent of low income working families claimed tax credits in 2003-04, a higher level of take-up than for Working Families' Tax Credit (WFTC) and significantly higher than for Family Credit. In their first year of operation, take-up was 65 and 57 per cent for WFTC and Family Credit respectively.

[1] *That's where the money goes*, Gregg, Waldfogel and Washbrook, 2005.

[2] *Families and children study*, Department for Work and Pensions (DWP), 2006.

[3] *Child Poverty Review*, HM Treasury, July 2004.

[4] *Delivering on child poverty: what would it take?* Lisa Harker, November 2006.

5.9 This Pre-Budget Report announces that, **from April 2007, the child element of CTC will increase by £80 to £1,845 a year,** in line with the Budget 2006 commitment to raise the child element at least in line with earnings until the end of this Parliament. This represents a total increase of £400 since its introduction in April 2003. In 2007-08, a family with two young children and a full-time earner on £16,500, half male mean earnings, will receive over £110 per week in CTC and Child Benefit, more than double the equivalent support in 1997-98. Table 5.1 shows the levels of support that CTC and Child Benefit will provide for families from April 2007.

Table 5.1: Minimum annual levels of support for families from April 2007

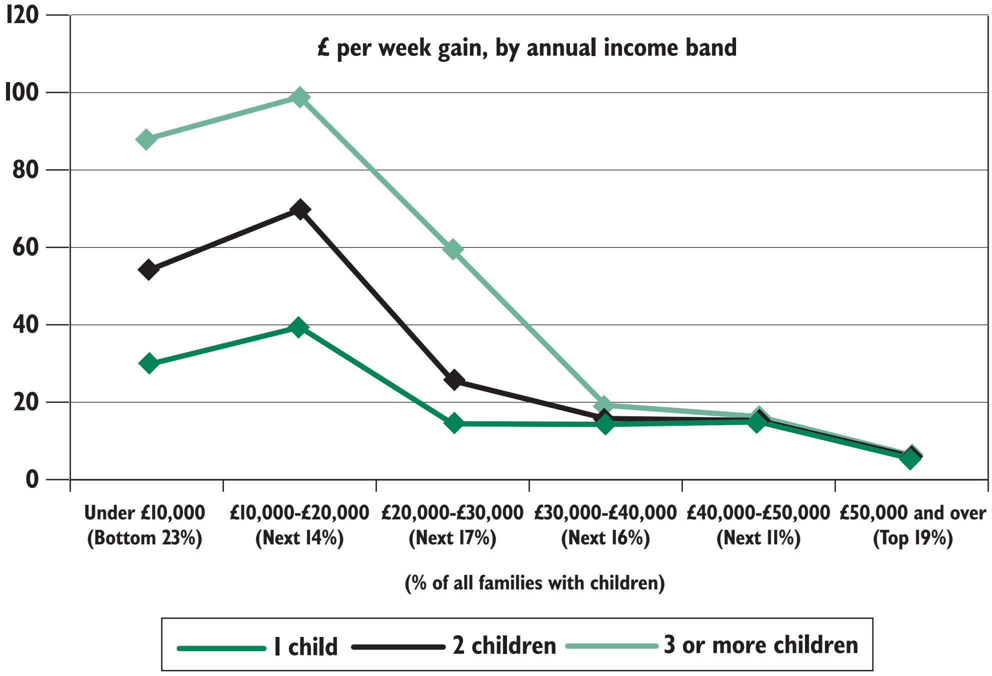
Annual family income *Per cent of families*	up to £14,495 *30*	up to £50,000 *80*	all families *100*
1 child	£3,330	£1,490	£940
2 children	£5,810	£2,120	£1,570
3 children	£8,280	£2,740	£2,200

Making families better off

5.10 Chart 5.1 shows the impact of the Government's measures to support families since 1997. It shows that all families have benefited but the greatest benefit has gone to families with low to middle incomes. For example, families with two children and an income in the range £10,000 to £20,000 are on average around £70 a week better off.

5.11 The Government recognises the importance of a healthy diet in the final weeks of pregnancy and the additional costs faced by parents when their children are born. Low-income families may already claim the Sure Start Maternity Grant, worth £500 per child, to help with these additional costs. **This Pre-Budget Report announces additional support for all families. From April 2009, every mother-to-be will become eligible for Child Benefit from week 29 of their pregnancy, so that women will be up to £200 better off by the birth of their first child and up to £130 better off at the birth of subsequent children**.

Chart 5.1: Gains for families with children from tax credits and other children's measures by 2007



Source: HM Treasury.

5.12 As a result of the Government's reforms to the personal tax and benefit system and the National Minimum Wage, by April 2007 and in real terms:

- families with children will be on average £1,550 a year better off, while those in the poorest fifth of the population will be on average £3,450 a year better off;
- a single-earner family on half male mean earnings with two children will be £3,900 a year better off; and
- a single-earner family on male mean earnings with two children will be £255 a year better off.

Tax credits

5.13 In the 2005 Pre-Budget Report, the Government announced a series of reforms to improve the tax credit system by increasing certainty for claimants. The Government has begun to introduce these changes, for example, by increasing the income disregard to £25,000 and shortening the renewal window to five months. End of year adjustments leading to an overpayment fell by a fifth between 2003-04 and 2004-05. Once the measures announced in the 2005 Pre-Budget Report come fully into effect, the level of end-year adjustments is expected to fall by a further third.

5.14 In addition to these policy measures, HM Revenue and Customs (HMRC) has worked hard to improve its service to claimants by improving its procedures, making its communications more claimant friendly and its forms easier to complete. This has meant fewer overpayments are caused by processing or software error and accuracy in processing and calculating awards rose to 97.7 per cent in 2005-06 – up from 78.6 per cent in 2003-04. This is a comparable level to HMRC's performance in handling claims for Child Benefit.

5.15 Following the successful reduction of the window to five months earlier this year, **the Government will shorten the renewal period to four months in 2007.** This will further reduce the time over which claimants are paid on potentially out of date information.

Box 5.1: Tax credits have improved choices for working families

The introduction of tax credits has improved choices for working families and eased the burden on parents seeking to balance work and family. By increasing financial support for families with children, tax credits make it easier for one parent in a couple to work part-time or remain at home to care for their children. Tax credits have also improved financial returns to work, helping parents to re-enter employment after a period of caring for their children.

This can be shown by considering the effects of the Government's reforms on a family with two children under the age of 11, with a single earner on half male mean earnings (£16,500). Where one parent chooses not to work, the family is now £4,500 a year better off than under the 1997-98 tax and benefit system, increasing the level of support should one parent choose to stay at home to care for the children full-time. Should the non-working partner return to work, the family would then find itself an additional £2,200 a year better off, compared to £1,200 a year in 1997-98. In this way the Government is supporting families' choices over balancing work and family life, by providing more support to stay at home and better incentives to return to work.

Child maintenance

5.16 The payment of child maintenance can make a significant difference to the lives of low-income families and lift many children out of poverty. Since 2003, parents with care on the new child support scheme have been able to keep the first £10 per week of any child maintenance paid without it affecting their benefit entitlement. This is known as the Child Maintenance Premium and currently over 50,000 parents are benefiting from it. By the end of 2008 the Government **will extend the Child Maintenance Premium to parents with care on the old child support scheme.** It is estimated that this will benefit an extra 40,000 parents with care, with an additional 15,000 more children receiving the full amount of maintenance paid by the non-resident parent. The Government's forthcoming child maintenance White Paper will set out further reforms to help tackle child poverty; promote parental responsibility; provide a cost-effective and efficient service and value for money for the taxpayer; and improve simplicity and transparency.

Financial support for young people

5.17 Skills are key to increasing individual opportunity, improving labour market flexibility and boosting productivity. The Government has an ambition to raise participation in education and training from 75 per cent to 90 per cent at age 17 by 2015, so that all young people have the skills they need to achieve in a modern, global economy. In support of this, the Government is committed to a vision of a single, coherent system of financial support for 16-19 year olds, which ensures that all young people have the support and incentives they need to participate and achieve in education and training. The Leitch Review of Skills, published on 5 December and described in Chapter 3, sets out new ambitions for the UK to reach world-class skills levels.

Engaging the most disadvantaged young people 5.18 Evidence suggests that where young people spend prolonged periods unemployed or inactive, it has a negative impact on their employment prospects and life chances. Since April 2006, the Government has been piloting Activity Agreements and Allowances targeted on the most disadvantaged 16-17 year olds. These extend conditional financial support to this group, setting a clear expectation that young people will progress into learning, and offering them the financial support and opportunity to do so. The findings of this pilot will inform the review of financial support for 16–19 year olds. This Pre-Budget Report **announces that the Government will consider extending these pilots to support young people to make the transition back into learning.**

Support for children and young people

Review of children and young people 5.19 Budget 2006 launched a joint HM Treasury and Department for Education and Skills (DfES) policy review to inform the 2007 Comprehensive Spending Review (CSR) on how to secure further improvement in outcomes for children and young people. Under the umbrella of this review, sub-reviews will focus on support for disabled children, youth services, and services for families caught in a cycle of low achievement. Further details are set out in Chapter 6.

Children in care 5.20 The state has a special responsibility for children in care, and yet outcomes for this group are extremely poor – both in absolute terms and relative to their peers. For this reason, these young people are at the heart of the Government's wider programme to tackle the poor outcomes and social exclusion of the most vulnerable groups in society. Fulfilling the commitment in the Schools White Paper[5] to consult on a wide-ranging set of proposals to transform outcomes for children in care, the Government published *Care matters: Transforming the lives of children and young people in care*, for consultation in October 2006. A number of working groups have been established to consider particular issues, such as the long-term future of the care population, placement reform and best practice in schools. The Government will publish an initial response to the consultation, including a version for young people, in 2007.

Budget-holding lead professionals 5.21 *Support for parents: the best start for children*[6] set out an ambition to promote greater personalisation of services. It announced a series of Single Account Holder pathfinders to test whether better service packages for children, young people and families can be delivered by giving lead professionals a budget with which to procure goods and commission services directly from providers. £10 million in additional funding over two years has been made available to support the pilots. Since June 2006, 15 pilots have been established in 16 local authorities and will run until April 2008.

[5] *Higher Standards: Better Schools for All*, Department for Education and Skills, October 2005.

[6] *Support for parents: the best start for children*, HM Treasury and Department for Education and Skills, December 2005.

Parent Support Advisers **5.22** *Support for parents* also announced £20 million to support the piloting of a new school-based outreach role, Parent Support Advisers, in over 600 primary and secondary schools in the most deprived areas. This new, preventative role is intended to support children and families where there are early signs that they could benefit from additional help. A total of 20 local areas have been selected to run the pilots and 100 schools now have Parent Support Advisers in place. It is anticipated that as many as 700 schools will have Parent Support Advisers provision by spring 2007.

Childcare and work-life balance

5.23 Flexible, affordable and high-quality childcare provision is an important element of the Government's strategy to both provide support to families and eradicate child poverty. *Choice for parents, the best start for children: a ten year strategy for childcare*, published alongside the 2004 Pre-Budget Report, set out the Government's long-term vision for childcare and early years services.

Delivering the ten year strategy **5.24** The Government is committed to ensuring that parents have greater choice and flexibility in balancing work and family life. From April 2007, paid maternity leave will be extended from six to nine months, and the Government has an aim of 12 months paid maternity leave by the end of the Parliament. The Government will also continue to examine the case for extending the right to request flexible working to parents of older children in the future.

5.25 Good progress has been made in delivering the other commitments set out in the ten year strategy, including:

- the creation of over 1,040 Sure Start Children's Centres, ahead of schedule, providing integrated early childhood services for children and their families (see Box 5.2 below);
- the creation of over 3,500 extended schools, offering additional services, out of school activities and greater engagement with parents and the local community, including high quality childcare between 8am and 6pm all year round;
- Royal Assent of the Childcare Act on 11 July 2006 that introduces new duties on local authorities to improve child outcomes and secure a sufficient supply of childcare and a new system of regulation and inspection for childcare and early education; and
- delivering high quality childcare, through new training opportunities and support from the Transformation Fund, and the creation of a new graduate Early Years Professional status, with the first graduates receiving training from September 2006.

Box 5.2: Sure Start Children's Centres

The Government is ahead of schedule on reaching a nationwide network of 3,500 Sure Start Children's Centres by 2010, which bring together early education, health, family support and employment support for young families. There are many examples across the country of children's centres transforming the lives of children and families. It will be vital for these centres to continue to develop innovative, locally based approaches to service delivery and to remain accountable to the communities they serve.

The Government also recognises the significant challenges involved in ensuring that excellent practice is spread across all centres so that they bring high quality services for all. To achieve this, DfES is taking a number of important steps, including:

- **establishing a comprehensive performance management framework, including a set of key performance indicators, against which all centres will be accountable, and new statutory targets for local authorities introduced in the Childcare Act 2006;**
- **appointing a new consortium, Together for Children, which will oversee the roll out of all centres and ensure that good practice is spread effectively across the country; and**
- **developing tools to enable children's centres to benchmark their expenditure and services against others, and proposals to strengthen the ability of children's centre managers to monitor and improve value for money.**

Affordability for families

5.26 The Government wants families to be able to afford flexible, high-quality childcare that is appropriate to their needs and continues to believe that the childcare element of the Working Tax Credit is the most effective way of delivering support for low- to moderate-income families. This offers parents support with up to 80 per cent of costs, up to a limit of £300 a week (£175 for one child). Alongside this, the £55 per week income tax and national insurance contributions (NICs) exemption for employer-supported childcare, is improving childcare affordability for parents.

Workplace nurseries

5.27 Budget 2006 announced £16 million of new funding to establish capital grants to help small and medium-sized employers' workplace nurseries. Investment will be delivered through Regional Development Agencies, led by the London Development Agency. Funds will be allocated in areas where there is most evidence of demand, particularly in areas of economic growth and regeneration. Grants for these areas will be announced early in 2007, based on proposals from small and medium-sized enterprises.

FAIRNESS FOR DISABLED PEOPLE

5.28 The Government is committed to improving the rights and outcomes of disabled people. The additional provisions of the Disability Discrimination Act 2005 came into force from December 2006. Most notably, all public sector organisations now have a statutory duty to promote equality of opportunity for disabled people, eliminate unlawful harrassment and publish a Disability Equality Duty. Alongside the proposals set out in the Welfare Reform Green Paper[7] including the reforms to incapacity benefits contained in the Welfare Reform Bill, currently before Parliament and detailed further in Chapter 4), this will enhance the opportunities for disabled people to participate fully in society by putting in place extensive support to help them re-engage with the labour market and gain employment, while also providing adequate support to those who are not able to work.

[7] *A new deal for welfare: Empowering people to work*, Department for Work and Pensions, June 2006.

Improving the life chances of disabled people

5.29 The Office for Disability Issues (ODI), set up in December 2005, is taking forward the recommendations of the 2005 Strategy Unit report,[8] in partnership with other Government departments. The ODI's first annual report was published in July 2006, and charts progress so far. The involvement of disabled people is critical in ensuring that policy design and service delivery respond to individual needs and aspirations. In order to ensure that the voices of disabled people are heard at the heart of Government, a new advisory non-departmental public body, Equality 2025: The United Kingdom Advisory Network on Disability Equality, will be launched in December 2006.

Independent living

5.30 The Government is committed to ensuring disabled people have choice and control over the support they need to live their everyday lives. Thirteen local authorities have been selected to run individual budget pilots, from spring 2006, which aim to improve the ability of disabled people and older people to live independently. These pilots are continuing to examine the effectiveness of giving individuals a choice of their budget in the form of cash, services or a combination of the two. As part of the 2007 CSR, the Government is looking at the effectiveness of the support that disabled people and children receive through the Children and Young People review, described earlier in this chapter, and the Mental Health and Employment review, described in Chapter 4.

PROMOTING SAVING, ASSET OWNERSHIP AND INCLUSION

5.31 The Government seeks to support saving and asset ownership for all across the lifecycle – from childhood, through working life and into retirement. Since 1997, the Government's savings strategy has focused on:

- improving the environment for saving – through a stable macroeconomy, a sound regulatory framework and employment opportunity for all;
- developing a range of savings opportunities suitable for each life stage – including the Child Trust Fund, Individual Savings Accounts and pensions;
- providing adequate incentives for saving through the tax and benefit system – for example, the Child Trust Fund, Individual Savings Accounts and the pensions tax regime all offer opportunities for tax-advantaged savings; and
- empowering individuals with the capability to make the right saving choices.

5.32 In aggregate, household wealth is higher than ever before. Net wealth, adjusting for rising personal debt, has grown by around 65 per cent in real terms since 1997.

Promoting saving and asset ownership for all

Child Trust Fund

5.33 The Child Trust Fund was introduced in April 2005 to promote saving and financial education and ensure that in future all children have a financial asset at age 18. Under the scheme, all newborn children receive £250 to be invested in a long-term savings and investment account, and children from lower-income families receive £500. Budget 2006 announced further payments into these accounts at age seven of £250 for all children, with children from lower-income families receiving £500.

[8] *Improving the life chances of disabled people*, Prime Minister's Strategy Unit, January 2005.

5.34 Over 2.2 million Child Trust Fund accounts are now open. In the first year of operation, over three quarters of parents opened their child's account; over a third of children received an extra payment from the Government; and early evidence from providers suggests that there have been significant additional contributions into children's accounts.[9] The Government will be doing more to promote engagement in the run-up to Christmas through a new advertising campaign, followed, in January, by a Child Trust Fund Week to raise awareness and participation among parents.

5.35 The Government recognises that children in care are a particularly vulnerable group, who often lack the support networks available to other children. In view of this, the Government announced in October 2006 that it **will provide an extra £100 per year for every child who spends the year in care**, in order that their Child Trust Fund provides a more significant asset for them to access on entering adult life.[10]

5.36 The Child Trust Fund will be used as a focus for financial education in schools, and will be a vital tool for engaging young children in developing the financial capability to manage their own Child Trust Fund at age 16 and to make well-informed decisions about their finances throughout their lives. Budget 2006 announced that the Government was exploring the use of a Schools Money Week as a focus for financial education. The Government is continuing to work with financial education bodies in developing the resources for teachers to support this initiative.

Individual Savings Accounts

5.37 Individual Savings Accounts (ISAs) were introduced in 1999 as a replacement for Tax-Exempt Special Savings Accounts (TESSAs) and Personal Equity Plans (PEPs). The objective has been to develop and extend the savings habit and to ensure that tax relief on savings is more fairly distributed. The evidence shows that ISAs have been successful in meeting these objectives: for example, over 16 million people – more than one in three adults – now have an ISA, with nearly £215 billion subscribed since their launch. ISA and PEP savings are supported by an estimated £1.8 billion a year in tax relief.

5.38 The Government is keen to build on this success. In order to provide stability for savers and certainty for the industry and following the conclusion of the review, the Government has announced that **it will make ISAs permanent beyond 2010, and that it will introduce a package of reforms designed to simplify the regime, make it more flexible for savers and providers and further promote saving.** These reforms are set out in Box 5.3.

Box 5.3: Individual Savings Accounts: proposed reforms

Following an internal review of the ISA regime, and in response to representations received, the Government proposed in November 2006 to:

- **make ISAs permanent beyond 2010;**
- **guarantee an overall annual investment limit of at least £7,000;**
- **bring PEPs within the ISA wrapper;**
- **remove the Mini/Maxi distinction within ISAs;**
- **allow Child Trust Fund accounts to roll over into ISAs on maturity; and**
- **allow transfers from the cash into the stocks & shares component of ISAs.**

The Government intends to implement this package of reforms as soon as practicable. Further detail on these reforms is published alongside this Pre-Budget Report, setting out proposals for implementation and seeking views on a range of practical issues.[a]

[a] *Individual Savings Accounts: proposed reforms* – available on the HM Treasury website at http://www.hm-treasury.gov.uk.

[9] *Child Trust Fund: Statistical Report 2006*, HM Revenue & Customs, September 2006.

[10] *Care Matters: Transforming the Lives of Children and Young People in Care*, Department for Education & Skills, October 2006.

Saving Gateway

5.39 Through the Saving Gateway, the Government is exploring the use of matching – a Government contribution for each pound saved. The aim is to encourage saving among lower-income households and to promote engagement with mainstream financial services. Evidence from an initial pilot, launched in 2002, confirmed that matching could encourage genuinely new savers and new saving.[11]

5.40 A second pilot was launched in March 2005, involving around 22,000 participants. This is testing the effects of alternative match rates and contribution limits, initial endowments and the support of a range of financial education bodies. An interim evaluation report, published in July 2006, found that participants are overwhelmingly positive about the scheme and the matched payments they receive on their savings, and that participants intend to save regularly into their accounts.[12] The final evaluation of the second pilot is due to be published in spring 2007.

5.41 Many people use Christmas savings clubs and hamper schemes as a means of saving. In the light of recent events, the Government has asked Brian Pomeroy, Chair of the Financial Inclusion Taskforce, to conduct a review into these schemes. The aim of the review, which will report back by Budget 2007, is to both increase understanding of who uses the schemes and why, and also consider how the saving needs of this group of consumers might be better met by mainstream financial services providers. This review will not consider the regulatory aspects of the issue, which are being covered by the Office of Fair Trading and the Department of Trade and Industry, in consultation with the Financial Services Authority (FSA).

Promoting financial capability

5.42 Financial capability is vital to enable people to participate in a modern economy and to manage their finances effectively. People need access to information, the knowledge and skills to interpret it, and the confidence to take action.

5.43 The Government announced in the 2005 Pre-Budget Report that it would:

- address financial capability more explicitly in the curriculum by including it in the new functional mathematics component of GCSE mathematics and also in functional mathematics aimed at adults;
- encourage local authorities to provide more financial education to parents through Sure Start Children's Centres and locally-delivered family numeracy programmes; and
- provide information on opportunities for financial education to applicants for Social Fund Budgeting Loans.

5.44 On 18 October 2006, HM Treasury and the FSA hosted the first national conference on financial capability. The FSA has conducted a comprehensive survey into the financial capability in the UK and is delivering a number of projects to raise financial capability in schools and the workplace, and to target groups such as young people and prospective parents.[13]

5.45 The Government **will shortly publish a long-term strategy on financial capability**. This will be a consultative document, seeking views on how the Government can best use the levers at its disposal to reach people at key life stages and offer support for those most vulnerable to the consequences of poor financial skills. The strategy will also consider whether all consumers are being well served through current access to generic financial advice and how any gaps may be closed.

[11] *Incentives to save: Encouraging saving among low-income households*, University of Bristol, Personal Finance Research Centre, March 2005.

[12] *Interim Evaluation of Saving Gateway 2*, Institute for Fiscal Studies and Ipsos MORI Social Research Institute, July 2006.

[13] *Financial Capability in the UK: Delivering Change*, Financial Services Authority, March 2006.

Promoting financial inclusion

5.46 Access to mainstream financial services can be restricted for many people on low incomes. *Promoting financial inclusion*[14] outlined the Government's strategy, including the establishment of a Financial Inclusion Taskforce to oversee progress and a Financial Inclusion Fund of £120 million to support initiatives to tackle financial exclusion. In order to monitor these initiatives and identify areas where further work is required **the Financial Inclusion Taskforce will continue for an extra year to March 2008**. The Government will report on next steps for the financial inclusion strategy in the New Year.

Access to banking

5.47 Lack of access to banking services imposes costs on those who can least afford them. In December 2004, the banks and the Government agreed to work together towards a goal of halving the number of adults in households without a bank account and of making significant progress within two years. In its first annual report, the Taskforce concluded that steady progress had been made, but encouraged the banks to continue to address the difficulties faced in opening a bank account.[15] The Taskforce will provide a full assessment of progress towards the shared goal in spring 2007. A working group, chaired by the Rt Hon John McFall MP, was established with the support of the Economic Secretary to the Treasury in July 2006, which is currently examining what mechanisms can be used to support the provision of free cash machines in low-income areas. The working group is expected to report back to the Economic Secretary before the end of the year.

Access to affordable credit

5.48 Many low-income households rely on credit products with interest rates of over 100 per cent. The Financial Inclusion Fund has been used to establish a 'growth fund' of £36 million to support third sector lenders in providing affordable and appropriate credit. Distribution of this fund commenced over the summer, and £34 million has now been committed. The Taskforce will monitor the impact of this funding in addressing financial exclusion. To protect investment in the growth fund, and to enhance the capacity and skills of staff and volunteers working for third sector lenders, the Government **will make funding available from the Financial Inclusion Fund to support the training requirements of third sector lenders.**

5.49 The Government also recognises the damage inflicted on individuals and neighbourhoods by illegal lending. The Government will make £1.2 million available from the Financial Inclusion Fund for pilots to tackle illegal lending and provide support to victims in accessing mainstream alternatives. Existing pilots covering Scotland and the West Midlands will continue for an extra year to 2008. The new funding will also be used to expand the operation of the scheme to Sheffield, West Yorkshire and Liverpool.

5.50 Following consultation, and in order to increase flexibility to lend to those on low incomes, the Government has increased the maximum rate that credit unions can charge on loans from 1 per cent a month to 2 per cent a month. The change came into effect on 1 June 2006. The Government has also consulted on extending community investment tax relief to the personal lending activities of community development finance institutions. The Government continues to consider the case for, and practicalities of, this extension. In order to reduce some of the increased risk and cost associated with lending to vulnerable groups, the Government will implement, later this month, a scheme where, under certain circumstances, third sector lenders can apply for repayment by deduction from benefits, where normal repayment arrangements have broken down.

[14] *Promoting financial inclusion*, HM Treasury, December 2004.

[15] *Financial Inclusion Taskforce:* Report on progress towards the shared goal, Financial Inclusion Taskforce, March 2006 – available on the Financial Inclusion Taskforce website at http://www.financialinclusion-taskforce.org.uk.

5.51 The Social Fund provides a safety net of grants and interest free loans for the most vulnerable in times of need. In April 2006, reforms to the Budgeting Loans scheme were successfully introduced that equate to an increase of funding of £210 million over the three years to 2008-09.

Access to money advice

5.52 Credit is a useful tool for managing expenditure for most people but some have difficulty managing their borrowing and become over-indebted. The Government recognises that face-to-face money advice is an effective mechanism for tackling problem debt and has committed £45 million from the Financial Inclusion Fund to achieve a step-change in supply. Funding commenced in April 2006, and more than 6,500 clients had been advised by the end of November. In total it is expected that there will be 350 new full-time equivalent advisers in place by the end of 2006. To build on the good progress made by these projects, the Government **will make an additional £2.5 million available, from the Financial Inclusion Fund, for the recruitment and training of more new advisers.** This funding will take the total number of new advisers to over 500. In addition, the Government has awarded £6 million to organisations across England and Wales to pilot debt advice outreach. Early evaluation has yielded positive results, suggesting that the outreach method can be an effective way of delivering money advice to harder-to-reach groups of financially excluded people.

Facilitating access

5.53 Following a recommendation from the Financial Inclusion Taskforce, the Government **will support, from the Financial Inclusion Fund, a £5.4 million campaign to assist financially excluded people to access mainstream banking and credit products.** The campaign, to be delivered through DWP, will work with trusted intermediaries in day-to-day contact with the financially excluded to achieve an increase in the awareness and take-up of mainstream financial services products across England, Wales and Scotland.

FAIRNESS FOR PENSIONERS

5.54 One of the most significant demographic trends projected to occur over the next ten years is the ageing of the population. For example, by 2017 the number of those aged over 85 will increase by over a third.[16] To respond to the needs of today's older people and the challenges posed by demographic change, the Government has developed its Opportunity Age[17] strategy, which promotes independence and well-being in later life and aims to ensure that the Government adapts to, and benefit from, an ageing society. A comprehensive programme of reforms seeks to ensure that pensioners can share in rising national prosperity, and that older people are able to play a full and active role in society.

5.55 The Government is committed to tackling pensioner poverty, rewarding saving, and helping extend working lives to enable people to meet their retirement income aspirations. Its strategy for pensioners is based on the principle of progressive universalism, providing support for all and more for those who need it most, through both financial support, access to services and action to tackle age discrimination, improve public services, and encourage and support healthy active ageing.

Fairness for today's pensioners

Security for the poorest pensioners

5.56 The Pension Credit, launched in 2003, is the foundation through which the Government provides security for the poorest. It is made up of the standard minimum guarantee (Guarantee Credit) that ensures a minimum income for those aged over 60, and the Savings Credit, which rewards those who have built up small savings for retirement. 2.7 million pensioner households currently receive Pension Credit: 2.1 million receive the Guarantee Credit, a take-up level achieved a year ahead of target and 1.9 million receive the Savings Credit.

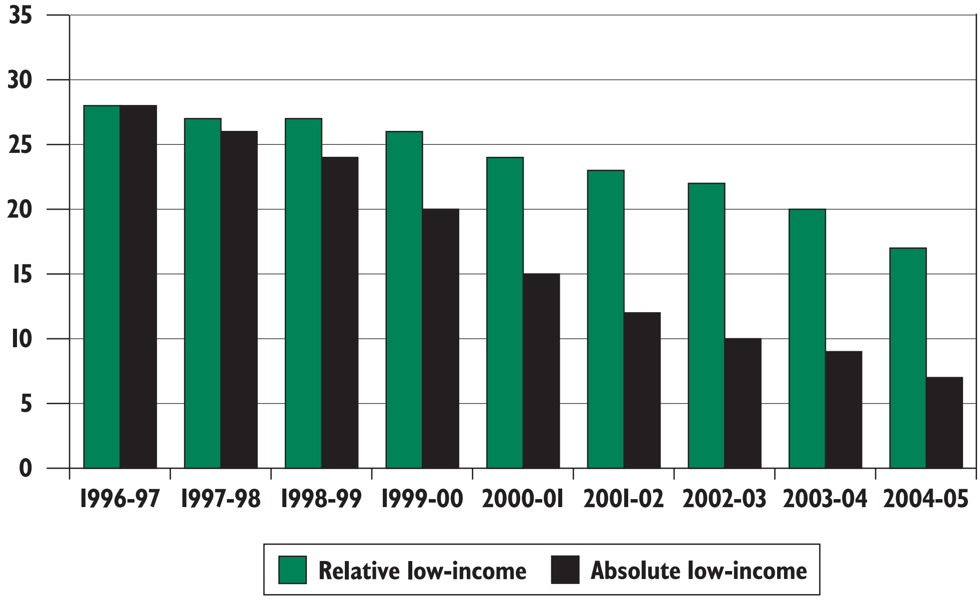
[16] *Long-term opportunities and challenges for the UK: analysis for the 2007 Comprehensive Spending Review*, HM Treasury, November 2006.

[17] *Opportunity Age: Meeting the challenges of ageing in the 21st century*, Department for Work and Pensions, March 2005.

5.57 In 2004, the Government committed to uprating the guarantee element of the Pension Credit in line with earnings until 2008. Accordingly, from April 2007, it will rise to £119.05 for single pensioners and £181.70 for couples. From April 2007, the Savings Credit will also rise to a maximum of £19.05 a week for single pensioners and £25.26 for couples. As described later in this chapter, the Pensions White Paper[18] announced that the guarantee element of Pension Credit will be uprated in line with earnings over the long term in order to ensure that the gains made against pensioner poverty are secure into the future.

5.58 Concentrating resources on the poorest pensioners has ensured that between 1996-97 and 2004-05 over one million pensioner households were lifted out of relative poverty and 2 million pensioner households were lifted out of absolute poverty. Half a million pensioner households have been lifted out of relative low-income poverty since the introduction of Pension Credit. As a result of the Government's reforms, the risk of a pensioner household being poor has fallen to 17 per cent and a pensioner is now no more likely to be poor than the population as a whole. Chart 5.2 below illustrates the progress that has been made in tackling pensioner poverty.

Chart 5.2: Percentage of pensioners living in low-income households (Great Britain)



Source: Department for Work and Pensions.

Support for all pensioners

5.59 The Government has continued to build on the foundations of support for retirement incomes provided by the basic and additional state pensions. The steps already taken to provide support for all pensioners include:

- guaranteeing that the April increase in the basic state pension will be in line with the Retail Prices Index for the previous September or 2.5 per cent, whichever is higher. From April 2007, the basic state pension will rise to £87.30. As described later in this chapter, the Government has also committed to uprating the basic state pension by earnings in the longer term;

[18] *Security in retirement: towards a new pensions system*, Department for Work and Pensions, May 2006.

- the continuation of Winter Fuel Payments of £200 for households with someone aged 60 or over, rising to £300 for households with someone aged 80 or over, for the duration of this Parliament;
- free television licenses for those aged over 75, and free prescriptions and eye tests for those aged 60 and over;
- ensuring that those entering hospital receive their full entitlement to the basic state pension and some other benefits for the duration of their stay; and
- introducing free off-peak local area bus travel, and committing to extend this to off-peak nationwide bus travel from April 2008, for those aged over 60, and all disabled people, in England.

Helping vulnerable households heat their homes

5.60 The Warm Front programme aims to help low income households, including the poorest pensioners, heat their homes to an adequate standard of warmth by providing heating, energy efficiency measures, and benefit entitlement checks. Through the Energy Efficiency Commitment, energy suppliers also play an active role in helping keep the homes of the fuel poor warm, by offering a range of energy efficiency measures, like insulation, free of charge. They also offer discounted energy efficiency measures to all other households. Last year, the Chancellor announced a further £300 million to expand the Warm Front programme to enable pensioners on Pension Credit to have central heating systems installed free of charge and to provide £300 discounts for central heating systems for all pensioners without it. Efficient and effective coordination and delivery of these policies will be important if we are to achieve our fuel poverty goals. Evaluation of Warm Zone pilots earlier this year highlighted their potential role in facilitating this. To build on this work, the Government today **announces new investment of £7.5 million to improve the effectiveness of Warm Front and Energy Efficiency Commitment**. This will fund projects aimed at using an area-based approach to identify households and provide the right coordinated set of advice and measures to them.

Support for pensioners who pay tax

5.61 The Government is committed to supporting pensioners who pay income tax. Increases in the age-related tax allowances will mean that in 2007-08 no one aged 65 or over need pay tax on an income of up to £145 a week and around half of pensioners will pay no tax on their income.

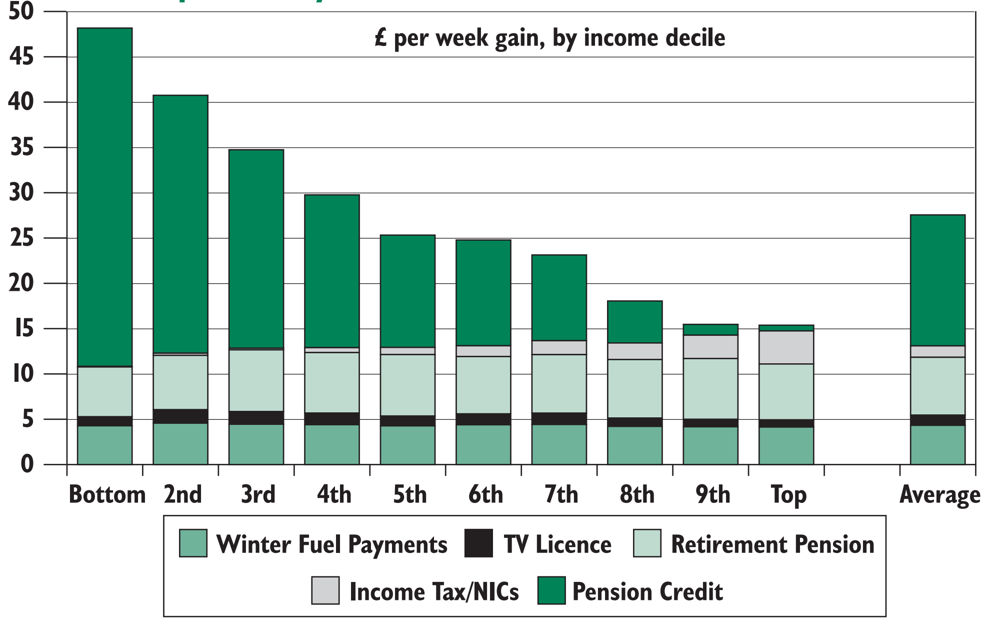
Security for today's pensioners

5.62 The Financial Assistance Scheme was established in 2004 to assist those who lost significant amounts when their pension schemes were wound up. The Pensions White Paper announced that this scheme is being extended. Around 40,000 people, who were within fifteen years of their scheme pension age on or before 14 May 2004, will benefit at a total cost of £2.3 billion.

Effects of measures to support pensioners

5.63 As a result of measures implemented since 1997, the Government is spending around £11 billion a year more in real terms on pensioners, focusing support on those who need it most. As a result of the Government's tax and benefits measures, these households will be on average £2,100 a year, or around £40 a week, better off. Women pensioners have also particularly benefited from the Government's support for older people. 3.2 million women have gained an average of £31 a week, while 1.1 million men are £29 a week better off. Overall, pensioner households will be on average £1,450 a year, or around £28 a week better off. Chart 5.3 shows the distributional impact of the Government's measures to support pensioners.

Chart 5.3: Gains for pensioner families from pensioner tax and benefit policies by 2007



Source: Department for Work and Pensions.

Fairness for tomorrow's pensioners

5.64 Since 1997, the Government has been successful in delivering macroeconomic stability and high employment, providing an environment within which individuals can confidently plan for retirement, and where more people have the resources and opportunities to save. Going forward, the Government is committed to providing a clear and sustainable framework for retirement provision within which individuals can make informed choices about how much to save and when to retire.

Pensions Commission

5.65 The Government established an independent Pensions Commission in 2002 to review the adequacy of private pension saving in the UK, and advise on appropriate policy changes, including whether there is a need to "move beyond the voluntary approach". The Pensions Commission found that although "on average, current pensioners are as well provided relative to average earnings as any previous generation",[19] there are a number of longer-term challenges to be addressed, including:

- rapid longevity gains leading to an increasing dependency ratio – an effect accentuated by the retirement of the "baby-boom" generation;
- inequalities in the state system, impacting especially on women and carers;
- reduced provision of pensions by employers; and
- failure of individuals to fill the gap left by employers, because substantial portions of the market are unserved by the pensions industry and there are behavioural barriers which impede rational long-term savings decisions.

[19] *A New Pension Settlement for the Twenty-First Century*, Pensions Commission, November 2005, page 31.

Pensions White Paper **5.66** In May 2006, the Government responded to the Pension Commission's report in the White Paper, *Security in retirement: towards a new pensions system*. It proposed a series of changes to both the state and private pensions systems and announced that, "During the next Parliament, we will re-link the uprating of the basic state pension to average earnings. Our objective, subject to affordability and the fiscal position, is to do this in 2012, but in any event by the end of the Parliament at the latest. We will make a statement on the precise date at the beginning of the next Parliament." Together with the other proposals, this will create a platform for private saving, ensuring that anyone who has been in employment or caring throughout their working life could receive £135 a week in state pension at retirement – which is £20 a week above the guaranteed income level.[20]

Fairness **5.67** To make the state pension fairer and more widely available, the Government proposes to reduce the number of qualifying years needed for a full basic state pension to 30 for those reaching state pension age from April 2010 and improve coverage for those caring for children and the severely disabled. As a result of the reforms, by 2025, over 90 per cent of women and men reaching state pension age will be entitled to the full basic state pension – compared to around 80 per cent without reform.

5.68 The White Paper also announced the intention to uprate the guarantee element of Pension Credit in line with earnings over the long term. Changes to the Savings Credit from 2008 will also ensure that it continues to focus resources on those with small savings. These changes will provide more certainty over the future role for Pension Credit, locking in reductions in poverty over time and ensuring that there are clearer incentives to save within the reformed system.

Simplicity **5.69** To simplify the current system, it is intended to reform the state second pension so that, by around 2030, it becomes a simple, flat-rate weekly top-up to the basic state pension. Under the new benefit, each qualifying year of work, parenting or caring will effectively top up the state pension by at least £1.40 a week at retirement.[21] Additionally, the abolition of contracting out for defined contribution schemes, intended to occur at the same time as the uprating of the basic state pension is re-linked to average earnings, will remove another source of complexity in the current system.

Personal responsibility **5.70** Together, these state reforms provide a clear foundation for a new approach to private pension saving, the key element of which is the creation, in 2012, of a new scheme of portable, low-cost personal accounts. They are being designed and introduced primarily for individuals for whom suitable savings vehicles have not previously been available or affordable, particularly low to moderate earners. Personal accounts will help achieve the goal set out in the 2002 Green Paper, to "encourage simple and flexible savings products, broadening access to the financial services industry".[22] They will entail:

- a minimum overall contribution of 8 per cent for the personal accounts of employees on earnings between around £5,000 and £33,000 a year – 4 per cent from the individual, 3 per cent from the employer and a further 1 per cent in the form of normal tax relief;[23]
- automatic enrolment for employees into either the new personal accounts scheme or their own employer's occupational scheme providing it meets a minimum standard; and
- non-employees, including the self-employed and non-workers, will be able to opt into the scheme.

[20] Figure relative to average earnings. If expressed in 2005-06 prices, following these reforms, an average earner retiring in the 2050s will receive £340 per week in state pensions.

[21] Figure relative to average earnings.

[22] *Simplicity, security and choice: Working and saving for retirement*, DWP, December 2002, page1.

[23] 1 per cent represents basic rate tax relief on individuals' contributions- in addition individuals may be entitled to higher rate tax relief.

5.71 Projections published by DWP estimate that 8 million people could be saving in a personal account. By retirement, their pension funds could be worth up to around 25 per cent more than if they were saving in the current system because of lower charges.

Sustainability

5.72 Following extensive consultation since the May White Paper, the Government intends to bring the proposed state pension reforms into effect through the Pensions Bill that was introduced in Parliament on 28 November. The proposed approach to the implementation and operation of personal accounts will be set out in a forthcoming White Paper later this month. Proposals will focus on the need to minimise the impact of personal accounts on those already providing good occupational pensions schemes and the burdens on employers, particularly small businesses. In addition, proposals will ensure that appropriate information is provided to enable people to make decisions on an informed basis. These proposals will build on the Government's current Informed Choice programme, plans for development of which will be set out in the forthcoming Financial Capability strategy.

Security for tomorrow's pensioners

5.73 These reforms build on earlier measures implemented by the Government to provide simplicity, security and choice in the pension system. The Government set up the Pension Protection Fund which, since its inception in April 2005, has offered protection to members of defined benefit occupational pension schemes in the event that the sponsoring company becomes insolvent when the pension scheme is in deficit. At the same time the Government set up the Pensions Regulator, which is a new risk based regulator overseeing a scheme specific funding regime to protect the benefits of members of work-based pension schemes.

Pensions simplification

5.74 Successive governments have offered tax relief on contributions to, and investment growth in, tax privileged pension schemes in order that those savings are used to produce an income in retirement. By saving in any tax-privileged pension vehicle, individuals are committing to using the resulting fund for the purpose of providing an income in retirement. This principle remains central to the simplified pensions tax regime introduced from April 2006. In order to ensure that the pensions tax rules continue to meet the original intention of the new regime, in addition to the announcements on Alternatively Secured Pensions (ASPs) and Pensions Term Assurance, the Government today **announces a package of measures that deliver technical improvements to the tax rules while consulting on areas for potential further deregulation with the industry.** Published alongside this Pre-Budget report, *The Annuities Market,* clearly sets out the Government's position regarding ASPs and changes now being made to their treatment through the pensions tax system.

Alternatively Secured Pensions

5.75 Annuities are the best way to secure a guaranteed income for life in retirement – a view endorsed by the Pensions Commission. ASPs were introduced to meet the specific need of certain groups that have a principled religious objection to the pooling of mortality risk in annuities. It was never the intention that ASPs would become a mechanism to avoid compulsory annuitisation, or to leave a tax-favoured lump sum that could then be passed on.

5.76 The Government therefore announces the **introduction of changes to the tax regime for ASPs at Finance Bill 2007 with effect from 6 April 2007**. There will be a requirement to withdraw a minimum level of income each year from an ASP fund and the facility to transfer funds on death as a lump sum to pension funds of other members in the scheme will be removed from the authorised payment rules, with these payments attracting an unauthorised payments charge. These proposals will bring practice and policy intention into line and provide a fair balance between meeting the needs of those with principled religious objections to annuitisation and the needs of the wider public. However, if these proposals prove unworkable, or there is continued evidence of the use of pensions tax relief to provide capital sums throughout retirement, the Government will consider whether to remove access to ASPs altogether. Draft legislation has been published today.

Pensions Term Assurance

5.77 The Government has become aware that, as a result of the flexibilities that the new pensions tax regime has brought in, life insurance policies that provide lump sum death benefits alone are being offered as personal pension arrangements eligible for pensions tax relief. This undermines the principles set out above. The Government will therefore work with the pensions industry to explore in time for the Budget, how the principles can be applied to pensions term assurance contracts. Any changes the Government decides to make will not effect either personal arrangements entered into before 6 December 2006 or existing types of employer arrangements.

SUPPORTING CHARITIES AND THE THIRD SECTOR

5.78 The third sector, including charities, voluntary and community organisations, cooperatives, mutuals and social enterprises, is integral to forming a fair and enterprising society, with a culture of volunteering and giving. The Government continues to provide a wide range of tax reliefs and other provisions to ensure that the third sector plays a key role in society.

Third sector review

5.79 Budget 2006 announced the largest ever consultation with the sector to inform a review into the future role of the third sector in social and economic regeneration. This consultation has reached in excess of 1,000 third sector organisations in nine regional events together with 84 sub-regional and sub-sectoral events. This joint HM Treasury and Cabinet Office review is overseen by a cross-departmental ministerial group.

5.80 *The future role of the third sector in social and economic regeneration: interim report*, published alongside this Pre-Budget Report, sets out the key messages highlighted by the consultation and areas where the Government is considering action. Such areas include the role of the third sector in creating stronger and more connected communities and giving voice to diverse groups; how the Government can foster a culture of volunteering and mentoring; and what more needs to be done to improve and implement best practice in relations between the third sector and all levels of Government. In addition, this Pre-Budget Report announces:

- **a new Community Assets fund of £30 million**, taking forward the Government's commitment as set out in the Local Government White Paper to make it easier for communities and community groups to take on the management or ownership of local authority assets;
- an expectation that when Government departments and their agencies receive their 2008-09 to 2010-11 budgets through the 2007 CSR, the flexibility and certainty of that three year funding will be passed on to third sector organisations that they fund as the norm rather than the exception; and
- for 2007-08, the Department for Communities and Local Government will allocate an extra £6.5 million in the Safer and Stronger Communities block of Local Area Agreements.

5.81 The final conclusion and recommendations of the review and a shared vision for the third sector will feed into the 2007 CSR. Further details of the 2007 CSR are set out in Chapter 6.

Invest to Save Budget "Inclusive Communities"

5.82 Budget 2006 announced a ninth Invest to Save Budget (ISB) allocation round which will conclude early next year. A further £13.5 million will be allocated to service delivery projects that promote partnerships between third sector organisations and local authorities to deliver more effective services to local people, in line with local needs and priorities. Successful projects will be announced at Budget 2007.

5.83 ISB has been running for over eight years and the projects within the ISB portfolio are delivering positive results. This Pre-Budget Report **announces a review of the fund** that will examine how successfully the ISB has delivered against its criteria of partnership working enabling innovation and long-term efficiency in public service delivery, and to what extent pilot projects have been rolled out more widely. The evidence gathered as part of the ISB review will be published in spring 2007.

Volunteering

5.84 Budget 2005 announced up to £100 million of funding for v, a new charity launched in May 2006 to take forward the vision of the Russell Commission[24] report by creating a new framework to support youth volunteering. In its first six months, v has already commissioned 67,000 new youth volunteering opportunities and has raised £15 million from 39 corporate supporters. **To build on this, the Government will be consulting on how a new generation of young people can do more to volunteer in the run up to the London 2012 Olympics.** The Government will also consider the case for further incentives to encourage volunteering.

Social enterprise

5.85 In November 2006, the Government published an action plan detailing measures to support and promote a dynamic and sustainable social enterprise sector. The action plan also set out proposals to ensure the availability of appropriate information, advice and finance to social enterprise, including making up to £10 million available to support existing Government investments to ensure that social enterprises also benefit.

Charitable giving

5.86 A number of sector representatives provided views on charitable giving as part of their response to the third sector review, which the Government is now considering. The Government is continuing to ensure that charitable giving is well supported with a range of tax reliefs and is keen to work with the sector in finding ways to raise awareness and uptake of the existing incentives for giving. HM Treasury and HMRC are therefore working with the Charity Commission and different parts of the sector to identify and minimise any administrative burdens that may inhibit the take up of charitable reliefs.

Unclaimed assets

5.87 The Government welcomes the banking industry's commitment and progress towards introducing a scheme to allow genuinely unclaimed assets to be reinvested in the community with a focus on programmes for young people, financial education and financial exclusion. The industry and Government remain committed to reuniting owners with their assets as a first priority, and that a comprehensive reuniting exercise will precede any scheme launch. Once the scheme is in operation, owners will retain the right to get their money back.

5.88 In the Budget, the Government committed to consider the legal and accounting issues surrounding unclaimed assets. Having done this, the Government believes that in order to enable the banking industry to set up an unclaimed assets scheme, where the interests and rights of both consumer and industry are protected, it is necessary to bring forward enabling legislation. The Government will therefore bring forward proposals and consult widely.

[24] *A National Framework for Youth Action and Engagement*., Russell Commission, March 2005.

DELIVERING A MODERN AND FAIR TAX SYSTEM

5.89 A fair and modern tax system encourages work and saving, responds to business developments and globalisation and supports the provision of world-class public services. To ensure this, the Government will continue to develop a fair and effective tax system that provides a level playing field for all taxpayers.

Modernising tax administration

5.90 The majority of businesses recognise the role played by public services and public investment in promoting opportunities for investment and want to comply with their tax obligations. HM Revenue and Customs (HMRC) continues to work on transforming its relationship with business, and is consulting widely to drive that programme forward. Chapter 3 reports considerable progress over the past eighteen months, including how they are delivering the targets set at Budget 2006 to reduce the administrative burden on business of dealing with forms and returns, and audits and inspections. It also looks ahead at HMRC's long term vision for the relationship with business, setting out a comprehensive programme to transform the experience of dealing with HMRC and help businesses fulfil their tax obligations in the most efficient way.

Review of HMRC Links with Large Business

5.91 At Budget 2006, the Chancellor asked Sir David Varney, in his capacity as chairman of HMRC, to work with business representatives to identify how the needs of large business can be better taken into account in the administration of the tax system. The results of this work are set out in *Review of Links with Large Business*, published in November 2006. Implementation of the review's proposals will foster a relationship between business and HMRC built on greater trust and transparency, delivered by a risk-based audit approach which will ensure HMRC resources are focused on key risks so that issues are resolved quickly and companies obtain greater and earlier certainty about the tax implications of their commercial decisions. Further details are provided in Chapter 3.

Review of HMRC powers, deterrents and safeguards

5.92 As part of its ambition to create a world-class revenue department, the Government launched a review of HMRC powers and taxpayer safeguards in March 2005 to provide modern tools for the newly integrated HMRC. The review, informed by a consultative committee of tax experts, business representatives and others, is making good progress. In March this year HMRC launched its second consultation on the general principles of reform and in August more detailed consultation on modernising criminal investigation powers. HMRC is today publishing a summary of responses to the March consultation, which were generally supportive of the broad approach proposed. A detailed consultation on penalties for incorrect returns and a further consultation on criminal powers will follow shortly.

Reviewing HMRC administrative rules

5.93 In addition to minimising administrative burdens imposed on business through the tax system, as described in Chapter 3, HMRC is also reviewing its administrative rules. A new management act will deliver a modern, simpler and more consistent legislative framework for the administration of taxes that is easier both for taxpayers to understand and comply with, and for HMRC to operate. The first set of draft legislation for consultation covering the rules for notification and registration, returns, and assessments for income tax self assessment, corporation tax self assessment and VAT was published on 28 November and is available on the HMRC website. The aim, subject to the outcome of the consultation, is to introduce a Bill in the 2007-08 Parliamentary session.

HMRC online services

5.94 To increase the take-up of its online services, HMRC is investing in its supporting infrastructure and continuing to work with customers and other stakeholders on the implementation of Lord Carter's recommendations.[25] Legislation will be brought forward during 2007 to implement the changes which start in 2008. In July 2006, the Government accepted Lord Carter's revised recommendation for income tax self assessment, so that **the deadlines for filing returns for 2007-08 will be 31 October 2008 for paper and 31 January 2009 for filing online.**

Company filing dates

5.95 Following Lord Carter's recommendations and consultation by HMRC and Companies House, the Government will work to provide a single online filing facility by 2010. **To encourage earlier filing and give businesses certainty sooner, from 2008 the period during which an enquiry can be opened into a corporation tax return will be tied, for most companies, to the actual date HMRC receives the return rather than a fixed filing date.** HMRC will review the impact of these changes.

Modernising the tax system

5.96 The Government believes that the tax system should support its wider economic and social objectives by encouraging work and saving. The Government today announces measures to modernise the tax system and ensure that it keeps pace with developments in the business and personal sectors.

Tax-motivated incorporation

5.97 The Government is committed to ensuring that the small business tax system adapts to the changing business environment and that the UK is the best place in the world to start and grow a business. However, it remains concerned about the tax-motivated incorporation of the self-employed, which involves businesses taking advantage of structural differences in the tax and national insurance contributions (NICs) treatment that applies to companies. The Government will therefore continue to review how the system could be modernised, made simpler, more efficient and more competitive.

Tackling Managed Service Companies

5.98 At Budget 2006 the Government announced that it would respond to evidence of significant growth in Managed Service Company (MSC) schemes which are used to avoid paying employed levels of tax and NICs. There are existing rules – the Intermediaries legislation[26] – to ensure that the correct tax and NICs treatment is applied, but these rules are, in many cases, not being followed by MSCs. This gives them an unfair competitive advantage over compliant businesses and workers. In addition some workers are entering MSC schemes without understanding that they may be giving up employment rights.

5.99 The Government is **today announcing action to tackle Managed Service Company schemes** and is publishing a document on the measures and consulting on draft legislation to implement them. Personal Service Companies will not be within the scope of these measures with the Intermediaries legislation remaining in place as at present.

Income tax and NICs

5.100 The income tax personal allowances will increase in line with inflation in 2007-08. The NICs thresholds and limits will also increase in line with inflation. There will be no change to NICs rates for employers and employees, or to the profit-related NICs paid by the self-employed. Annex B provides further details of the rates and allowances in the tax and benefit system.

[25] *Review of HMRC online services*, Lord Carter of Coles, March 2006.

[26] Chapter 8, Part 2, Income Tax (Earnings and Pensions) Act, 2003; Section 4A, Social Security Contributions and Benefits Act 1992; Social Security (Intermediaries) Regulations 2000, SI 2000/727.

Construction Industry Scheme

5.101 The new Construction Industry Scheme will be introduced on 6 April 2007. The legislation to bring this into effect is being laid in Parliament this afternoon. It will reduce regulatory burdens and help the construction industry comply with its tax obligations. An increasing proportion of sub-contractors in the current scheme do not have their full tax and national insurance liabilities met by their deductions. To reduce the additional payments due after the end of the year, **the new scheme will have a standard deduction rate of 20 per cent.** To enable unregistered sub-contractors to start work sooner and encourage them to register, **the higher deduction rate will be 30 per cent.**

Taxation of foreign profits

5.102 The Government is determined to maintain the overall competitiveness of the UK, and since Budget 2006, has held productive dialogue with stakeholders on the taxation of foreign profits. Following the recent European Court of Justice (ECJ) judgment in Cadbury Schweppes, **changes to the Controlled Foreign Companies (CFC) rules are necessary to ensure they remain effective and to provide increased certainty for business.** The Government will consult with business in 2007 on a wider package of reform.

5.103 The Government will continue to defend the tax system robustly against legal challenges under EU law.

Six year limitation period for all direct tax claims

5.104 The Government **announces today that it will legislate to ensure that the limitation period for the recovery of direct tax paid by mistake of law is six years from the date of payment.** This is to ensure consistency with the limitation period for making claims in respect of direct taxes paid under assessment as a result of a mistake in a tax return, as specified in section 33 Taxes Management Act 1970 and paragraph 51 schedule 18 Finance Act 1998. This follows a recent House of Lords decision and restores the balance of interests secured by such a limitation.

5.105 Taking no action would risk unwarranted transfers from taxpayers in general to the current shareholders of certain claimant companies. The provision will have retrospective effect, but will not disturb the entitlement of those who have secured what amounts to a final judgment in their favour prior to 6 December 2006.

Capital allowances for cars

5.106 At Budget 2006 the Government published an analysis of the administrative burdens of the tax system, including capital allowances. The Government continues to examine opportunities for simplification and the recent consultation on modernising capital allowances for cars indicated businesses would welcome such reform. While there are significant opportunities to reduce administrative burdens, maximising the deregulatory gains of the reform depends on the design of incentives to purchase cleaner cars. The Government will therefore continue discussions with business, and present more detailed proposals at Budget 2007.

Film tax relief

5.107 The European Commission has now given final state aid clearance for the cultural test, which acts as the gateway to the new film tax relief. To ensure continuity in film tax relief during the transition to the new system, the Government has announced it will **extend section 42 relief for films until 31 December 2006. The new film tax relief will commence from 1 January 2007.**

North Sea oil

5.108 In the 2005 Pre-Budget Report, the Government announced that it would hold discussions with the North Sea oil industry on wider structural issues that have implications for the stability of the North Sea oil tax regime. These discussions were completed in September 2006 and the Government welcomes the constructive contributions from industry. The Government is considering the conclusions from these discussions and examining the options for further action on these strategic issues.

5.109 To address an anomaly identified during the course of these discussions, the Government today announces **the removal of fields from the charge to Petroleum Revenue Tax if they are redeveloped following full decommissioning.**

5.110 The Government also **announces the creation of a joint Government and industry working group** to examine the fiscal implications on the current regime in relation to the changed and dual use of North Sea infrastructure in, for example, carbon capture and storage.

Islamic finance

5.111 Since 2003 the Government has taken steps to level the tax and regulatory playing field for alternative finance products, including those designed to be Shari'a compliant. Building on this work, the **Government is working with stakeholders to develop legislative solutions that give equal tax treatment to alternative forms of bond, such as sukuk and amend the existing Community Investment Tax Relief scheme to cover alternative finance products.**

Life assurance companies

5.112 In 2006, the Government published a consultation on certain aspects of the taxation of life assurance companies. The Government welcomes the dialogue that it has had with industry and as an initial response **will bring forward legislation to amalgamate five business categories into one, simplify the rules applying on a transfer of insurance business and modernise the Crown option.**

Modernisation of Lloyd's insurance market

5.113 Following the meeting of the Chancellor's High Level Group on 18 October, a review is underway to look at modernising Lloyd's market practice. To support this process, the Government will introduce legislation to **address an anomaly in the tax framework for corporate members of the Lloyd's insurance market.**

General insurance reserves

5.114 To simplify the tax treatment of general insurance reserves the Government **will introduce legislation to repeal the current complex taxation rules and replace them with a narrowly targeted revenue protection measure**. Consultation will continue to finalise the scope of the legislative changes.

International accounting standards

5.115 Following consultation with business, new tax rules will be introduced for securitisation companies. The tax rules for financial instruments will be modified to address issues arising from the adoption of international accounting standards. Pending the outcome of further discussions, the corporation tax treatment of unclaimed bank balances will be deferred.

Sale and repurchase agreements

5.116 The Government will **consult with business with the aim of simplifying the tax legislation dealing with sale and repurchase agreements** for companies in order to improve the operation of the legislation and reduce compliance costs for companies. Draft clauses will be published shortly.

Stamp duty & stamp duty reserve tax

5.117 The Government will **exempt from stamp duty reserve tax (SDRT), with effect from 1 February 2007, purchases of shares in non-UK resident exchange traded funds** to support development and innovation in the market. It is also discussing with business what measures may be necessary to ensure that reliefs for Stamp Duty on Shares and SDRT continue to operate effectively following the implementation of the EU Markets in Financial Instruments Directive (MiFID) in November 2007.

Changes to the offshore funds tax regime

5.118 The Government will consult with industry to ensure tax rules in the Offshore Funds Regime do not act as a barrier to commercial development of multi-tiered funds. While consultation proceeds, the Government **will legislate in Finance Bill 2007 to address an immediate issue affecting existing multi-tiered fund structures.**

Authorised Investment Funds owning property

5.119 Alongside the introduction of UK-REITs, the Government has been considering the taxation of Authorised Investment Funds that invest in property. The Government has been consulting with interested parties and has identified a number of significant challenges. The Government will continue dialogue with stakeholders to establish how best to address these challenges.

EU Review of VAT and Financial Services

5.120 In the 2005 Pre-Budget Report, the Government announced it would delay implementation of the March 2005 ECJ judgment in the case of Arthur Andersen & Co Accountants concerning VAT and insurance-related services, pending progress in the European Commission review of the VAT treatment of financial services and insurance. The Government will continue to monitor the progress of the review in deciding whether to make the necessary changes to UK law, and will provide industry with sufficient notice following any decision to implement.

VAT: special method of declaration

5.121 Following informal consultation with affected businesses, the Government **will introduce from 1 April 2007 changes to the VAT rules that allow partly-exempt businesses to use bespoke calculation methods to agree how much VAT they can recover.** For the vast majority of the 20,000 businesses affected, these changes will simplify and speed up the administrative process for agreeing special methods of declaration. These changes will also require businesses to confirm that their proposed method gives a fair tax result. The new rules will also allow businesses to include the VAT on certain overseas supplies within their calculation method, which they currently have to reclaim separately.

VAT: retention of records

5.122 Following consultation with businesses, the Government **will bring forward changes in Finance Bill 2007 to clarify the VAT rules on which business records should be retained by the seller or passed to the buyer when a business is sold as a going concern.** This simplification measure will help businesses to retain or acquire the records necessary to ensure compliance with their tax obligations without imposing additional complexity or cost.

Alcohol duty

5.123 The Government is working with the alcohol industry to develop a shared vision of the alcohol duty regime that better reflects modern trade practices. Over 40 obsolete or over-burdensome provisions in alcohol legislation have already been repealed, and early next year, the Government will introduce a radically reformed system for guaranteeing deferred payments of excise duty to deliver significant savings for compliant businesses.

International shopping

5.124 The Government welcomes the recent decision by EU Member States to double the tax-free allowance for international travellers returning from trips outside the EU, with a further review in four years time. **The new allowance of £290 applies to goods for personal use** (excluding tobacco and alcohol products which have separate quantitative limits) and is expected to take effect next year. The increase follows calls by the Government for a higher limit to better reflect modern shopping habits of EU citizens, reduce the burdens on international travellers and allow customs authorities to focus on their key priorities of facilitating trade and combating large scale fraud. New limits on excise goods, for international travellers returning from trips outside the EU, have also been agreed, with an increase from 2 to 4 litres for still wine and a limit on beer set at 16 litres. Limits on perfume, coffee and tea will be abolished.

Protecting tax revenues

5.125 A fair and effective tax system depends on everyone paying their fair share of tax and receiving only those benefits to which they are entitled. While the vast majority of companies and individuals interact with the tax and benefit system in this way, a small minority do not. Such tax avoidance and tax fraud undermine the ability of the system to deliver its objectives, imposing significant costs on the rest of society. The Government's strategic approach to tackling avoidance, evasion and fraud is based on the principles of fairness and customer focus, ensuring that actions are tailored to the needs and behaviours of different taxpayers.

Tackling tax avoidance

5.126 To enable the Government to respond to avoidance more swiftly and in a more targeted fashion, Budget 2004 introduced a disclosure regime. In order to ensure that the regime functions consistently, the Government will **consult on a new power to investigate a scheme where there are reasonable grounds to believe that a promoter has failed to comply with its statutory disclosure obligations.**

5.127 **Legislation, effective from today, will also be introduced to tackle a number of artificial schemes used by companies to avoid tax that have been notified under the disclosure regulations. The Government is also removing the public quotation exemption from the Controlled Foreign Companies regime to prevent specific avoidance.**

Sale of lessors

5.128 As announced on 22 November 2006, and effective from that date, **legislation will be included in Finance Bill 2007, to tackle avoidance schemes that undermine the effect of the provisions on the sale of lessor companies introduced in Finance Act 2006.**

Structured finance

5.129 A measure to tackle avoidance involving structured finance schemes was announced on 6 June 2006 and enacted in Finance Act 2006.

Stamp duty land tax

5.130 This Pre-Budget Report **announces the introduction of secondary legislation, effective from 2pm today, to counter stamp duty land tax avoidance, including a number of known schemes using partnerships, sub-sales and leases.**

Capital gains tax

5.131 The Government is **introducing a measure effective from today that will prevent people creating and using capital losses purely to gain a tax advantage.** This measure will encompass the existing provision for companies included in this year's Finance Act without changing its effect.

Life insurance companies

5.132 **Legislation will be introduced effective from today to ensure that a transaction involving the transfer by life insurers of assets valued according to regulatory principles does not have inappropriate tax consequences.**

MTIC: VAT fraud

5.133 Missing Trader Intra-Community (MTIC) VAT fraud is a large-scale organised criminal attack on the EU VAT system, with the aim of creating large unpaid VAT liabilities and fraudulent VAT repayment claims. The scale of the attack on the VAT system increased in the latter part of 2005-06 and the first quarter of 2006-07, largely in response to a European Court case[27] that created legal uncertainty and removed one of HMRC's arguments used to deny suspect VAT repayment claims. New estimates published today[28] show that the scale of attempted MTIC fraud was between £3.5 billion and £4.75 billion in 2005-06; with an estimated negative impact on VAT receipts during the year of between £2 billion and £3 billion.

5.134 HMRC took proportionate steps to strengthen its operational response to MTIC fraud during 2005-06, including working with other law enforcement agencies to identify and destabilise the criminals behind the fraud and secure a number of convictions; and building a strong evidence base of the goods, people and tactics used in MTIC fraud. These measures helped to mitigate the impact on VAT receipts in 2005-06, though HMRC was obliged to repay suspect claims in the absence of sufficient evidence and robust legal arguments to deny them. However, a significant proportion of attempted frauds are now being stopped and the strengthened operational strategy has greatly reduced the level of attack, as reflected in the rapid fall in missing imports reported in ONS trade statistics.[29] Further legal rulings have

[27] The joined case of Bond House Systems Ltd and others (C-484/03, C-354/03, C-355/03).

[28] *Measuring Indirect Tax Losses – 2006*, HM Revenue and Customs, December 2006.

[29] *Balance of Trade in Goods*, ONS, November 2006.

provided HMRC with a strengthened basis to deny suspect VAT claims. This, together with the re-deployment of over 600 extra staff during 2006-07, mean that the vast majority of suspect repayment claims are now subject to in-depth checking and will not be paid unless and until found to be properly payable. HMRC is also pursuing monies previously paid out where there are suspicions they were associated with fraud.

5.135 The Government is determined to sustain the impact of its strategy and to ensure that HMRC has the tools it needs to combat MTIC fraud. **A further 100 HMRC staff are being redeployed to MTIC strategy, bringing the total to 1500.** As part of its wider strategy of working internationally to combat cross-border fraud, the Government is continuing negotiations with its European partners to secure the introduction of a reverse charge VAT accounting system for goods most commonly used in MTIC frauds. Further legislative measures will be brought forward in Budget 2007 as required.

Reform of VAT low value consignment relief

5.136 The Government continues to monitor the £18 VAT-free threshold for imports of small consignments from outside the EU. Despite the attempts of the Channel Island authorities to limit the exploitation of these rules, the cost of this relief has increased in the last six months to around £90 million per annum. The Government will assess the case for reform to protect tax revenues and will take into account the wider public interest, by balancing the compliance costs on carriers and importers with the impact on UK based retailers.

Tackling tobacco smuggling

5.137 Budget 2006 announced the Government's reinforced strategy for tackling tobacco smuggling. To enhance this strategy, and to tackle the growing problem of counterfeit tobacco, the Government has been working closely with the tobacco industry to identify measures to deal with this threat.

Tackling alcohol fraud

5.138 To tackle spirits fraud, the Government introduced the duty stamps scheme in October 2006. From 1 January 2007 all qualifying spirits sold in the UK must bear a UK duty stamp. However, there are signs that fraudsters are already changing their methods in response to this new environment, and the Government is discussing with the alcohol industry ways to tackle the emerging threat from counterfeit spirits.

Oils fraud

5.139 In the 2004 and 2005 Pre-Budget Reports, the Government announced that it would decrease the differential between rebated oil and main road fuel duties, in support of the oils strategy to combat fraud. HMRC is making good progress to reduce oils fraud to 2 per cent of the diesel market by 2006 and following Budget 2006, discussions with users of rebated gas oil have also provided a deeper evidence base on which to consider future decisions. This Pre-Budget Report announces that, with effect from midnight today, as originally announced in Budget 2006, **rebated oils rates will rise to maintain the differential with main fuel duties.** Further Government action to facilitate the use of biofuel/rebated oil mixes is outlined in Chapter 7.

5.140 HMRC continues to work closely with industry to identify and deal with potential risk areas within oils fraud. New controls have been introduced for aviation turbine fuel this year and HMRC will consult on proposals on the supply of marine fuels and on a potential risk-based relaxation of registered dealers in controlled oils (RDCO) requirements for small compliant suppliers. Following consultation, the Government announced in Budget 2006 proposed changes to the schedule of excepted vehicles entitled to use rebated gas oil, in order to achieve greater consistency and clarity. **The Government has today laid a draft Treasury Order amending the Schedule.**

Energy Products Directive derogations

5.141 The UK has a number of derogations from the Energy Products Directive that enable some oils to be charged duty at a reduced rate. These derogations are due to expire at the end of 2006. The Government has applied to the European Commission for an extension of the derogations for fuel used in private air and pleasure craft navigation, and waste oils reused as fuel, drawing attention in particular to the significant enforcement, regulatory and administrative burdens of withdrawing the derogations. The Commission has declined to renew the derogation on private air navigation. The Government will consider options for legislating the change so as to ensure a suitable period of transition and to minimise the longer-term compliance burden. The Government is yet to receive a response on private pleasure craft and waste oils.

TACKLING GLOBAL POVERTY

Delivering the 2005 commitments

5.142 The commitments made by the EU and the G8 in 2005 on aid, trade, debt relief and governance were important steps towards helping the poorest countries achieve the Millennium Development Goals (MDGs). The focus now has to be on international delivery. While debt relief commitments are being delivered, challenges remain in other areas. The Government's 2004 Spending Review announced that the Department for International Development's (DfID) budget will grow from £3.8 billion in 2004-05 to £5.3 billion in 2007-08, an increase in real terms of 140 per cent since 1997. In 2006, the UK has also taken specific steps towards providing universal primary education (MDG 2) and through the International Finance Facility for Immunisation (IFFIm), combating communicable disease (MDGs 4 and 6). The UK is today taking further steps to improve research and development that supports the MDGs.

Access to healthcare

5.143 Better population health is a prerequisite for developing countries to break out of the cycle of poverty. Many of the major causes of ill health and mortality can be prevented and treated with known and affordable technologies. Many developing countries face a challenge in providing a basic package of healthcare in an environment of severe under-funding and shortages of trained health workers in which barriers to increased take-up of services, like user fees, limit poor people's access. The UK is committed to increasing spending on basic services (education, health, water and sanitation, and social protection) to 50 per cent of our bilateral aid programme by 2010-11. In addition, the UK is also committed to working with developing countries to back ambitious long-term plans to strengthen health systems and help partner governments abolish user fees for basic health services.

HIV/AIDS

5.144 The HIV/AIDS pandemic risks undermining progress towards the MDGs. The UK is strongly committed to achieving the goal – set at the 2005 G7 Finance Ministers and Gleneagles G8 Summit and confirmed by the UN in June 2006 – of universal access to comprehensive HIV prevention, treatment and care by 2010 and has pledged £1.5 billion to AIDS programmes in the three years up to 2008. Strengthening basic health systems, improving access to affordable medicines and improving education, particularly for girls, are critical to success. The UK also supports the long-term replenishment of the Global Fund for AIDS, TB and malaria (GFATM). The UK welcomes the announcement by Germany that tackling HIV/AIDS will be a priority for its G8 Presidency. We will continue to work with the G8 and the wider international community to meet the goal to combat HIV/AIDS.

Research and development

5.145 At present, only 10 per cent of global research and development on health is targeted on diseases that affect 90 per cent of the world's population. The UK Government will double development research funding by 2010, including increased funding for a new generation of drugs and vaccines, particularly through public-private partnerships (PPP). The UK has also led international efforts, with Canada and Italy, to establish a $1.5 billion Advance Market Commitment (AMC), as a means of harnessing greater private sector investment and expertise into research and development for vaccines against diseases that kill millions in developing countries each year. We are committed to the launch of a pilot AMC for a

Pneumococcus vaccine in early 2007. Pneumoccocal disease kills 1.6 million people a year, of which nearly a million are children. A successful AMC would save 5.4 million lives by 2030. The UK believes that AMCs have the potential to accelerate the discovery of vaccines against other killer diseases like Malaria and AIDS.

Collaboration in UK development sciences

5.146 The UK has played a leading international role in promoting policies to help the poorest countries achieve the MDGs. The best policies are firmly rooted in excellent research. The impact of scientific research in the international development context would be strengthened by improved coordination between funders. However, scientific research to cover medical, environmental, agricultural and other aspects of development could be better coordinated to further the UK's contribution to eradicating poverty and disease. By maximising the focus, quality and impact of UK research, we can leverage improved responses to the challenges of meeting the MDGs. Greater collaboration and coordination between the major bodies supporting UK scientific research in the development context will help attain this goal. That is why the Secretary of State for International Development is today announcing **the establishment of a research collaborative for the development sciences.** The collaborative will be led by a high level steering board including leading scientists from the Research Councils, the Wellcome Trust and Government departments that fund development science, and supported by the Gates Foundation in an advisory capacity.

Innovative finance for development

5.147 In 2005 the UK launched an International Finance Facility for immunisation (IFFIm) in partnership with several other donors, which will save an estimated 10 million lives in the poorest countries. The UK has also made a long-term financial commitment over a 20 year period to support an international drug purchase facility, UNITAID, which will help supply poor countries with lower-cost life-saving medicines for AIDS, tuberculosis and malaria. The UK contribution to UNITAID will start at €20 million (around £15 million) in 2007 and, subject to performance, gradually rise to €60 million (around £40 million) by 2011.

Box 5.6 The International Finance Facility for Immunisation

Worldwide, 2-3 million children under the age of five die every year from diseases for which we have, or soon will have, a vaccine. The GAVI Alliance (formerly the Global Alliance for Vaccines and Immunisation) was set up in 2000 to address this. Since 2000, GAVI has immunised over 115 million children and saved 1.7 million lives.

IFFIm was launched by the UK in September 2005 to enable GAVI to significantly expand its immunisation programmes. It will use the capital markets to convert long-term legally binding commitments from donors (UK, France, Italy, Spain, Sweden, Norway, South Africa, Brazil) into up-front resources for development. This frontloading will provide in over 70 of the poorest countries an additional $4 billion to GAVI over the next ten years, immunising an extra 500 million children in the poorest countries and saving 10 million lives, including 5 million children by 2015.

On 7 November 2006, the inaugural bond issue for IFFIm was concluded, raising $1 billion to purchase life-saving vaccines for children. As a gesture of solidarity the first six bonds were individually bought by His Holiness Pope Benedict XVI, the Archbishop of Canterbury, the Chief Rabbi, the Muslim Council of Britain, the Hindu Forum of Britain and the Network of Sikh Organisations. The remaining bonds were 1.75 times oversubscribed.

There are strong health and economic reasons for frontloading resources for immunisation. Early immunisation supports 'herd immunity'. When a child is vaccinated, it not only reduces the risk of him/her catching the disease, but also reduces the risk to others who come in contact with the child. This prevents the spread of disease and many more lives are saved faster.

Education **5.148** Education is one of the most cost effective investments that a country can make to support long-term development, enhancing economic growth as well as health outcomes. There has been some progress towards the education MDGs but not enough. Every day almost 80 million primary school-aged children are denied an education. If the education MDGs are to be achieved, out-of-school children must be enrolled by 2008. Developing countries need long-term predictable financing to enable investment in schools and teaching materials and to train teachers to deliver quality education. That is why the UK has announced that it will **spend at least £8.5 billion ($15 billion) on aid for education over the next ten years and that, for the first time, it will enter into ten-year agreements to help countries finance their education plans.** The UK will continue to call on donors to deliver on their promises and provide long-term predictable financing to support countries' education plans and to achieve the education MDGs.

5.149 Many developing countries are already building on their existing education plans to prepare comprehensive and costed long-term plans to break the cycle of under-investment in education and meet the MDGs. In May, at the Abuja Financing for Development conference, 22 African countries committed to develop ten-year education plans. Following this, in September 2006, at a Ministerial Roundtable on Education at the IMF/World Bank Meetings in Singapore, seventeen African countries presented their progress on developing 10-year education plans. Fully developed and implemented, these plans would secure primary education for an additional 25 million children. At the Ministerial Roundtable, the UK called for an international donor conference on education in 2007, which the European Commission will host.

5.150 Nowhere is the importance of education, both to individuals and to society, more clearly demonstrated than through educating girls. Girls' education has a positive impact on individual's livelihoods, reducing rates of child mortality and HIV and AIDS infection as well as improving the nutrition and subsequent welfare of future generations. However, girls are more likely to be out of school and the UK is therefore calling on countries to include measures to improve the deliver of girls' education in their education plans.

5.151 Children in conflict are also particularly vulnerable. Approximately 39 million children – half of the world's children who are denied a primary school education – live in countries affected by conflict. Education in the midst of conflict can provide an important mechanism for the registration of young children and protection against abuse and can help states to recover from conflict. The UK will work with donor partners, developing countries and international agencies to strengthen the delivery of education to children affected by conflict.

Debt relief **5.152** The experience of the last ten years of the Heavily Indebted Poor Countries (HIPC) Initiative has shown that debt relief can be an extremely effective tool in support of poverty reduction. Under the HIPC initiative the debt burden of the world's poorest countries is being reduced over time by some $60 billion, allowing the savings from debt relief to fund country-owned strategies aimed at reducing poverty. The recent decision by the World Bank and International Monetary Fund (IMF) to remove the sunset clause of the HIPC Initiative will enable all potentially eligible countries to benefit from HIPC debt relief.

5.153 The agreement on the Multilateral Debt Relief Initiative in 2005 will see the debts of 38 HIPCs to the IMF and concessional lending arms of the World Bank and the African Development Bank reduced by over $50 billion. Debt relief worth $38 billion is now being delivered to the 20 countries that have completed the HIPC Initiative. The UK also attaches great importance to extending multilateral debt relief to all of the poorest countries, not just those countries deemed eligible under the HIPC Initiative. The UK will therefore continue to pay its share of the debt service owed to the World Bank and African Development Bank by other low-income countries that meet criteria for ensuring that the debt service savings are used for poverty-reduction. The UK urges other donor countries to agree to deeper debt relief for all low-income countries.

United Nations reform **5.154** The Government welcomes the report of the Secretary General's High Level Panel for System-wide Coherence in the areas of Development, Humanitarian Assistance and the Environment, on which the Chancellor served. The report[30] sets out a series of ambitious but achievable recommendations to improve performance, efficiency, accountability and results within the UN system; to enhance the voice of developing countries; to establish an empowered gender agency; to enhance the UN's role in responding to humanitarian disasters; and to reform the governance of environmental activities to improve their effeciveness. The report provides a clear vision of how the UN should act as one with much stronger coordination between it's agencies, and coherence should be improved at headquarters, with action taken to avoid duplication and overlapping mandates. The Government will work with all stakeholders to implement the recommendations of the report as a matter of priority.

Trade **5.155** Under the right circumstances, trade can be a key driver of economic growth, development and poverty reduction. In the face of a current rise in protectionist sentiment, urgent reform of the global trading system is needed. The UK was extremely disappointed by the suspension of negotiations in the Doha Round of world trade talks this July and is calling for an urgent resumption and conclusion of full negotiations. Key World Trade Organisation (WTO) players need to show bold and concerted leadership to revive the talks and deliver significant increases in market access for developing countries, end export subsidies, substantially reduce all trade-distorting domestic support, and provide effective special and differential treatment to enable developing countries to capture the gains from trade. Developing countries must also have the flexibility to design, plan and sequence trade reforms in line with their country-owned development and poverty reduction strategies.

Aid for trade **5.156** Efforts to open markets and phase out subsidies will only generate a limited supply-side response from poorer countries unless they are complemented by the necessary investments to boost their capacity to trade, to help them participate effectively and fairly in the global trading system. Before the WTO ministerial in Hong Kong in December 2005, developed countries made 'aid for trade' pledges and agreed to prioritise investments in infrastructure. At the Annual Meetings of the IMF and the World Bank in Singapore this September, the UK announced that its support for 'aid for trade', which includes training trade specialists and building trade institutions, as well as support for infrastructure – like roads, ports, and telecommunications – is expected to increase by 50 per cent by 2010-11. This will equate to $750 million a year in 2010.

5.157 Together European countries and the European Commission will increase assistance to a total of €2 billion a year by 2010. Japan has also promised $10 billion over three years and the US a total of $2.7 billion a year by 2010. The UK calls for all countries to turn their commitments into concrete and credible financing, within a new 'aid for trade' framework that cuts red tape and builds the infrastructure that businesses in poor countries need to compete.

Climate change **5.158** The Stern Review highlights that it is the poorest countries and people that are most vulnerable to the effects of climate change. Climate change will have serious effects on agriculture, water supply and health, posing a major obstacle to continued growth and poverty reduction in developing countries. Alongside international action to reduce greenhouse gas emissions, support is needed to help the poorest countries adapt to climate

[30] The full report can be downloaded at: http://www.un.org/events/panel/resources/pdfs/HLP-SWC-FinalReport.pdf

risks, so that the changing climate does not undermine poverty reduction. The UK welcomes the UN Secretary General's announcement at the Nairobi conference in November of steps to help developing countries – especially those in Africa – participate in the Kyoto Protocol's Clean Development Mechanism.

5.159 The UK has already contributed £10 million over three years to two funds agreed by the UN Framework Convention on Climate Change (UNFCCC) Parties: the Special Climate Change Fund (SCCF) and the Least Developed Countries Fund for Climate Change (LDCF). The UK is committed to mainstreaming climate risk reduction into development activities by DfID and multilateral organisations. We already have schemes underway to improve the quality and availability of climate risk data in Africa, and more widely to develop coherent approaches to climate risk screening and assessment. In addition the UK, with Canadian International Development Research Centre, has initiated a £30 million change research programme for 2006-2010, focusing on Africa.

Emergency relief

5.160 The UK Government has played a leading role in seeking international agreement to create the UN Central Emergency Relief Fund (CERF), which will have its own budget to enable the UN to respond immediately and substantially in the aftermath of a disaster, without waiting for donor pledges. The UK is the single largest donor so far with a contribution of £40 million, and has committed to giving £40 million a year over the next three years, making a total commitment £160 million. In addition, the UK has already contributed £50 million to a new IMF Shocks Facility to help reconstruction in countries ravaged by natural disasters or hit by commodity shocks.

5.161 Peace is the first condition for successful development and the Government will continue to support peacekeeping operations. The UK committed an additional £20 million to the African Union Mission in Darfur in February this year, bringing the total UK contribution to £52 million. Since September 2003 the UK has also provided over £126 million in humanitarian assistance to Sudan. The UK aim to work with others in the international community to support Sudan to reach a lasting peace, lay the foundations for sustained poverty reduction and begin to make progress towards the achievement of the MDGS. In 2006-07 the UK will be donating £110 million to Sudan.

5.162 As a member of the Core Group for Lebanon, the UK is actively supporting the Government of Lebanon in its efforts to recover from the crisis, reconstruct its economy and carry out the necessary reforms to ensure growth and stability in the future. The UK has contributed £22.3 million to meet priority relief needs to cover bridge repairs, humanitarian assistance, water sanitation and mine clearing. The UK will continue to provide support and expertise to the Government of Lebanon in the run-up to the reconstruction donor conference, which will take place in Paris in January 2007.

Reconstruction in Iraq

5.163 By the end of 2006, the UK will have disbursed the £544 million pledged in March 2003 for reconstruction in Iraq. In November 2006, the UK pledged a further £100 million over three years for economic regeneration. In addition, the UK and international partners continue to work alongside the Iraqi Government to support the December 2005 Stand-By Arrangement, Iraq's current IMF programme, which was successfully reviewed in August 2006 by the IMF Board.

6 DELIVERING HIGH QUALITY PUBLIC SERVICES

The Government's aim is to deliver world-class public services through sustained investment and far-reaching reform. The 1998 Comprehensive Spending Review (CSR) put in place a modernised framework for public spending and performance management to support the delivery of the Government's long-term priorities.

A decade on from the start of the first CSR, the Government is now conducting a second CSR reporting in 2007. Building on an analysis of the key long-term challenges facing the UK, the 2007 CSR provides the opportunity to assess what further investments and reforms are needed to equip the UK to respond. In preparation for the 2007 CSR, this Pre-Budget Report announces:

- **solid progress in the Government's SR04 efficiency programme, with departments and local authorities reporting gains of £13.3 billion by September 2006, over halfway towards the target of over £21 billion by 2007-08;**
- **building on this success, the baseline savings ambition for the 2007 CSR period will be at least 3 per cent per year across central and local government, with a focus on net cashable savings to free-up resources to meet the challenges ahead;**
- **administration budgets across departments will be reduced by at least 5 per cent per year in real terms over the 2007 CSR period, releasing resources for reallocation to frontline services;**
- **an early CSR07 settlement for the Department for Constitutional Affairs, which will see its budget fall by an annual average of 3.5 per cent in real terms over the 2007 CSR period;**
- **an early CSR07 settlement for education capital with investment rising from £8.3 billion in 2007-08 to £10.2 billion in 2010-11, a total of £36 billion over the next four years; and**
- **the publication of Sir David Varney's review of public service transformation, making recommendations to strengthen and join up public service delivery and make public services more efficient and responsive to the needs of users.**

The Pre-Budget report outlines further measures directing resources to the Government's priorities, including:

- **a further £130 million direct to schools in England in 2007-08, including to support personalised teaching and extended services;**
- **an increased focus on small group and one-to-one support, with the Every Child a Reader scheme rolled out nationally to 30,000 children a year by 2010-11, and an additional £10 million in 2007-08 to increase personalised support in schools where boys are falling behind; and**
- **an additional £84 million to support the ongoing expansion of counter-terrorism capabilities in the Intelligence Agencies.**

6.1 The Government's aim is to deliver world-class public services through sustained investment and far-reaching reform. High quality education and training, a modern health service, a fair and effective criminal justice system and a fast and reliable transport network provide the essential foundations for a flexible economy and a fair society, which is well placed to prosper in the increasingly competitive global environment.

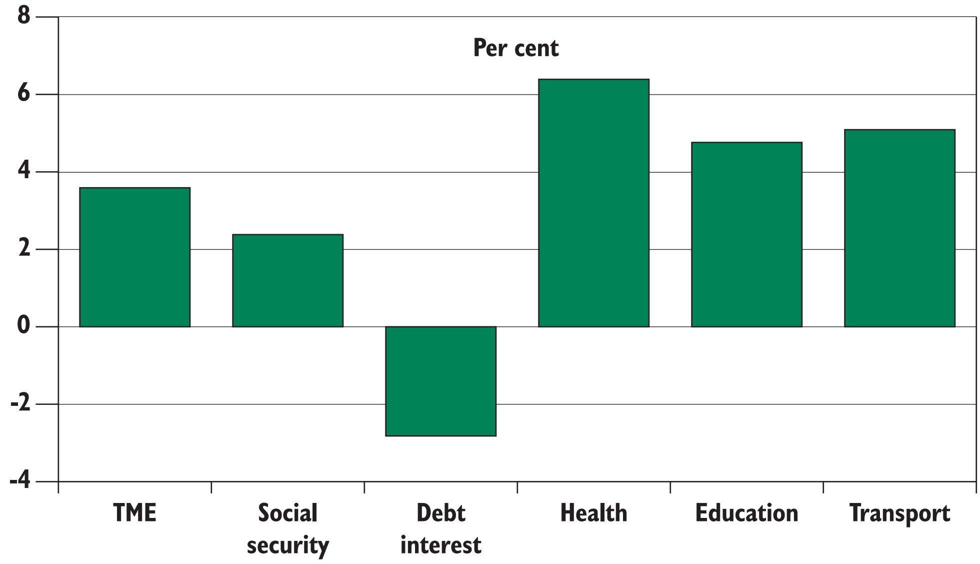
Investing in priorities

6.2 In June 1997 the incoming Government launched the first Comprehensive Spending Review (CSR), to lay the foundations for a modernised public spending and performance management framework that supports the prudent and efficient planning of expenditure over the medium to long term. The 1998 CSR, the most fundamental and in-depth examination of public spending ever attempted, enabled the Government to re-focus resources on its priority areas such as health, policing, education and transport.

6.3 Successive Spending Reviews in 2000, 2002 and 2004 built upon these foundations to deliver further increased resources in these priority areas. These increases in spending were made possible by stable and sustainable economic growth, with falling debt interest payments and low unemployment, as illustrated by Chart 6.1. By 2007-08, compared with 1997-98:

- spending on the National Health Service (NHS) will be nearly 90 per cent higher in real terms, with overall UK health spending as a proportion of GDP expected to rise from 6.8 to over 9 per cent, around the EU average;
- total spending on education will be 60 per cent higher in real terms, rising from one of the lowest in the industrialised world to among the highest; and
- public expenditure on transport is planned to increase by over 60 per cent in real terms.

Chart 6.1: Releasing resources for priorities – real annual average growth rates, 1997-98 to 2007-08



Source: HM Treasury.

6.4 By matching this growth in spending with ambitious reforms to support the efficiency, delivery and accountability of public services, the Government has been able to achieve major improvements in the outcomes achieved across front-line services, including:

- increased resources for the NHS have helped save around 200,000 lives since 1996 as a result of reductions to mortality rates from cancer and cardiovascular disease among people aged under 75;
- over 58 per cent of 16 year olds now achieve five or more good GCSEs, up from 45 per cent in 1997, with some of the biggest improvements seen in disadvantaged areas with a history of low achievement; and
- between 1997 and 2005-06 overall crime rates fell by 35 per cent, and the risk of being a victim of crime is now the lowest recorded by the British Crime Survey since it began in 1981.

Preparing for the decade ahead

Changing domestic and international context

6.5 While much has been achieved in the past decade, the world is changing rapidly, with new challenges emerging that must be addressed in order to lock in these benefits for the decade to come. Since the 1998 CSR huge social, economic and technological changes have transformed the environment in which public services operate. An ageing population, changing patterns of work and family life, the development of the internet and other far-reaching changes have created new and rising demands on public services, ranging from childcare to education and training, and to health and social care. The international context has changed too, with the rapid pace of global economic integration, the emergence of new security challenges following the end of the Cold War, increasing pressures on global ecosystems and a growing international consensus around tackling global poverty.

2007 Comprehensive Spending Review

6.6 These developments will shape the decade ahead, with fundamental implications for public services that will require innovative policy responses, co-ordination of activity across departmental boundaries and sustained investment in key areas. In July 2005, the Chief Secretary to the Treasury therefore announced the launch of a second CSR reporting in 2007. The 2007 CSR will set departmental spending plans and priorities for the years 2008-09, 2009-10 and 2010-11. A decade on from the start of the first CSR, the 2007 CSR provides the opportunity for a fundamental review of the balance and pattern of public expenditure, taking stock of what the programme of investment and reform has delivered to date, and identifying the further steps needed to meet the challenges and opportunities of the decade ahead.

6.7 Over the last year the Government has been laying the groundwork for the 2007 CSR, by taking forward a detailed programme of analytical work involving:

- an examination of the key long-term trends and challenges that will shape the next decade;
- detailed reviews on specific cross-cutting issues where innovative policy responses across departmental boundaries will be required in order to meet the challenges ahead;
- an ambitious and far-reaching value for money programme to release the resources needed to address these challenges, involving further development of the efficiency programme in the areas identified by the Gershon Review, a set of zero-based reviews of particular areas of departments' baseline expenditure, and a review of the opportunities for transforming public services led by Sir David Varney, to assess their effectiveness in delivering the Government's long-term objectives;

- a more strategic approach to asset management and investment decisions, ensuring the UK is equipped with the infrastructure needed to support both public service delivery and the productivity and flexibility of the wider economy; and
- a review of the performance management framework to continue driving outcome-focussed improvements and ensure that public services are accountable and responsive to the needs and expectations of users.

This chapter provides a detailed progress report on each of these elements of the Government's preparations for the 2007 CSR.

MEETING THE LONG-TERM CHALLENGES

Long-term challenges

6.8 *Long-term opportunities and challenges facing the UK: analysis for the 2007 Comprehensive Spending Review,*[1] published on 27 November 2006, describes some of the key long-term trends that will continue to transform both the environment in which public services operate and the UK's role in the world in the decade to come, in particular:

- demographic and socio-economic change, with rapid increases in the old age dependency ratio on the horizon and rising consumer expectations of public services;
- the intensification of cross-border economic competition, with new opportunities for growth, as the balance of international economic activity shifts toward emerging markets such as China and India;
- the rapid pace of innovation and technological diffusion, which will continue to transform the way people live and open up new ways of delivering public services;
- continued global uncertainty with ongoing threats of international terrorism and conflict, and the continued imperative to tackle global poverty; and
- increasing pressures on natural resources and the global climate, requiring action by governments, businesses, and individuals to maintain prosperity and improve environmental care.

6.9 As announced in Budget 2006, CSR07 will be informed by the analysis and conclusions of a series of reviews on key cross-cutting issues where innovative policy responses will be required in order to meet the challenges set out above. An overview on the reviews, described in more detail in other chapters, is set out below.

Demographic & socio-economic change

6.10 Chapter 5 sets out the steps the Government is taking to promote fairness and social justice. To continue making further progress in the context of demographic and socio-economic change over the decade ahead:

- Budget 2006 launched a joint HM Treasury and Department for Education and Skills (DfES) policy review of children and young people to secure further improvement in outcomes. Further details are set out in Box 6.1;
- Budget 2006 also announced a review of the policies needed to improve mental health outcomes and employment, recognising that too many people are excluded from the world of work when, with the proper support, it should be possible for them to find or remain in work benefiting their health and the wider economy (further details are set out in Chapter 4); and

[1] *Long-term opportunities and challenges for the UK: analysis for the 2007 Comprehensive Spending Review,* HM Treasury, November 2006.

- building on the Government's response to Kate Barker's *Review of Housing Supply*,[2] a policy review on supporting housing growth will inform the 2007 CSR to determine the infrastructure implications of growth in different spatial forms and locations, and establish a framework for sustainable and cost effective patterns of growth, as described in Chapter 3.

Box 6.1 Review of Children and Young People

Preventing problems, or intervening as soon as they are identified, is essential to sustain children's life chances. *Every Child Matters*, the Government's programme of reform of services for children, has brought significant improvements. The Review of Children and Young People has identified a number of areas where further progress can be made. For example, continued progress on educational attainment, building social and emotional skills, and supporting parents to play their role in their child's development. The review has received views and inputs from around 200 organisations and has also held consultation events with academics, parents, young people and practicioners from public and voluntary services. Under the umbrella of this review, sub-reviews are focusing on:

- **a strategy for youth services: building on progress made through *Youth Matters*, the review has identified the need to go further to break down the barriers that currently prevent some young people participating in positive activities, raising the quality and consistency of what is made available and involving more young people in the design and delivery of their own opportunities for development;**
- **support for disabled children: despite many examples of good practice, the review has found effective public service responsiveness to the needs of disabled children is not a universal experience. Further progress is needed to understand the impact of support for disabled children, including earlier intervention, enhancing the ability of disabled children and their families to influence the way services are delivered to them, and ensuring local public services cooperate sufficiently to deliver effective packages of care; and**
- **support for families caught in a cycle of low achievement: there are a minority of families with multiple problems leading to particularly harmful outcomes for their children, and using significant resources from a number of public agencies, reducing these services' ability to redirect resources towards prevention for others. This review has identified the need for more effective, coordinated care for these families across different public services, particularly between services for children and for adults.**

6.11 As set out in *Long-term opportunities and challenges facing the UK*, the number of older people, particularly those aged over 85, is expected to rise sharply over coming years with significant implications for public services, such as long-term care for the elderly. Recent reports from Derek Wanless for the King's Fund, the Joseph Rowntree Foundation and others have made important contributions to the debate around the future of social care provision, which will also be informed by Individual Budgets, Partnerships for Older People Projects, direct payments and the In Control programme. In assessing proposals, as part of the long term vision of the 2007 CSR, the Government will consider whether they are affordable, whether they are consistent with progressive universalism and whether they promote independence, dignity, well-being and control in line with *Improving the Life Chances of Disabled People*, the White Paper *Our Health, Our Care, Our Say* and the National Service Framework for Older People.

[2] *Review of Housing Supply*, HM Treasury and the Office of the Deputy Prime Minister, March 2004.

Changing global economy

6.12 The steps set out in Chapters 2 to 4 to entrench macro-economic stability, raise productivity growth and increase employment opportunity for all are essential to ensure every individual and business is able to seize the opportunities of an increasingly competitive and integrated global economy. To make further progress over the CSR07 period:

- the *Eddington Transport Study*, published on 1 December 2006, sets out criteria for securing the maximum long-term benefit from transport investment on economic productivity, stability and growth (further details are set out in Chapter 3);
- the Leitch Review of Skills, published on 5 December 2006, sets out ambitions for the skills profile that the UK should aim to achieve by 2020 (further details in Chapter 3);
- in order to ensure that all regions of the UK prosper in the decades ahead, the Government is reviewing the effectiveness of sub-national interventions on economic development and the regeneration and renewal of deprived areas (further details in Chapter 3); and
- the *Barker Review of Land Use Planning*, published on 5 December 2006, shows how planning policy can better deliver economic growth and prosperity alongside other sustainable development goals (further details in Chapter 3).

Innovation & technological development

6.13 The rapid pace of technological change is set to continue over the decade ahead, creating new opportunities for both businesses and public services. To help harness these opportunities, the Sainsbury Review of science and innovation policies across government will look at what needs to be done to ensure the UK's continued success in wealth creation and scientific policy-making. Chapter 3 sets out further details and also describes the other work the Government is taking forward to maximise the impact of the UK's science and innovation system, including the Cooksey Review of health research and the Gowers Review on intellectual property.

Continued global uncertainty

6.14 Whilst the UK has faced terrorist threats in the past, the global reach, capability and sophistication of international terrorist groups places the current threat on a scale not previously encountered. As part of the Government's continued commitment to meet this challenge, **this Pre-Budget Report announces £84 million to support the ongoing expansion of counter-terrorism capabilities in the Intelligence Agencies launched in the 2004 Spending Review settlement.** Global security in the decade ahead will be shaped by a range of factors, including international responses to poverty, future conflict and areas of instability. As part of its response to these challenges, the 2007 CSR will be informed by a review of the delivery of the Government's counter-terrorism and security strategies. With spending on counter-terrorism and resilience rising to £2 billion by 2007-08, double the pre-9/11 levels, this review is an opportunity to ensure the best use of these resources, including examining the case for a single security budget, and to provide a strategic framework for investment choices.

Environmental pressures & climate change

6.15 *The Stern Review on the Economics of Climate Change*,[3] published in October 2006, examined the consequences of climate change in both developed and developing countries, and the specific implications for the UK. The review, led by Sir Nicholas Stern, concluded that climate change is the greatest market failure the world has seen: the costs of unabated climate change could be between 5 and 20 per cent of global GDP. In contrast, the costs of action to reduce greenhouse gases to avoid the worst impacts of climate change can be limited to around 1 per cent of global GDP. Chapter 7 details the Government's progress and sets out further measures the Government is taking to tackle this challenge.

[3] *Stern Review on the Economics of Climate Change*, Cambridge University Press, October 2006.

Engaging wider society

6.16 The Government alone cannot meet these challenges: citizens, communities, businesses and non-governmental organisations will all play a vital role in shaping the future of UK society. To inform the 2007 CSR and develop a shared understanding of how the country must respond to the challenges of the decade ahead:

- over the past year HM Treasury has consulted extensively to develop a shared understanding of the key long-term challenges and their implications for public services. The conclusions of this analysis and consultation were published in *Long-term opportunities and challenges facing the UK* and box 6.2 sets out the next steps the Government is taking to engage the public;
- the Government has engaged in the largest ever consultation with the third sector as part of a review of its future role in the social and economic regeneration of the UK. *The future role of the third sector in social and economic regeneration: interim report* is published today, as discussed in further detail in Chapter 5; and
- Sir Michael Lyons' Inquiry is addressing the long-term challenges facing local government and is considering how any reforms to the role and funding of local authorities could help meet those challenges, as discussed in more detail later in this chapter.

Box 6.2 Engaging the public on the long-term challenges facing the UK

Recognising that every citizen, business, and community has a major stake in the outcomes of the 2007 CSR, the Government wants to ensure that it is fully informed by widespread public engagement on the long-term challenges facing the UK. As part of its analysis and preparations to date, the Government has already undertaken extensive consultation with over 2000 third sector organisations, service users, front-line professionals, businesses, think-tanks and academics amongst others.

The Government has begun the process of assessing the long-term policy choices it will have to confront in the 2007 CSR and beyond to deliver on its ambitions in the changing domestic and international environment. In addition to the specific policy reviews set out above, the Cabinet has set up Ministerial working groups in six key areas of policy: maintaining a strong and stable economy; public services; security, crime and immigration; energy and environment; foreign policy; and the role of Government. These reviews and discussions are ongoing and will be informed by the analysis set out in *Long-term opportunities and challenges facing the UK.*

Through the policy reviews, Ministerial working groups, the development of delivery agreements for Public Service Agreements and other forms of engagement, the Government will continue to stimulate public debate and listen to people's views on the key opportunities and challenges for the UK and how government, citizens, businesses and communities should be responding to them in the decade ahead.[4]

[4] The Government invites views on the key opportunities and challenges for the UK. These should be sent to csr2007@hm-treasury.gov.uk or CSR2007, FREEPOST 18249, London, N4 1BR.

ENSURING VALUE FOR MONEY

6.17 To ensure that historic increases in investment are translated into better outcomes across public services, the Government has taken a series of steps to drive improvements in delivery and value for money. Achieving greater efficiency supports the delivery of public services by enabling the Government to reinvest resources in further improving key front-line services. The 2004 Spending Review (SR04) set out the Government's ambition of achieving annual efficiency gains of over £21 billion by 2007-08.

6.18 In line with the recommendations of the Gershon Review, the SR04 efficiency programme has focused on key processes that are common across government business and bringing the worst performing business units up to the level of the best. Solid progress has been made, with **departments and local authorities reporting annual efficiency gains of £13.3 billion by the end of September 2006, more than halfway towards the target of over £21 billion by 2007-08**. These include:

- the Ministry of Defence (MOD) launched the People, Pay and Pensions Agency in April and forecasts a reduction of 40 per cent against the previous cost of providing HR services, delivering savings of over £300 million;
- the Department of Health has secured a further £300 million reduction in the cost of reimbursing pharmacists for drugs dispensed, achieved as part of the annual negotiation of the pharmacy contract;
- the Home Office has delivered efficiency gains in asylum support costs totalling £445 million, in part by renegotiating accommodation contracts and using more economical pre-planned accommodation rather than expensive emergency accommodation; and
- local authorities have achieved a total of around £1.9 billion of efficiency savings by the end of March 2006, and are expected to achieve a further £1.3 billion in 2006-07, surpassing the 2007-08 target for local authorities of around £3 billion one year early.

6.19 Reporting on the progress of the Government's efficiency programme in February 2006, the National Audit Office (NAO) recognised that the programme was the first to look at efficiency across the public sector as a whole. The NAO recognised the challenges of verifying and validating efficiency data.[5] The Office of Government Commerce (OGC) has developed, in consultation with the NAO, a framework and criteria against which reported efficiency gains can be assessed.[6] This has improved the way the Government is able to measure and assess efficiency gains.

Workforce reductions

6.20 As part of departmental efficiency programmes, the 2004 Spending Review also outlined plans for a gross reduction of 84,150 posts in civil service and military administration and support functions by 2007-08. These plans include 13,550 staff reallocated to front-line services, leading to a net reduction of 70,600 posts. Budget 2006 reported that gross reductions of over 40,000 posts had been achieved by the end of December 2005. This strong progress has continued, as table 6.1 shows, with **a further 14,600 posts removed, resulting in gross reductions of nearly 55,000 by the end of September 2006**. The programme remains on course to meet its targets.

[5] *Progress in Improving Government Efficiency*, NAO, February 2006.

[6] Further information at http://www.ogc.gov.uk/

Table 6.1: Workforce reduction across departments

Department	Reductions	Reallocations to front line roles	Total reduction
Department for Work and Pensions	20,337	6,667	27,004
HM Revenue & Customs	7,716	2,745	10,461
Ministry of Defence	9,948	0	9,948
Other departments	7,550	0	7,550
Total	45,551	9,412	54,963

Lyons relocations

6.21 The 2004 Spending Review set out the Government's aim to move 20,000 posts out of London and the South East by 2010. **As at the end of September 2006, over 10,500 posts have been successfully relocated confirming that progress is over half way towards the 2010 target.** Examples include:

- over 2,400 posts relocated to Wales;
- over 2,200 posts relocated to Yorkshire and the Humber; and
- over 2,000 posts relocated to the North West.

Transforming government procurement

6.22 The purchase of goods and services by the public sector accounts for a significant proportion of public expenditure, and of demand for goods and services in the economy. The Office of Government Commerce (OGC) supports and challenges departments to secure better value for money savings. The Government is well on track to meet its target of £3 billion of value for money savings from procurement by the end of the 2004 Spending Review period, having already made £2.6 billion of savings in 2005-06.

6.23 To ensure high quality public services, value for money and spending in a sustainable way, the Government will need to maximise the opportunities that businesses can offer through their commercial expertise and ability to innovate. The Government has already made improvements in its procurement capability in recent years. To make the step-change required to further harness business expertise, the Government will shortly announce detailed plans to transform government procurement.

The Kelly Report

6.24 The Government is continuing to implement the recommendations of the Kelly Report.[7] The Public Sector Construction Clients Forum, established in 2005, is working on a guide to the Green Book to promote and encourage the implementation of robust whole-life value techniques, and is also looking at identifying and promoting fair payment techniques.

Value for money in the 2007 CSR

6.25 The 2007 CSR marks the next stage of development in the Government's programme for delivering better value for money in public services. To continue to improve front-line service delivery and release the resources needed to respond to new long-term challenges, CSR07 will go beyond the ambition set in the 2004 Spending Review efficiency programme by:

- deepening the government-wide efficiency programme in the operational areas established by the Gershon Review, with greater engagement of frontline professionals to identify opportunities for service improvements;

[7] See *Increasing competition and improving long-term capacity planning in the government marketplace*, OGC, December 2003.

- taking a radical look at the way that government spends money on programmes and policies ten years on from the first CSR, through a set of zero-based reviews of departments' baseline expenditure;
- delivering a step-change in the management of the public sector asset base, taking forward the recommendations of the Lyons Review of asset management; and
- reviewing the opportunities for transforming service delivery across government, looking at how the channels through which services are delivered can be made more efficient and responsive to the needs of users.

6.26 In July 2006 the Government published an interim report on its value for money programme, announcing that it had already identified scope to deliver savings of at least 2.5 per cent per year over the 2007 CSR period. Based on the further progress that has been made across government, both on the current programme and on departments' preparations for the 2007 CSR, **this Pre-Budget Report can confirm that the baseline savings ambition for the 2007 CSR period will be at least 3 per cent per year across central and local government.** Furthermore, the focus of the CSR07 value for money programme will be on delivering net cashable savings, which will free-up resources to meet new challenges.

6.27 These savings will be delivered through a combination of operational efficiencies, building on the 2004 Spending Review efficiency programme by looking to drive further efficiency savings out of common government processes, and zero-based reviews, re-examining departments' baseline expenditure to reflect changing priorities. For example:

- the Department for Trade and Industry is leading work to simplify the Government's business support schemes, moving from more than 3,000 schemes to no more than 100 by 2010 (described in further detail in Chapter 3);
- the Department for Communities and Local Government (DCLG) is reviewing its housing investment programme to lever in greater private sector investment and identify opportunities to reduce construction costs in the procurement of new social housing and properties for low cost home ownership; and
- the Foreign and Commonwealth Office (FCO) will move to a new hub and spoke system of providing regional management support to local overseas staff and, together with the Department for International Development, will also increase the proportion of overseas staff in co-located offices in host countries from 43 per cent to over 70 per cent.

6.28 Following the early CSR07 spending settlements announced at Budget 2006, **this Pre-Budget Report announces further settlements for the Department for Constitutional Affairs (DCA) and a number of smaller departments** which will embed ongoing value for money savings into their medium-term expenditure planning and lay the foundations for a CSR focussed on meeting the challenges of the decade ahead. Further details are set out in box 6.3.

Box 6.3: Embedding efficiency in departmental expenditure planning

Budget 2006 announced that the Department for Work and Pensions, HM Revenue & Customs, HM Treasury and the Cabinet Office had identified ambitious value for money reforms over the CSR07 period which will enable them to continue improving services within budgets that fall by 5 per cent a year in real terms in 2008-09, 2009-10 and 2010-11.

Since the Budget, strong progress has been made across all departments in their value for money preparations for CSR07. **This Pre-Budget Report announces that the DCA has now also agreed a CSR07 settlement, which will reduce its budget by an annual average of 3.5 per cent in real terms over the CSR07 period.** This settlement, together with over £100 million of up-front transformation funding, will enable the DCA to take forward a series of investments and reforms to improve the efficiency and delivery of justice, including:

- reform of legal aid procurement following the independent review led by Lord Carter, to deliver a system that is financially sustainable over the long term, offers both choice and quality, allows efficient suppliers to prosper and safeguards the future provision of legal aid for those who need it;
- modernisation of the courts, with a long-term programme of investment and renewal in the courts estate, alongside measures to reduce running costs by streamlining back office functions; and
- rationalisation of the Tribunals Service, with the creation of a regional based management structure and an integrated jurisdiction allowing cases to be heard more effectively and flexibly, underpinned by investment to modernise the estate and make better use of IT in case processing.

In addition, this Pre-Budget Report announces early CSR07 settlements for five small departments which will reduce their budgets by 5 per cent a year in real terms over the CSR07 period: the Privy Council Office, National Savings & Investments, the Central Office of Information, the Food Standards Agency and the Government Actuary's Department.

The Government has set aside £1 billion in modernisation funding for the early settlements announced to date, enabling these departments to release a total of over £2 billion in nominal savings over the three years of the CSR07 period and to embed ongoing efficiences over the longer term.

Administration budgets

6.29 Administration budgets set for departments help to drive economy and efficiency in the running of government itself. By harnessing the potential of new technologies and driving out operational efficiencies in the running of departmental business, the Government will also be able to make further progress in reducing the proportion of taxpayers' money that is spent on the administration of departments. Having frozen administration budgets in nominal terms over the 2004 Spending Review period to ensure that all additional expenditure went directly to frontline services, this Pre-Budget Report announces that **the Government will go further over CSR07 with 5 per cent annual real reductions in administration budgets across departments, thereby reducing the proportion of public spending spent on administration to a new low.** MOD administration costs will also be brought into the administration budget control regime on this basis.

6.30 In line with real reductions in administration budgets in the 2007 CSR, the Government will continue to drive value for money in the procurement of professional services. Guidance will be issued to all central departments to ensure tighter control over consultancy fees and contract charges, with tougher budgeting rules to avoid incentives to contract out work from the civil service where this does not offer value for money.

Public sector pay

6.31 Public sector pay accounts for around a quarter of all public spending, and controlling pay is therefore essential in delivering value for money and keeping inflationary pressures in check. The Public Sector Pay Committee (PSPC), established in 2005, sets common objectives for pay across government and ensures that pay awards and pay systems are evidence-based, consistent, and financially sustainable over the long run. The PSPC has already led to real progress on achieving affordable pay settlements, with pay awards recommended by Pay Review Bodies (PRBs) for 2006-07 averaging just 2.25 per cent, the lowest figure since 1993.

6.32 In July 2006, the Chancellor of the Exchequer wrote to the PRBs emphasising the continuing need to ensure pay settlements are based on the achievement of the Government's inflation target of two per cent. The Government will continue to ensure that public sector pay awards contribute to the low and stable inflationary environment and are sustainable in the long term, as well as providing value for money. As part of this commitment, and in preparation for the 2007 CSR, each department will prepare pay and workforce plans setting out how they will achieve this throughout the 2007 CSR period. DCLG will similarly prepare pay and workforce plans for employees in the local government sector.

6.33 The PSPC is continuing to review progress on local pay and will consider options to encourage increased regional flexibility. PRBs are required to have regard to regional and local labour markets, and their effects on recruitment and retention. Relevant departments are required to make clear to PRBs how they expect pay to reflect different local and regional markets. In addition, civil service pay guidance instructs departments to ensure that their pay and reward systems reflects their individual labour market.

Public investment

6.34 The 1998 CSR established public investment as a long-term priority, recognising its crucial contribution to both public service delivery and the productivity and flexibility of the wider economy. Since then, subsequent Spending Reviews have addressed the legacy of under-investment in the nation's public infrastructure, increasing public sector net investment from just 0.6 per cent of GDP in 1997 to a planned level of $2^1/_4$ per cent from 2006-07 onwards. This substantial growth in public investment has been underpinned by reforms to the budgetary and fiscal framework, including separate capital and resource budgets that safeguard long-run capital investment.

6.35 Together with private investment, public sector investment is delivering improvement to capital assets used for public services:

- the NHS is undertaking the biggest hospital building programme in history, with 57 new hospital schemes open since 1997, and another 31 under construction;
- since 1997, all schools have benefited from building improvement, and the Government has committed to providing 21st century facilities for all secondary school pupils and rebuilding or refurbishing half of all primary schools; and
- significant improvements have been achieved in the quality of the strategic road network.

Capital in the 2007 CSR

6.36 Having addressed the most urgent investment backlogs, the challenge for the CSR07 period is to ensure that the Government is getting maximum value for money from its asset base and further investment is focused on the areas where it is most needed to meet the challenges ahead. The 2007 CSR will therefore take a more strategic approach to investment and asset management practices throughout the public sector. Building on the recommendations of the Lyons Review of Asset Management, the centrepiece of this new approach is the development of a unique Asset Management Strategy (AMS) for each department, which sets out the steps departments are taking to maximise the value of their existing asset base and provides a firm foundation for future investment decisions. Departmental AMS will focus on:

- improving the management and utilisation of the assets departments use to deliver public services;
- basing future investment decisions on a more complete assessment of the condition and performance of the existing asset base;
- taking a zero-based approach to capital budgeting, more fully realising the benefits of separate resource and capital budgets; and
- disposing of assets no longer required for public service delivery.

Asset management strategy

6.37 Recognising the importance of efficient management of the Government's asset base to the performance of public services, the 2007 CSR will ensure all departments place greater focus on improving their asset management practices. As part of their AMS, departments will be required to demonstrate that they have in place effective organisational and institutional frameworks for good asset management, consistent with the recommendations of the Lyons Review of Asset Management. This will include:

- robust financial management frameworks;
- clear and effective delegation and accountability;
- robust investment appraisal systems; and
- a framework to assess additional utilisation opportunities of assets and their potential for Wider Markets Activity.

A zero-based approach to capital budgeting

6.38 To strengthen the information base for investment decision-making in the 2007 CSR, the Government is:

- publishing an updated National Asset Register in early 2007, as part of a comprehensive survey of the condition and performance of the public sector asset base; and
- taking a zero-based approach to capital budgeting to ensure that further investment is focused where it is most effective and in the areas where it is most needed to meet the challenges ahead.

Asset disposals

6.39 The 2007 CSR will also encourage all departments to fully explore the potential for realising greater commercial value from their existing asset base. In their individual AMS, departments will outline plans for the exploitation of under-utilised assets and the disposal of assets no longer required for service delivery. These will build upon the progress already made towards the Government's objective of realising £30 billion of asset disposals by 2010-11. The Government is on track to meet this target, **having delivered £5.9 billion of asset disposals in 2005-06, bringing the total up to £12.2 billion since 2004-05.** Box 6.4 provides an update on progress in the disposal of surplus assets in central and local government.

Box 6.4: Asset disposals over the CSR07 period

In 2004, the Government announced an objective to dispose of £30 billion of surplus assets by 2010-11, in order to release under-utilised resources for the investment needed to meet future challenges. The Lyons Review of Asset Management assessed this ambition to be stretching but achievable.

With total asset disposals of £12.2 billion since 2004-05, the Government is on course to meet its objective. As part of the preparatory work for the CSR07 capital review, departments have identified candidates for disposal that ensure the Government remains on track, including:

- **the MOD continues to deliver its strategic programme of estate rationalisation, with total asset disposal receipts reaching £2.2 billion by 2011. The future programme includes the redevelopment of defence training sites, increasing normalisation in Northern Ireland; and the sale of defence estate in Greater London;**
- **the Department for Transport plans to dispose of land and buildings held by the Highways Agency, Channel Tunnel Rail Link and British Railways Board (Residuary) Ltd, releasing over £300 million by 2011;**
- **the Department of the Environment, Food and Rural Affairs plans to sell between £90 million and £100 million of assets across the CSR07 period; and**
- **over the last six months, the FCO have disposed of land in Bangkok worth £50 million and offices in Kampala worth over £2 million.**

6.40 To further strengthen incentives for effective asset management, following consultation with departments, the Government will be implementing changes to the treatment of impairments from 2007-08, removing barriers in the budgeting system to the disposal of surplus assets.

Public corporations

6.41 In addition to the sale of £30 billion of fixed assets by 2010-11, the Government will continue to work with departments and local authorities to consider the potential sale options for public corporations, trading funds and financial assets where:

- they are no longer required to meet the Government's public service objectives;
- the private sector can generate operational efficiencies in the ongoing management of assets and services (through a sale or PPP structure); and
- resources are released from a sale that can be reinvested in public services.

6.42 In line with its commitment to retain only those assets that are required to meet its public service objectives, the Government has completed the sale of Westinghouse for around

£3 billion on 16 October 2006. The Government continues to explore other asset disposals, including the potential sale of part of its stake in British Energy, continuing to seek to realise value from its stake in Urenco and finalising the sale of the Tote.

6.43 Building on this progress, as part of the 2007 CSR, the Treasury will be working with departments to realise the disposal of other public corporations, trading funds and assets where it is economically productive and represents value for money. Additionally, the Government is working with London and Continental Railways to develop restructuring options for the company that could be implemented once section two of the Channel Tunnel Rail Link comes into service.

Public sector spectrum

6.44 In the response to Professor Martin Cave's 2005 audit of public sector spectrum,[8] the Government committed to drive forward a more efficient longer-term management of public sector spectrum through trading, auctions and incentive pricing. The Government and the Office of Communications (Ofcom) are continuing to work together to ensure this programme's long-term success. By the end of 2006, relevant government departments will submit specific proposals to HM Treasury for early release or sharing of spectrum holdings. This will allow the setting of ambitious targets for the sale or leasing of spectrum in the 2007 CSR. The Government will set out detailed plans in March 2007 for the implementation of significant changes to public sector spectrum, and forecasts of future spectrum requirements.

6.45 The UK will switch to digital-only television between 2008 and 2012. The Government's established policy is that future use of the spectrum released following digital switchover should be determined in a technology-neutral auction or auctions. Ofcom will consult shortly on how the cleared spectrum should best be made available for use, with the aim of making a decision in mid-2007.

Investment in education and skills

6.46 Investment in education and skills is vital to making a reality of the Government's commitment to achieve a world-class skills base in the UK. The Leitch Review of Skills sets out ambitions for the skills profile that the UK should aim to achieve by 2020, as described in Chapter 3. The Government has committed record levels of investment to education and skills, with total spending projected to rise to 5.7 per cent of GDP by 2008. Capital investment in the educational estate has risen to unprecedented levels, to £8.3 billion by 2007-08, helping to reverse decades of underinvestment. In 1997 many schools were in poor condition, at or near the end of their expected life and unsuitable for the needs of the modern curriculum. Since 1997 the Government has been committed to a programme of investment across the education estate, including:

- delivery of 3,500 children's centres, one in every community by 2010, with a milestone of 2,500 to be open by 2008;
- a long-term programme of investment in the primary school estate to rebuild or refurbish over half of primary schools over around 15 years;
- providing every secondary school pupil with 21st century facilities through Building Schools for the Future, a long-term programme of strategic investment to rebuild or refurbish all secondary schools over 15 years; and
- increased investment in the further education estate, to deliver a world-class training infrastructure that gives employers confidence to invest in training, and a more responsive sector able to adapt to the rapidly changing needs of employers and learners.

[8] *The Independent Audit of Spectrum Holdings*, Professor Martin Cave, December2005. Available at: www.spectrumaudit.org.uk.

6.47 **This Pre-Budget Report announces that capital investment in education will rise by an additional £250 million, £750 million and £1,850 million over the years 2008-09 to 2010-11. This will result in a total of £8.6 billion in 2008-09, £9.1 billion in 2009-10, and £10.2 billion in 2010-11 invested in the fabric of educational institutions over the CSR07 period, a total of £36 billion over the next four years**. Capital expenditure on education will see annual average growth in real terms of 4.1 per cent over the 2007 CSR period.

REFORMING THE DELIVERY OF PUBLIC SERVICES

Service transformation

6.48 Budget 2006 announced that the Chancellor had asked Sir David Varney, former Executive Chairman of HMRC and former Chairman of O_2, to advise him on the opportunities for transforming the delivery of public services, in particular by looking at how the channels through which services are delivered can be made more responsive to the needs of citizens and businesses. Sir David's report to the Chancellor is published today alongside this Pre-Budget Report.[9] Box 6.5 sets out the key recommendations for further reform in joining up service provision across the public sector.

Box 6.5: Transforming the delivery of public services

Service transformation: A better service for citizens and businesses, a better deal for the taxpayer **builds on the Government's progress in reforming the delivery of public services in the last decade. It responds to the changing expectations of citizens and business, who see their time as an increasingly limited resource, and to the opportunities offered by innovative delivery methods and new technologies. The report identifies how public service delivery can be strengthened by focusing directly on citizens' and businesses' needs and joining up government front-line contact with those needs in mind; saving citizens, businesses and government both time and money. It lays the groundwork for CSR07 transformation of customer contact, including:**

- **developing single contact services for bereavement, change of address and birth by 2010, initiated as pilots, to drive citizen and business focused cross-government working;**
- **improving Directgov and Businesslink.gov so they become the primary information and transactional channels for citizens and businesses, providing citizens and businesses with 24 hours-a-day, 7 days-a-week access to public services;**
- **improving public sector contact centre performance by establishing performance targets and best practice benchmarks, reducing operating costs by 25 per cent, equivalent to a saving of £400 million pounds per year by the end of the CSR07 period;**
- **taking forward proposals to develop a cross-government identity management system to enable greater personalisation of services and to reduce duplication across government, building on a proof of concept project to share data between HMRC, DWP and 12 local authorities;**
- **promoting the importance of citizen and business insight in the design and delivery of public services and developing better use of government channels to encourage a shift of use from face to face services and contact centres towards e-channels;**
- **developing better coordinated and focused face-to-face services, through a cross-government estates strategy, underpinned with departmental plans for increased third sector delivery of these services and more mobile working; and**
- **establishing a detailed delivery plan and quantitative performance indicators which form the basis of a published annual report on service transformation.**

[9] *Service transformation: A better service for citizens and businesses, a better deal for the taxpayer*, HM Treasury, November 2006.

6.49 The Government strongly welcomes this report and will take forward its recommendations as a comprehensive service transformation programme. The service transformation programme will also feed into the 2007 CSR value for money programme. This will provide a means to improve the convenience and access citizens and businesses will have to public services, but in particular for the most vulnerable in society who have the hardest task in accessing services.

6.50 Citizens should be able to access public services in relation to changes in their personal or family life events through a single point. **This Pre-Budget Report announces that, under the leadership of the Secretary of State for Work and Pensions, the Government will immediately establish a feasibility study into a change of circumstances service, starting with bereavement.** If this is successful, the Government will look to make rapid progress in this area.

6.51 Changes in technology and developments in the service sector point to citizens and businesses increasingly wanting to resolve their queries with fewer points of contact, 24 hours-a-day, 7 days-a-week. A much wider number of transactions need to be available online at a time convenient to them. Improving Government's online services is one of Sir David Varney's central recommendations, consequently, **the Government will look to substantially strengthen, and improve the cross-government DirectGov and Businesslink e-services programmes, working with the key departments involved.**

6.52 **A delivery plan to implement Sir David Varney's report for the 2007 CSR will be published next year, led at official level by Sir Gus O'Donnell, the Cabinet Secretary, and the Permanent Secretaries Steering Group (PSSG).** This will include plans for better co-ordinating online services, contact centres and face-to-face services across government, including releasing £400 million for new priorities by the end of 2010-11 from reducing the operating cost of contact centres by 25 per cent. The plan will be informed by advice from the Delivery Council, recently established by the Cabinet Secretary, which builds on and subsumes the work of the Public Services Productivity Panel that is drawing to a close.

Public service reform

6.53 Since their introduction in 1998, Public Service Agreements (PSAs) have played a vital role in galvanising public services to deliver ambitious outcomes, building capacity and providing unprecedented levels of transparency. The service improvements achieved over the last decade have provided the impetus for a more devolved approach, and in successive spending reviews the performance management framework has evolved away from a centrally driven focus on inputs and the prescription of processes, to giving frontline public service professionals increasing flexibility to deliver the outcomes that really matter to the public.

6.54 The Government will further strengthen its approach to performance management and public service delivery in the 2007 CSR, ensuring that it remains focussed on meeting the core needs of citizens and businesses in a rapidly changing world by:

- setting clear national priorities, which drive the collective efforts of departments and frontline professionals in meeting the challenges ahead;
- strengthening accountability for delivery, to ensure sustained improvements are delivered across diverse public service outcomes;
- incentivising responsive public services, by giving public servants the freedom and flexibility to tailor services and develop innovative approaches to reflect local needs; and
- empowering communities and citizens to engage, shifting the balance of the framework so the front line is able to combine a focus on meeting national priorities, with greater accountability to the citizens and the diverse communities they serve.

Setting clear national priorities

6.55 With 90 per cent of existing PSA targets due to come to an end in the forthcoming Spending Review period, a new set of PSAs in the 2007 CSR will express a more focussed list of key cross-government priority outcomes. This smaller set of corporate PSAs will reflect genuine choices about priorities for the 2007 CSR period, serving to unite efforts across departmental and organisational boundaries in meeting them. To ensure the efficient use of resources and a coherent framework for delivery across all departmental business, these PSAs will be complemented by a wider set of strategic objectives within each department.

Strengthening accountability

6.56 In the 2007 CSR systematic engagement and collaboration with public service professionals early in the process will inform the way PSA outcomes are defined, measured and delivered. This will ensure that the Government sets robust indicators, which do not distort operational priorities or create perverse incentives, and that effective plans for delivery are in place from the outset.

6.57 Departments will be required to produce a single, coherent, cross-departmental Delivery Agreement for each PSA, informed by consultation with the delivery chain. Delivery Agreements will clearly set out the level of ambition, strategy for delivery, and role of each organisation involved, allowing scope for delivery plans to reflect the most effective balance between the diverse levers and drivers which impact upon delivery – from competition and choice, to inspection and regulation. For the first time these Delivery Agreements will be published, both to enhance Government's accountability to the public and to ensure key actors throughout the delivery chain are focused on achieving the priorities.

Responsive public services

6.58 Further changes to the performance management framework will also ensure that central bureaucracy does not crowd out local flexibility. In the 2007 CSR every PSA will be underpinned by a small basket of national-level indicators. Precise targets and minimum standards will only be attached to national indicators where this is the most effective way to drive delivery. To increase the responsiveness of public services to the needs of customers, this approach will allow for greater use of indicators that capture user experience and satisfaction.

6.59 The Government also has a crucial role to ensure that the data it asks of the front line is proportionate and appropriate, and that it is collected efficiently. Building on the commitments in the Local Government White Paper, and in the run-up to CSR07, HM Treasury will work with the Better Regulation Executive to establish a mechanism for delivering a sustained reduction in the burden of data requests that departments, their agencies and inspectorates place on the front line.

User engagement

6.60 Finally, the performance management framework will embed a new focus in public services on engaging the communities and citizens they serve, building on recent policy developments. *Strong and Prosperous Communities – The Local Government White Paper*[10] sets out how the Government will empower communities to engage, for example through extending the Community Call for Action across all public services and encouraging the use of local charters. In the 2007 CSR, PSA Delivery Agreements will further drive systematic use of mechanisms that enable citizens to hold public services more directly to account. The Government is also exploring options for giving citizens greater access to timely data on performance of local services, providing 'bottom-up' pressure to improve services and giving users a greater basis on which to exercise choice.

The Third Sector

6.61 As described in Chapter 5, the third sector plays a pivotal role in shaping a fair and enterprising society. The sector also has a specific role to play in the delivery of improved public services through engaging citizens and delivering innovative and responsive

[10] *Strong and Prosperous Communities – The Local Government White Paper*, Department for Communities and Local Government, October 2006

personalised services. The Government provides investment to build capacity in third sector organisations through the Futurebuilders Fund, which has offered investments of grant and loan finance to over 170 organisations since 2004, totalling £68 million. The independent Futurebuilders Advisory Panel is due to report on the Futurebuilders programme at the end of this year. As part of this report, the Government is asking the Panel to look at further opening up the fund to all third sector organisations working to deliver public services. This would particularly help those organisations working on environmental activities including recycling, and those involved in community leisure and sports, many of which are social enterprises.

6.62 Budget 2005 announced the participation of Cumbria, Dorset, Nottingham,[11] Portsmouth and Tower Hamlets Councils as local area pathfinders, committed to exploring ways in which the third sector can add value to the delivery of local services. The Government will shortly publish a report on the outcomes of the pathfinders as part of the evidence base for the third sector policy review. Each of the Councils involved is now implementing a range of actions to deliver a better relationship with the local third sector based on the Compact principles.

Review of Government Offices

6.63 The Government has made strong progress in implementing the review of the Government Offices (GOs), published alongside Budget 2006.[12] Strong performance management and governance measures have been introduced to help GOs achieve a more strategic focus and to enhance their input into central Government policy. The GOs and central government have agreed a benefits framework, which provides the basis for monitoring delivery against the full range of review outcomes. In particular, this will deliver a more streamlined, outcome-focused GO network.

Local government

6.64 Local government has an increasingly important role to play in the delivery of complex public service outcomes. The Local Government White Paper, published in October 2006, sets out how the Government intends to strengthen the role of local government, and increase local flexibility to deliver better outcomes across communities. The Government will create mechanisms for more citizen pressure and greater dynamism at a neighbourhood level, so that the front-line is more accountable to the public, building on this approach through the 2007 CSR. The Government will also reduce unnecessary performance monitoring burdens on local authorities, freeing them up to respond with local solutions to national priorities, and to deliver on the needs of individuals and neighbourhoods. In particular, local authorities will see a significant reduction in the number of national performance indicators, from between 600 to 1,200 down to 200, and a revised Local Area Agreement (LAA) process through which the Government and local partners will agree and manage a limited number of improvement targets for each local area.

6.65 While the new framework will see increased devolution of decision making to local areas, there remains a crucial role for external challenge and assessment. The White Paper realises the Budget 2005 ambition on inspection gate-keeping in relation to local services inspection. The Audit Commission will lead an area-based risk assessment, with the other inspectorates, to inform a programme of intervention. This builds on the successes of the Comprehensive Performance Assessment (CPA) in driving improvement in local authority performance. This will be known as the Comprehensive Area Assessment and will be put in place from 2009-10.

6.66 An independent inquiry, led by Sir Michael Lyons, is addressing the long-term challenges facing local government and is considering how any reforms to the role and funding of local authorities can help to meet those challenges. The Lyons Inquiry's two reports to date have set out his interim findings on funding and on function. Its report on the role of local authorities, published in spring 2006, fed directly into the White Paper.

[11] Nottingham City Council came on board as a pathfinder after Budget 2006.

[12] *Review of Government Offices*, Office of the Deputy Prime Minister and HM Treasury, March 2006.

6.67 The Local Government White Paper, and the Eddington, Leitch and Barker reviews described in Chapter 3, have made important recommendations relating to the Lyons Inquiry. The Government has therefore now asked Sir Michael to consider further their implications in order to ensure a coherent approach to the role, function and funding of local government. The Lyons Inquiry's final report will be published around the time of Budget 2007.

Inspection reform

6.68 The Government remains committed to modernising inspection policy and practice by refocusing inspection on what is most relevant, rationalising processes to better manage complex patterns of scrutiny and reducing burdens on the front line. The overall aim of the strategy is to create a modernised inspection system that gives high performing institutions freedom to deliver while ensuring swift action and intervention for poorer performers. As a result of modernising inspection programmes and a greater use of risk-based, proportionate approaches leading to fewer burdens on front line services, departments' public service inspectorates are close to finalising plans to reduce inspectorate expenditure by around a third over the medium term.

6.69 As well as programme modernisation, structural reforms will go a long way to securing the benefits of a reformed and rationalised inspection. Following the successful passage of the Education and Inspections Act, from 1 April 2007 Ofsted's role will be expanded to include new functions, bringing together for the first time in one body responsibility for inspection of education, children's services and skills; this delivers one key component of the Government's strategy on public sector inspection. To deliver other key elements, a Bill to create the new local services inspectorate is expected to be introduced in the third Parliamentary session, as announced in the Local Government White Paper. A Bill to create a new regulator for the health and adult social care sector is expected to be introduced later in 2007.

6.70 Following debate in Parliament regarding the merger of the five criminal justice inspectorates, the Government has decided for the time being to focus immediate efforts on working to secure the benefits of the institutional merger through closer collaborative working. Inspectorates will be held to account regularly for progress on these issues, and the need for further legislation, including structural changes, will be kept under close review.

DELIVERING BETTER OUTCOMES ACROSS PUBLIC SERVICES

Education

6.71 Spending on education in the UK will double in nominal terms between 1997-98 and 2007-08, rising as a proportion of GDP from 4.5 per cent to 5.7 per cent. These sustained levels of investment, taken together with reforms such as the Literacy and Numeracy Hour, specialists schools and city academies, have supported substantial improvements in pupil results. In 1997, 45.1 per cent of pupils achieved 5 GCSEs at grades A* to C. In 2006, following year on year increases, this figure now stands at 58.1 per cent of pupils. The Government is on course to reach its target of 60 per cent of pupils achieving 5 grades at A* to C by 2008. However, attainment gaps by gender, ethnicity and socio-economic background persist. For example, 62 per cent of girls achieved 5 GCSEs at grades A* to C in 2006, whereas only 52 per cent of boys reached the same level of achievement.

6.72 The Government is committed to raising attainment for all, narrowing attainment gaps, and improving wider outcomes for children, with a long term-ambition for all pupils to have access to the levels of support and opportunity currently available to pupils in the independent sector. In this context, Budget 2006 set out that the Government would aim – over time and adjusting for inflation – to increase funding towards today's private sector day school levels. As a first step towards this long-term goal, Budget 2006 announced that school capital investment would rise from £6.4 billion in 2007-08 to £8.0 billion by 2010-11 – matching 2005-06 private sector per pupil capital investment in real terms. This Pre-Budget Report sets overall capital plans for the Department for Education and Skills for the 2007 CSR period, consistent with this commitment. Further details are set out earlier in this chapter.

Personalised teaching and learning

6.73 Personalised teaching and learning in whole class settings, backed up by tailored support within and beyond the classroom, can drive up results for under attaining groups. Budget 2006 announced additional resources of £585 million over 2006-07 and 2007-08 to support personalisation. **This Pre-Budget Report announces a further £130 million direct to schools in England in 2007-08, including to support personalised teaching and extended services.** These additions, channelled through the Schools Standards Grant, mean that direct payments to schools will rise to an average of £200 per pupil for primary schools, and £225 per pupil for secondary schools. The Gilbert Review, announced in Budget 2006, is considering what steps are necessary to make personalisation a reality in every school and classroom, and will conclude by the end of the year.

6.74 Available evidence suggests that attainment gaps emerge from an early age and that differences in literacy – as key to accessing the rest of the curriculum – are an important factor. The Literacy Strategy, and now the Primary National Strategy, have supported major gains in the number of children achieving expected levels at Key Stages 1 and 2. Proposals set out in the Rose Review on the use of synthetic phonics will further raise standards. The evidence also suggests that some children, particularly those that have fallen behind at an early stage, need extra support and can benefit significantly from intensive tuition. A recent study shows that six year old children taking part in the Every Child a Reader scheme, in which focused support is given to those significantly behind expected reading levels, make progress in reading at well over four times the normal rate and can be brought up to nationally expected levels. Insights from the Rose Review will help improve this approach still further and consideration will be given to the scope for greater cost effectiveness. **This Pre-Budget Report announces that the Every Child a Reader scheme will be rolled out nationally over the CSR07 period, benefiting over 30,000 children a year by 2010-11.**

6.75 The Government is committed to helping parents support their children's early learning needs and progress in literacy. Children and their families now receive books between the ages of 6 and 9 months; 1 and 2 years; and 3 and 4 years of age. **To build on this offer, the Government announces £4 million to ensure that every child in England making the transition to both primary school and secondary school will receive a book from Autumn 2007.**

6.76 While attainment gaps open early, they continue to widen over time. The transition to secondary school can be a particularly difficult period, with many pupils, and especially boys, falling behind between Key Stage 2 and Key Stage 3. **This Pre-Budget Report announces £10 million in 2007-08 to improve guidance to schools on supporting boys' reading and writing, and provide additional small group support and tuition targeted towards 400 secondary schools where the gender gap is largest.**

High quality teaching

6.77 High quality teaching is a key factor in supporting pupils' learning across all phases of education. The Teach First programme is already recruiting outstanding graduates to teach in challenging schools in London and Manchester. Budget 2005 announced that the scheme would be extended across a further four cities. **This Pre-Budget Report announces that Teach First will now expand on a regional basis and will provide high quality graduate teachers to a total of eleven cities by 2009-10.**[13]

Health

6.78 In Budget 2002, the Government announced real increases in NHS funding of 7.2 per cent a year over five years, building on the recommendations of the Wanless report.[14] As a result of these increases the NHS will have received an uplift of almost £100 billion by 2008.

[13] In addition to London and Manchester, Teach First will set up a Midlands regional base (covering Birmingham, Coventry and Nottingham), a Yorkshire and Humberside base (covering Leeds, Sheffield, Bradford, Doncaster and Huddersfield) and a North West regional base (covering Liverpool and the existing operation in Manchester).

[14] *Securing our Future Health*, Derek Wanless, April 2002.

Health spending, which was one of the lowest in Europe, will now be around the European average by 2008. This increase has helped deliver significant improvements in service standards and outcomes:

- over 380,000 fewer patients are waiting for treatment compared with 1997. The number of patients waiting over six months for an operation at the end of September 2006 was less than 200, reduced from around 280,000 in 1997;
- over 98 per cent of those attending Accident and Emergency are now seen within four hours, compared with 80 per cent in 2001-02; and
- heart disease and cancer have been significantly reduced, with 99.9 per cent of people with suspected cancers seen by a specialist within two weeks of an urgent GP referral. 99.3 per cent of patients diagnosed with cancer are treated within one month of the decision to treat.

Transport

6.79 The Government has provided a funding commitment for transport at record levels to deliver sustained improvements to transport networks. Such major investment, currently £260 million per week, has made a real difference to people's travelling experiences:

- on road safety, the number of people killed and seriously injured fell by 33 per cent in 2005, and for children the fall was 49 per cent, compared with the average annual figures between 1994 and 1998;
- the use of local public transport continues to rise, with increases of 8 per cent in bus use and 28 per cent in light rail use between 2000 and 2005; and
- rail performance continues to improve, with punctuality and reliability at 87 per cent, exceeding the 2006 target and reaching the highest level since 2000. Over 4,300 train vehicles with better access for disabled passengers are now in passenger service.

6.80 *The Eddington Transport Study,* published on 1 December 2006, sets out criteria for securing the maximum long-term benefit from transport investment on economic productivity, stability and growth. Further details are set out in Chapter 3.

Security

6.81 In recognition of the significantly increased and enduring nature of the danger of specified operational locations, **the Secretary of State for Defence announced in October an additional tax-free operational allowance worth in total over £60 million a year, based on current commitments.** To be known as the Operational Allowance, this will increase the pay of those serving in Iraq, Afghanistan and the Balkans by up to £2,240 for a 6-month operational tour, and will be backdated to 1 April 2006. For around half of those serving, this will be worth more than the amount they would pay in tax and national insurance while there. All military personnel eligible for the Operational Allowance will be better off as a result.

7 Protecting the Environment

The Government is committed to delivering a strong economy based not just on high and stable levels of growth and employment but also on high standards of environmental stewardship. Climate change is a very significant challenge, and the recently published Stern Review on the Economics of Climate Change has highlighted how long-term global prosperity will be undermined if early and coordinated international action is not taken.

This Pre-Budget Report sets out the next stage in the Government's strategy for tackling climate change both domestically and globally, including:

- **promoting the development of a global carbon market** through the expansion and strengthening of the EU Emissions Trading Scheme and linking it to schemes outside the EU;
- **taking further steps towards realising carbon capture and storage technology,** including tendering for consulting engineers to help enable a decision in 2007 on whether to support a UK-based demonstration plant;
- **an increase in all rates of air passenger duty,** with effect from 1 February 2007, in recognition of the environmental costs of air travel;
- **an inflation-based increase of 1.25 pence per litre (ppl) in the rate of road fuel duty with effect from midnight tonight;** and the same increase of 1.25 ppl in duty for rebated fuels, maintaining the differential with main fuel duty rates;
- **a package of measures to encourage the development of the biofuels market** and innovative types of biofuels;
- **an ambition for all new homes to be zero carbon within a decade with a time-limited stamp duty exemption** for the vast majority of new zero-carbon homes;
- **legislation to ensure householders installing microgeneration are not subject to income tax** on any payment for surplus electricity exported back to the grid; and
- **the extension of the Landlords Energy Saving Allowance** to 2015 and to corporate landlords.

The Pre-Budget Report also reports on the Government's strategy for tackling other environmental challenges, including:

- **confirmation that the standard rate of landfill tax will increase by £3 per tonne to £24 per tonne with effect from 1 April 2007.** The Government will also consider the case for steeper increases in the tax from 2008.

Sustainable development

7.1 The Government is committed to delivering strong, stable and sustainable economic growth. To achieve this aim it is crucial to take care of the natural environment and the resources on which economic activity depends. Economic growth need not be at the expense of the environment. Instead it must be based on the principles of sustainable development: integrating economic prosperity with environmental protection and social equity.

Long-term challenges

7.2 Growth in economies and populations is putting greater pressure on the environment and greater demand on the world's natural resources. Managing this pressure has been identified as a key long-term challenge, set out in *Long-term opportunities and challenges: analysis for the 2007 Comprehensive Spending Review,* published on 27 November 2006.[1] The report assesses how growth has led to increasing levels of degradation, potentially threatening the future benefits derived from the environment. It points to a number of key areas for further action over the coming decade and beyond including:

- *climate change* – the most pressing environmental issue the world faces, which will require a coordinated, international response so that the worst effects can be avoided at manageable cost. Some climate change is already inevitable, so the UK and other countries will also need to plan to adapt;
- *rising levels of waste* – both municipal and commercial and industrial waste streams are expected to increase steadily, at a time when the UK is committed to reducing the volume of waste sent to landfill;
- *water scarcity and water quality* – changes to the UK's climate and demographics will lead to increased pressure on water supplies in some areas, particularly south-east England. Pollution from diffuse and point sources continues to put the quality of water bodies at risk; and
- *biodiversity* – ecosystems with greater biological diversity are more adaptable and resilient to external shocks and changes. Globally, between 10 per cent and 30 per cent of mammal, bird and amphibian species are currently threatened with extinction, and some estimates place the rate of extinction as high as 1,000 times the typical historical background rate. Biodiversity also plays an important regulatory role domestically, underpinning the healthy functioning of the environment.

7.3 Some of these environmental challenges are global, requiring coordinated international action. Notably, the UK accounts for only 2 per cent of global carbon dioxide emissions and this figure is expected to fall to 1.5 per cent by 2020. So the UK is working internationally to reduce emissions in a coordinated way and to encourage the development of sustainable technologies to help achieve this. At the same time, however, domestic action is also needed to enable the UK to meet these environmental challenges. The Government believes this can be done in a way that actively supports increased productivity and growth. Key to this is improving the flexibility of individuals and businesses to respond to changing circumstances through both current policy measures and longer-term innovation and technological change.

Government intervention

7.4 Every section of society – business, individuals and government – has a role to play in helping meet the UK's climate change and other environmental goals. For its part, the Government recognises it is required to take action where market failures prevent long-term economic and environmental consequences from being taken into account in decision-making. A key aim of government intervention is to encourage behavioural change, particularly with regard to the use of energy, waste and water. Investment to increase efficiency in these areas is often a cost-effective option for businesses and households, but short-term cost considerations and market failures can create barriers to the take up of more efficient alternatives. Intervention can correct these market failures, ensuring the implementation of the 'polluter pays' principle in which environmental costs are fully internalised in economic decisions.

[1] *Long-term opportunities and challenges: analysis for the 2007 Comprehensive Spending Review*, HM Treasury, November 2006.

Principled approach

7.5 HM Treasury set out detail about how environmental policy should be developed in its 2002 publication, *Tax and the Environment*. In the 2005 Pre-Budget Report, the Government reiterated the principles that underpin the decision as to whether government intervention is needed and, if so, what the action should be:

- the decision to take action must be evidence-based;
- any intervention to tackle environmental challenges must take place at the appropriate level;
- action to protect the environment must take account of wider economic and social objectives;
- action on the environment must be part of a long-term strategy;
- the right instrument must be chosen to meet each particular objective; and
- where tax is used, it will aim to shift the burden of tax from 'goods' (e.g. employment) to 'bads' (e.g. pollution).

Box 7.1: Action since 1997 to tackle environmental challenges

On climate change:

- **the EU Emissions Trading Scheme to which the UK's contribution will reach savings of 8 million tonnes of carbon (MtC) below business as usual per year by 2010;**
- **the climate change levy and climate change agreements which will deliver emissions reductions of over 6 MtC per year by 2010;**
- **the Renewables Obligation in the electricity supply sector which will save 2.5 MtC per year by 2010;**
- **the Energy Efficiency Commitment to improve energy efficiency in homes which will deliver annual savings of at least 1.9 MtC per year by 2010; and the Warm Front and other fuel programmes which will save 0.4 MtC per year by 2010;**
- **new building regulations which will save 1.5 MtC per year by 2010;**
- **the Low Carbon Buildings Programme and reduced VAT rates to support microgeneration;**
- **the Landlords Energy Saving Allowance and reduced VAT rates for energy-saving materials;**
- **the UK Energy Research Partnership to support research and development;**
- **the Renewable Transport Fuel Obligation which will save 1 MtC per year by 2010;**
- **reformed vehicle excise duty and company car tax to encourage the take up of low-polluting cars, which will save around 0.5 MtC per year by 2010; and**
- **differentials in fuel duties to encourage the use of less-polluting fuels, such as biofuels.**

On managing waste and protecting our natural resources:

- **significant increases in the standard rate of landfill tax;**
- **the Landfill Allowance Trading Scheme to incentivise local authorities to reduce waste going to landfill in the most cost-effective way;**
- **a £1.28 billion PFI programme for new waste management infrastructure;**
- **the aggregates levy to encourage the more sustainable use of aggregates; and**
- **a voluntary initiative to tackle pollution from pesticides used in agriculture.**

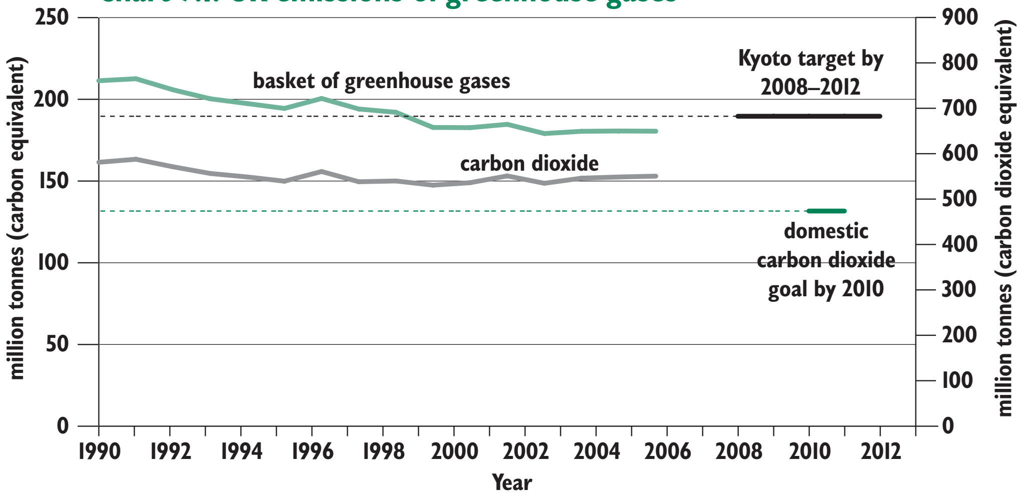
7.6 Within this framework it is essential that the Government uses the most effective instrument to achieve its aims. For instance, regulation or voluntary agreements can be effective where there are a limited number of polluters, or where market failures make product standards for energy or water efficiency the most cost-effective instrument of behavioural change. Spending measures might have a role to play where the polluter cannot afford to reduce the pollution or where the equity or distributional issues make tax or similar measures unacceptable. Fiscal measures can tackle negative externalities by internalising environmental costs into prices and encourage the behavioural changes needed to move to a more sustainable economy. Indeed, as highlighted in its *Statement of Intent on Environmental Taxation,* published in 1997, the Government believes that fiscal measures can be an important part of a wider package of measures and is committed to reforming the tax system to shift the burden from 'goods' to 'bads'.

7.7 Overall, it is crucial that environmental policy is the outcome of balanced decision-making. All intervention by the Government to meet environmental aims must also take account of the impact of any action on our wider economic and social objectives, including macroeconomic stability, business competitiveness, social inclusion and reducing fuel poverty. Within this principled framework for decision-making, the Government has taken significant steps to tackle environmental challenges since 1997, using both fiscal and non-fiscal instruments. Examples of measures introduced are set out in Box 7.1.

Progress to date

7.8 This package of innovative measures, using both tax and non-tax instruments, has resulted in the UK making significant progress on all its environmental priorities, while maintaining strong economic growth.

Chart 7.1: UK emissions of greenhouse gases

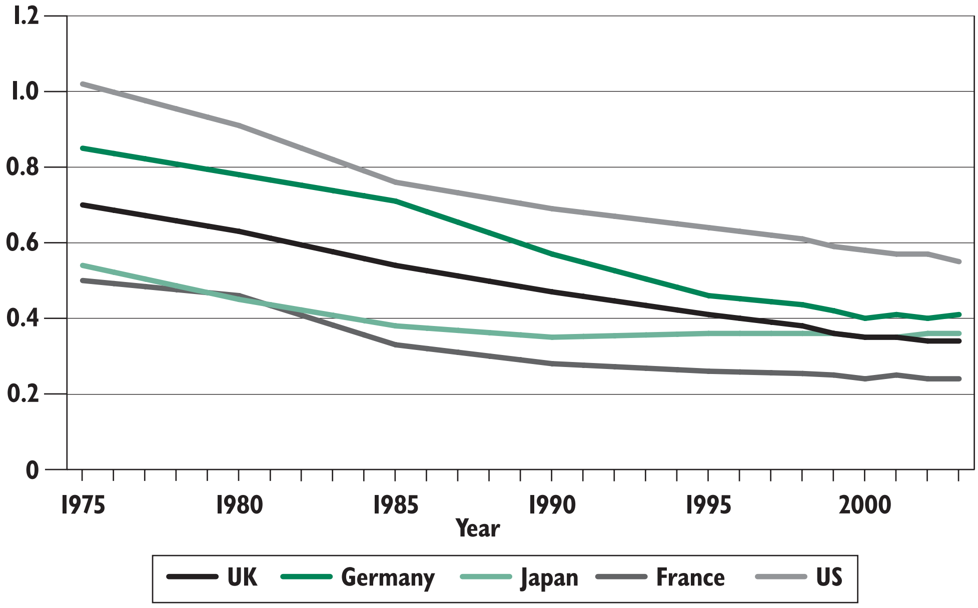


Note: Estimates for 2005 are provisional.
Source: netcen, Defra.

7.9 On climate change:

- UK greenhouse gas emissions fell by 14.5 per cent between 1990 and 2004. The UK is the only G7 country already meeting its Kyoto commitment to reduce greenhouse gas emissions by an average of 12.5 per cent compared with 1990 levels over the years 2008 to 2012. Following the measures announced in the Climate Change Programme Review, projections suggest that by 2012 the UK could reduce its emissions by between 23 to 25 per cent from 1990 levels, going far beyond its Kyoto commitment; and
- carbon intensity, which measures the level of carbon emissions against gross domestic product (GDP), has improved by 55 per cent since the early 1970s at a rate of 2 per cent per year.

Chart 7.2: Carbon intensity – energy related CO_2 emissions/GDP



Source: IEA CO_2 emissions from combustion 1971-2003, 2005.

7.10 Good progress has also been made in other areas. On air quality, between 1997 and 2003, nitrous oxide emissions were reduced by 22 per cent and sulphur dioxide emissions were reduced by 41 per cent. Between 1997-98 and 2005-06, the volume of waste going to landfill fell by 25 per cent and household recycling rates in England increased from around 8 per cent to nearly 27 per cent. Between 2001 and 2005, there was a reduction in sales of virgin aggregate in Great Britain of around 18 million tonnes and an estimated increase in recycled aggregate of around 8 million tonnes. 62 per cent of England's rivers were of good chemical quality in 2004, compared with 43 per cent in 1990. 70 per cent were of good biological quality, up from 60 per cent in 1990.

TACKLING THE GLOBAL CHALLENGE OF CLIMATE CHANGE

Stern Review on the Economics of Climate Change

7.11 The Stern Review on the Economics of Climate Change,[2] announced by the Prime Minister and the Chancellor of the Exchequer in July 2005, was set up to understand more comprehensively the nature of the economic challenges of climate change and how they can be met, both in the UK and globally. Published on 30 October 2006, the Stern Review brings together the latest science on climate change and employs economic methods to assess both the human and environmental impacts of, and responses to, climate change. It examines the consequences of climate change in developed and developing countries, and promotes understanding of the costs and benefits involved in meeting the challenge.

Box 7.2: The Stern Review on the Economics of Climate Change

- **The scientific evidence is overwhelming: climate change is a serious threat and demands an urgent response. Global atmospheric temperatures have risen by about 0.7 degrees Celsius over the last 100 years, with the majority of this rise occurring since the 1970s. Depending on the amount of greenhouse gases emitted and the sensitivity of the climate system, the Intergovernmental Panel on Climate Change (IPCC) predicts that global average temperatures could rise by between 1.4 and 5.8 degrees Celsius by the end of the century.**
- **Climate change on this scale would have very serious impacts on world output, human life and the environment, with all countries affected. The IPCC estimates that the global economic costs of an increase in average global temperature of 2.5 degrees Celsius could be between 1.5 and 2 per cent of global GDP per year. If we do not act, the overall costs of climate change would be equivalent to losing at least 5 per cent of global GDP now and forever.**
- **The risks can be substantially reduced if greenhouse gas levels in the atmosphere can be stabilised between 450 and 550 parts per million carbon dioxide equivalent. This will require global emissions to be at least 25 per cent below current levels by 2050.**
- **Climate change mitigation is a global public good and demands an international response, based on a shared understanding of long-term goals, to support large reductions in greenhouse gas emissions around the world. The costs of taking action can be limited to around 1 per cent of global GDP if there is coordinated multilateral action.**
- **Three elements of policy are required for an effective global response: pricing of carbon – through tax, trading or regulation – with economic efficiency pointing towards a common global price; support for innovation and research, development and deployment of low-carbon technologies; and actions to encourage behaviour change and energy efficiency in the move to a low-carbon economy. In addition, action to reduce deforestation and enable adaptation to climate change is also important.**

7.12 The Government welcomes the Stern Review. Its key conclusions are in line with the Government's existing policy, including its focus on achieving agreement on a post-2012 international framework to address climate change; using multilateral emissions trading as a primary means of pricing carbon in the economy; encouraging the development and deployment of new technology both in developed and developing countries; and incentivising behavioural change especially on energy efficiency.

[2] *Stern Review on the Economics of Climate Change*, October 2006, Cambridge University Press

Tackling climate change through international action

7.13 The Stern Review shows that coordinated international and multilateral action is essential to keep costs manageable and avoid damaging competitiveness. Through the UN Framework Convention on Climate Change (UNFCCC) and the Kyoto Protocol, the world has an international framework within which all governments can work together towards global emissions reductions in an equitable manner. At the Nairobi meeting on the Framework Convention in November 2006, governments agreed a work plan to help developing countries consider the impacts of climate change and how they can best adapt to it. In addition there was further agreement on clean energy investment and deforestation, and ongoing discussions on the future Framework.

International leadership

7.14 The UK Government championed climate change through its G8 and EU presidencies during 2005 and will continue to take the lead internationally on this issue. The Gleneagles Summit in July 2005 achieved significant progress as G8 leaders formally recognised that climate change is a serious and long-term challenge, caused by human activity, which demands an urgent response. The Gleneagles Communiqué and Plan of Action set out a range of agreed actions and principles for tackling climate change. The G8 also committed to work together on a range of global energy issues and recognised the importance of engaging with developing countries to ensure that they can meet their energy needs in a sustainable way. Indeed, the leaders of a number of fast-growing economies – China, India, Brazil, South Africa and Mexico – also attended the G8 Summit and agreed to join G8 countries in taking forward a Dialogue on Climate Change, Clean Energy and Sustainable Development. The commitment to delivering the Gleneagles Plan of Action on Climate Change, Clean Energy and Sustainable Development was reconfirmed at the second Ministerial Dialogue held in Monterrey, Mexico on 3-4 October 2006.

Clean energy investment framework

7.15 The Clean Energy Investment Framework, which is designed to facilitate greater public and private investment in cleaner, more efficient energy, is a direct response by the multilateral development banks to the Gleneagles Action Plan. It complements the Clean Development Mechanism which stimulated investment flows from developed to developing countries of €1.9 billion in 2005, up from €400 million in 2004. The focus of the Framework is on the provision of access to energy in developing countries, the transition to a low-carbon economy and the need to adapt to climate risks, particularly in the poorest countries. The UK has called for a target of $20 billion public and private investment to be set by the banks and looks forward to the full implementation of the Framework. In partnership with the World Bank, the World Economic Forum and the World Business Council on Sustainable Development, a conference will be held in early 2007 to bring the private sector into the Framework.

Pricing carbon through emissions trading

7.16 The Stern Review highlights the role of a common carbon price signal across countries and sectors to ensure that emissions reductions are delivered in the most cost-effective way. The EU, with a strong lead from the UK, has taken the world's most significant step towards carbon pricing by establishing the EU Emissions Trading Scheme (EU ETS) which keeps emissions within fixed limits whilst allowing emissions to be reduced at least cost. The EU ETS is the UK's principal pricing instrument and a key component in a comprehensive UK framework to effectively mitigate climate change.

7.17 EU ETS sets a limit on carbon emissions for 12,000 installations in major industrial sectors across the 25 EU Member States, including over 1,000 sites in the UK. Phase One began in January 2005 and will reduce carbon dioxide emissions in the UK by around 4.6 MtC (around 8 per cent) below the projected emissions of the installations covered by the Scheme by 2007. In November 2006, the European Commission took important decisions on ten Member States' proposed National Allocation Plans (NAP) for EU ETS Phase Two (2008-12). The UK was the only country whose NAP was approved, not rejected, by the Commission. The

Commision decided to reduce allowances permissable in all nine other Member States' NAPs and take allowance levels to below those of 2005 for those Member States. This will ensure scarcity in Phase Two and gives the scheme credibility going forward. The UK NAP for Phase Two commits the UK to contributing emission reductions of 8 MtC per year below business as usual, with 7 per cent of allowances being allocated through the use of auctioning.

7.18 In October 2006, the UK Government published its vision for the long-term future of emissions trading, with the aim of developing EU ETS as the basis of a global carbon market and forging an EU agreement to a post-2012 framework. The UK's key proposals are to:

- set a new Europe-wide emissions reduction target of 30 per cent by 2020 and then at least 60 per cent by 2050, providing greater long-term certainty for business;
- foster a deeper, more liquid market by considering expansion of EU ETS to cover more sectors and gases;
- move towards more auctioning of allowances in future phases to ensure a more efficient allocation; and
- extend the scheme beyond Europe – first, by guaranteeing that credits from Clean Development Mechanism projects in developing countries will be valid for compliance in EU ETS beyond 2012, which will enable not only financial flows but technology transfer to the world's poorest countries; and second, by enabling similar schemes in other countries, such as those being developed in Japan, Australia, the North Eastern American states and California, to trade with the European scheme.

7.19 The first step towards expanding the EU ETS was reached at the meeting of EU Finance Ministers in November 2006, when the countries of the European Free Trade Area – Iceland, Liechtenstein, Norway and Switzerland – agreed in principle to the creation of a pan-European trading scheme. The UK will continue to make links with other countries to deepen and strengthen international emissions trading and **the Pre-Budget Report announces new partnerships with:**

- **the French Finance Ministry to develop joint work on economic instruments to tackle climate change, particularly around the improvement of the functioning of EU ETS; and**
- **the Government of New Zealand to develop joint work and to share advice and experience on emissions trading and other economic instruments to tackle climate change.**

Global carbon market

7.20 Over the last few years a new market in global emissions reduction has developed from trading in allowances created under the EU ETS, national schemes in other countries and the flexible mechanisms of the Kyoto Protocol – the Clean Development Mechanism and Joint Implementation. However, to secure the full benefits of cost-effective global emissions reduction this nascent market needs to evolve, achieving greater scale and liquidity, long-term visibility, and the convergence of currently separate schemes and elements. London is already the pre-eminent centre for this new global market. **The Government will therefore next year bring together the leading market makers in the City with the key international institutions and countries to examine the accounting, legal and institutional infrastructure, and common standards and vision required to support a mature global emissions trading market.**

International collaboration on biofuels

7.21 To further develop new low-carbon transport fuels, the UK has initiated a joint Task Force with Brazil, South Africa and Mozambique to promote the development of a sustainable regional biofuels industry in Southern Africa. This will bring together key partners, including the World Bank and local industries, with leading experts from Brazil, to promote the production and use of biofuels in the region and to enhance South-South technology transfer.

International action on energy efficiency

7.22 With global energy demand expected to grow by 60 per cent over the next 25 years as some two billion people worldwide are connected to an energy supply, energy efficiency forms a crucial element in ensuring sustainable energy supplies. The UK is committed to action at EU and international level to raise the efficiency of energy-using products and is leading the international task force established at Gleneagles to reduce stand-by power to 1 Watt (the IEA 1 Watt initiative). As there is a clear advantage in coordinating action at an EU level, the UK Government will also be encouraging the European Commission to take forward proposals in their Energy Efficiency Action Plan.

Deforestation

7.23 Around 18 per cent of global greenhouse gas emissions come from deforestation. The Stern Review highlights the importance of reducing deforestation as part of the global effort to combat climate change. Sustainable forestry management has the potential to deliver many economic benefits for local communities, as well as wider environmental gains. Forests are of great global importance for climate change and biodiversity. But they are also sovereign territory of those countries, and only those nations can decide what happens to them. Over the coming months the UK Government will therefore be working in partnership with other governments including Brazil, Papua New Guinea, Costa Rica and the Coalition of Rainforest Nations, with Germany as Presidents of the G8 and the EU, and with the World Bank and other interested parties, to explore ways of mobilising international resources to assist developing countries in sustainable forestry management.

Adaptation

7.24 The Stern Review also emphasises the importance of adaptation, as some impacts of climate change are no longer avoidable. In particular, assistance to developing countries is crucial in ensuring that the changing climate does not adversely impact on growth in these regions, as they will be most affected by the effects of climate change. The UK has already contributed £10 million over three years to the Special Climate Change Fund and the Least Developed Countries Fund for Climate Change. The UK also has schemes underway to develop more effective approaches to climate risk screening and assessment worldwide, and to improve the quality and availability of climate risk data in Africa.

Tackling climate change through domestic action

7.25 Alongside the Government's international strategy, further domestic action to tackle climate change needs to continue to support economic growth and take account of future energy market conditions which may be more difficult than in the recent past. The EU ETS, which already covers approximately half of UK carbon emissions including those from electricity generation, forms the central component in the Government's domestic policy framework to tackle climate change. Further domestic action must take account of EU commitments to the post-2012 international framework and must be carefully designed to complement the EU ETS.

Reducing emissions in the energy supply sector

7.26 In July 2006, the Government published its Energy Review[3] which set out the challenges for future energy policy in meeting the UK's objectives of: a reliable energy supply; lower greenhouse gas emissions; the promotion of competitive energy markets; and adequate and affordable heating for every household in the UK. The solution to meeting these different challenges is the promotion of a diverse energy supply including renewable energy, nuclear power and fossil fuels using new carbon abatement technology to reduce emissions. The Government's role is to provide the right incentives to allow the market to invest in this range of technologies, using policies such as current fiscal measures, the Renewables Obligation, and importantly a long-term carbon price created by the EU ETS.

Carbon capture and storage

7.27 Carbon capture and storage (CCS) could reduce the carbon dioxide emissions from fossil fuel power stations by as much as 90 per cent. The Stern Review also highlighted the strategic role that CCS technology could play globally to lower carbon emissions, particularly in fast-growing economies with rising fossil fuel consumption such as China and India. Budget 2006 launched a consultation on the barriers to wide-scale commercial deployment of CCS in the UK, and the potential role of economic incentives in addressing those barriers, the responses to which are being published today. Since the Budget, the Government has set up a taskforce to examine the regulatory framework that will facilitate CCS. The UK also pressed successfully for reform in international fora: in November 2006 the London Convention was amended to allow carbon dioxide to be stored in geological formations below the sea, a major step towards enabling the implementation of CCS.

7.28 The Government made clear in the Energy Review that the next logical step for CCS would be building a full-scale demonstration plant, subject to it being cost-effective. **The Government is announcing today that the Department for Trade and Industry (DTI) will shortly tender for consulting engineers to ensure that the Government's understanding of the costs of a CCS plant based in the UK is robust, and to help the Government assess whether supporting one through a challenge fund or other mechanism would provide value for money.** The details of any support package will be subject to further analysis and consultation. These actions will enable a decision in 2007 on whether to support a UK-based demonstration plant.

7.29 The Government is also continuing to work with the Norwegian Government through the North Sea Basin Task Force to develop a common set of principles to regulate the transport and storage of carbon dioxide beneath the North Sea. The Task Force will submit a report to the UK and Norwegian energy ministers early in 2007 which will lay the foundations for a regulatory framework to enable CCS to develop effectively, safely and in line with the Government's environmental principles. **As a next step, the UK and Norway have agreed the terms of reference for a joint study of the infrastructure needed to transport and store carbon dioxide below the North Sea and will work together on an analysis of the appropriate market framework and value chain which can help deliver this. The outcome of this and other collaborative work will be published by July 2007.** As mentioned in Chapter 5, a joint Government and industry working group will examine the fiscal implications of the current North Sea tax regime in relation to the changed and dual use of North Sea infrastructure including for CCS. The UK is also leading a joint EU-China project to build a commercially viable near-zero emissions coal (NZEC) power plant in China.

Microgeneration

7.30 Microgeneration technologies, such as solar heating and micro-wind, have the potential to contribute to both improved energy security and lower carbon emissions. In order to stimulate demand for these new and emerging technologies, the Government has

[3] *The Energy Review: The Energy Challenge*, DTI, July 2006.

introduced reduced VAT rates and the Low Carbon Buildings Programme to encourage their adoption by individuals. Budget 2006 announced an additional £50 million to fund Phase Two of the Low Carbon Buildings Programme which aims to stimulate the market for certain microgeneration technologies so that, at the programme's close, they can be commercially supplied to the market at a lower price than at present. Public sector organisations and charitable bodies will be the recipients of the grants under this scheme, which aims to be up and running by December 2006.

7.31 Surplus electricity generated by microgeneration technologies can be sold back to energy suppliers. **To further reduce the barriers to adoption of these technologies, the Government will legislate in Finance Bill 2007 to confirm that, where an individual householder installs microgeneration technology in their home for the purpose of generating power for their personal use, any payment or credit they receive from the sale of surplus power is not subject to income tax, and they are not required to include it in their income tax return.**

Environmental technologies

7.32 As announced alongside the publication of the UK's National Allocation Plan for EU ETS Phase Two, a new Environmental Transformation Fund will be established to support renewable energy, biofuels and other non-nuclear, low-carbon technologies including CCS. Details will be announced in the 2007 Comprehensive Spending Review. Budget 2006 also announced the launch of the Energy Technologies Institute, a 50:50 public private partnership, to deliver a step change in the funding, strategic direction and outcome of UK energy science and technology. A prospectus[4] was launched earlier this year setting out the role of the Institute and inviting expressions of interest from potential industry partners. BP, E.ON UK, Shell, EDF Energy, Rolls Royce and Scottish and Southern Energy are already involved in this unique venture and £550 million in public and private contributions has been raised so far.

Security of energy supply

7.33 It is crucial to the economy that reliable and competitively-priced supplies of electricity and gas are available to households and business. Last winter, a tight demand-supply balance pushed wholesales prices higher than normal. This year, import capacity is expected to increase by nearly a third, storage levels are high and wholesale prices have begun to fall. Upward pressure on utility bills is therefore expected to abate, and supply in both the electricity and gas sectors looks likely to meet demand.

Reducing emissions in the business sector

7.34 Growing awareness of climate change issues, alongside the introduction of key Government policies, has led to many more companies contributing towards emissions reductions and taking action to improve their energy efficiency. The Government is committed to implementing a coherent policy framework that supports these actions. Since its introduction in 2005, the EU ETS has established a carbon price for approximately half the UK's carbon emissions, including all emissions from electricity in the economy. The Government has sought to complement the EU ETS with a range of national measures to improve business energy efficiency.

Climate change levy

7.35 The UK's energy tax – the climate change levy (CCL) – was introduced in 2001 to encourage businesses to reduce energy demand and subsequently the EU made it a requirement for all Member States to tax the business use of energy. The CCL was accompanied by a 0.3 percentage point cut in employer national insurance contributions (NICs) resulting in a net reduction in tax liability for business. The levy, and parallel taxes in other EU countries, provide an important complement to the EU ETS by incentivising firms to improve energy efficiency and so supporting achievement of the EU ETS cap. Analysis suggests that the same level of environmental and efficiency gains would not have been made by the EU

[4] *Energy Technologies Institute Prospectus*, DTI, September 2006.

ETS alone. As set out in paragraph 7.25, domestic action must be carefully designed to complement the EU ETS and the Government will continue to review the case for reforms to the CCL. The context is the impact on the overall level of carbon emissions and the development of EU ETS Phase Three after 2012.

7.36 The CCL plays a crucial role in enabling the UK to meet its Kyoto targets. Independent analysis by Cambridge Econometrics[5] estimated that the levy will deliver cumulative savings of 16.5 MtC to 2005. By 2010, it is estimated that the levy will be saving around 3.5 MtC a year, well above initial estimates, and will have reduced energy demand in the commercial and public sector by nearly 15 per cent a year compared with the levy package not being in place. The full impact of the CCL was set out in detail in a report published at Budget 2006. The Government expects that the rates of the levy will at least keep pace with inflation over time. **As announced in Budget 2006, having kept the CCL at its original level for its first five years, the Government confirms that CCL rates will increase in line with inflation from 1 April 2007 to maintain the levy's environmental impact. The new rates will be:**

- **Electricity 0.441 of a penny per kilowatt hour (KWh)**
- **Gas 0.154 of a penny per KWh**
- **LPG 0.985 of a penny per kilogramme (kg)**
- **Solid fuels 1.201 pence per kg**

Climate change agreements

7.37 Climate change agreements (CCAs), which allow energy-intensive firms an 80 per cent reduction on the CCL in return for delivering energy-saving measures, were introduced in 2001 alongside the levy. CCAs were originally forecast to save 2.5 MtC a year but these targets have already been exceeded by an extra 1 MtC in the period to 2002, and by 1.4 MtC in the period to 2004. Indeed, CCAs have increased carbon savings above the level that would have been achieved if all firms paid the full CCL rates. By 2010, it is estimated that CCAs will deliver savings of around 2.8 MtC per year. Regular reviews of existing CCAs by the Department for Environment, Food, and Rural Affairs (Defra) continue to ensure that the energy efficiency improvements and emissions reductions delivered by the agreements are maximised. Since Budget 2006, State aids clearance has been received to enable two additional sectors to sign CCAs – the Cold Storage and Distribution Federation (covering large temperature-controlled storage facilities) and the British Glass Manufacturing Federation (covering the manufacture of glass beads, laminated and safety glass). Over 50 sectors are now able to benefit from the 80 per cent discount in CCL in return for agreeing to improve energy efficiency and/or reduce emissions.

Enhanced Capital Allowances and the Carbon Trust

7.38 Alongside the CCL and CCAs, the Government has also introduced Enhanced Capital Allowances (ECAs)for energy-saving technologies, with over 14,000 approved products now eligible for support, and increased funding for the Carbon Trust which provides businesses with advice on improving their energy efficiency, as well as interest-free loans to fund capital energy-saving projects such as lighting, insulation and boilers. In 2004-05, the Carbon Trust worked with over 2,800 organisations, resulting in cost savings of £200 million for business.

7.39 Budget 2006 announced that the Financial Secretary to the Treasury and Richard Ellis, chair of the East of England Development Agency, would jointly chair a task group, comprising representative business organisations, Regional Development Agencies and the Carbon Trust, to consider the scope for improving existing ways of providing information and support on energy efficiency to business. An analysis was conducted of the services available to businesses in this field, and the business organisations conducted surveys of their members' knowledge and experience of them. The group found that there are a large number of different Government-sponsored advice services which are poorly coordinated and do not

[5] *Modelling the Initial Effects of the Climate Change Levy*, Cambridge Econometrics, March 2005, available at www.hmrc.gov.uk

necessarily match customer needs. It also identified some key barriers to greater energy efficiency uptake by business, including insufficient information and misunderstanding of costs and benefits. In response to these findings, the Government will seek to streamline and coordinate services as part of the wider programme to reduce the complexity of business support, and better tailor services to business needs. The Regional Development Agencies will promote streamlined advice on resource efficiency through Business Link. In addition, the CBI, the Engineering Employers' Federation, British Chambers of Commerce and the Federation of Small Businesses have agreed to play a more active role in engaging their members, for example by using their networks to provide more information and signposting services through workshops and webpages.

Large non-energy-intensive organisations

7.40 In the Energy Review, the Government highlighted that there is the potential for further cost-effective carbon savings from large non-energy-intensive organisations such as supermarkets and large hotels. This sector of the economy is already covered by some policy measures, such as the CCL and the carbon price established by the EU ETS which is passed through in electricity prices. In October, the Government launched a consultation on how to improve energy efficiency in this sector and set out possible policy options, including a mandatory trading scheme and voluntary benchmarking and reporting.

Reducing emissions in the household sector

7.41 Households account for over a quarter of UK energy consumption and carbon emissions. Many household energy efficiency measures can reduce emissions cost-effectively but are not taken up due to a variety of market failures. New policies have been introduced by the Government to help reduce short-term cost barriers and send effective signals to the marketplace.

Energy Efficiency Commitment

7.42 In 2002, the Government introduced the Energy Efficiency Commitment (EEC) which requires energy suppliers to achieve targets for installing energy efficiency measures in the household sector, particularly among the most vulnerable. The current phase of the EEC, over 2005-08, roughly doubles the activity of the first phase; combined, these should deliver savings of nearly 1 MtC a year by 2010. Budget 2006 announced that suppliers could count extra work carried out in this phase of EEC towards their targets in the next period. As a result, five suppliers agreed to carry out an additional 250,000 subsidised installations of home insulation under the current phase, bringing forward annual carbon savings of 35,000 tonnes and reducing household bills by around £20 million. The Government believes that activity in the third phase of EEC (2008-11) could save a further 0.9-1.2 MtC a year by 2010, whilst recognising that the scheme needs to remain cost-effective and practical and the overall policy framework needs to continue to take account of wider social considerations. **As set out in Chapter 5, the Pre-Budget Report announces new investment of £7.5 million to improve the coordination between, and effectiveness of, Warm Front and the Energy Efficiency Commitment. This will fund projects using an area-based approach to identify households and provide the right coordinated set of advice and measures for them.**

Energy services market

7.43 The development of an energy services market, where energy suppliers sell particular services rather than energy alone, could improve energy efficiency across the economy and benefit consumers. HM Treasury hosted a seminar in January 2006 to explore possibilities for encouraging the development of such a market, and an independent industry group developed proposals to feed into the Energy Review. The Energy Review set out the aim of incentivising energy suppliers to engage more actively with customers in order to deliver greater energy efficiency in the home and noted that the energy companies are willing to go in this direction – to change their whole business model – given the right policy framework.

7.44 Budget 2006 announced funds totalling £9.75 million for local authorities and energy companies to pilot new ways of reducing energy demand. A tendering process has been undertaken to select schemes that encourage improved energy efficiency in homes, such as improved billing and metering, and an update on progress will be made shortly. The results of these trials, together with further analytical work and consultation with interested parties, will inform whether, and if so how, a move towards an energy services model can be achieved. **To encourage more households to become low-carbon, and to develop the energy services model, the Government will examine the possibility of establishing new methods of financing energy audits and energy-saving measures that could over time pay for themselves in lower fuel bills.**

Code for sustainable homes

7.45 To lower the carbon impact of new development and encourage energy efficiency in housebuilding, the Department for Communities and Local Government (DCLG) will shortly publish the Code for Sustainable Homes which will set out levels for sustainability in homebuilding and challenge developers to go further in meeting these standards. The Government will also continue to drive forward improvements in the sustainability of new housing through tougher building regulations. Alongside the 2002 update to regulations, the new Part L building regulations, which came into force on 6 April 2006, will increase the energy efficiency of new homes by 40 per cent. This will mean that the fuel bills for an average three-bed semi-detached home with gas central heating built to the new 2006 building regulations will be £120 a year less than its equivalent built in 1997. These new standards (including measures for boilers announced in April 2005) will deliver a saving of 0.98 MtC per year by 2010. Going forward, and incorporating the new Code for Sustainable Homes, the Government will also be setting out a consultative timetable for progressively strengthening building regulations in England and Wales to reflect the energy efficiency levels set out in the Code.

Zero-carbon homes

7.46 **It is the Government's ambition that, as a result of this strengthening, by 2016 all new homes will be 'zero-carbon', meeting the highest Code standard for energy efficiency. To bring forward progress towards this aim, the Pre-Budget Report announces that a stamp duty exemption for the vast majority of new zero-carbon homes will be introduced in 2007.** The exemption, which will be time limited, is designed to incentivise demand for zero-carbon homes among homebuyers, recognising that in order to raise energy efficiency standards significantly beyond where they are now the industry will have to modernise production methods and innovate through employment of new materials and technologies. Full details will be published at the time of Budget 2007.

Private rented sector

7.47 A particular market failure exists in the private rented sector because cost savings from investing in energy efficiency are difficult for landlords to recover in increased rent. In Budget 2004, the Government took action to correct this market failure by introducing the Landlords Energy Saving Allowance (LESA) which provides an allowance of up to £1,500 for landlords who invest in cavity wall and loft insulation. LESA has since been extended to solid wall and hot water system insulation as well as draught proofing. Following more detailed work on the operational delivery of the proposed Green Landlord Scheme, the Government no longer intends to reform the Wear & Tear Allowance by making it conditional on the energy efficiency of the property, but will instead expand the scope of the existing LESA. **The Government therefore announces, subject to any necessary State aids clearance: the expansion of LESA to corporate landlords; an extension to the existing sunset clause from 2009 to 2015; the application of the allowance per property rather than per building, ensuring that even smaller properties have access to the full allowance; and the addition of the acquisition and installation of floor insulation as qualifying investment.**

Product policy

7.48 Labelling, standards and other requirements for large household appliances have raised the share of A-rated fridges and freezers from 1 per cent in 1997 to 65 per cent in 2005, saving 0.45 MtC a year by 2010 compared with 1999 and enough electricity to power 750,000 homes. However smaller consumer electronics such as televisions, DVD players and digital set-top boxes emit up to 1MtC a year when on standby, costing each household around £25 a year in wasted electricity. Budget 2006 announced a new initiative, in partnership with major retailers and the Energy Saving Trust, to introduce voluntary schemes in the retail sector to encourage the purchase of more energy efficient alternatives in consumer electronics.

Reducing emissions in the public sector

7.49 The public sector has an important role to play in setting an example to encourage all individuals, households and firms to improve their energy efficiency and limit their environmental impact. All government departments have to produce focused action plans to reduce carbon emissions and to renew them annually. In June 2006 the Government announced that all the central government office estate is to be carbon neutral by 2012, and set new targets for energy efficiency, water, waste and biodiversity. At the local authority level, a best value energy efficiency indicator requires local authorities to address their energy consumption and a seminar held at HM Treasury in October 2006 brought together central and local government to encourage the further dissemination of best practice and innovation. The Carbon Trust also runs a revolving loan fund to support energy efficiency investment by local authorities and other public sector organisations, delivered by Salix Finance.

7.50 The public sector spends over £125 billion on goods and services a year and it is vital that this investment is spent in a way that is good for the environment as well as good value for money. It is a condition of funding for the Building Schools for the Future programme that all schools being rebuilt or subject to major refurbishment meet the Building Research Establishment's environmental assessment method 'very good' or 'excellent' rating for schools. **To extend our ambition for low-carbon buildings, the Government will now test even higher standards for new and refurbished schools to reduce their carbon emissions by up to 60 per cent over existing standards, and in some cases up to carbon neutrality.**

Reducing emissions in the transport sector

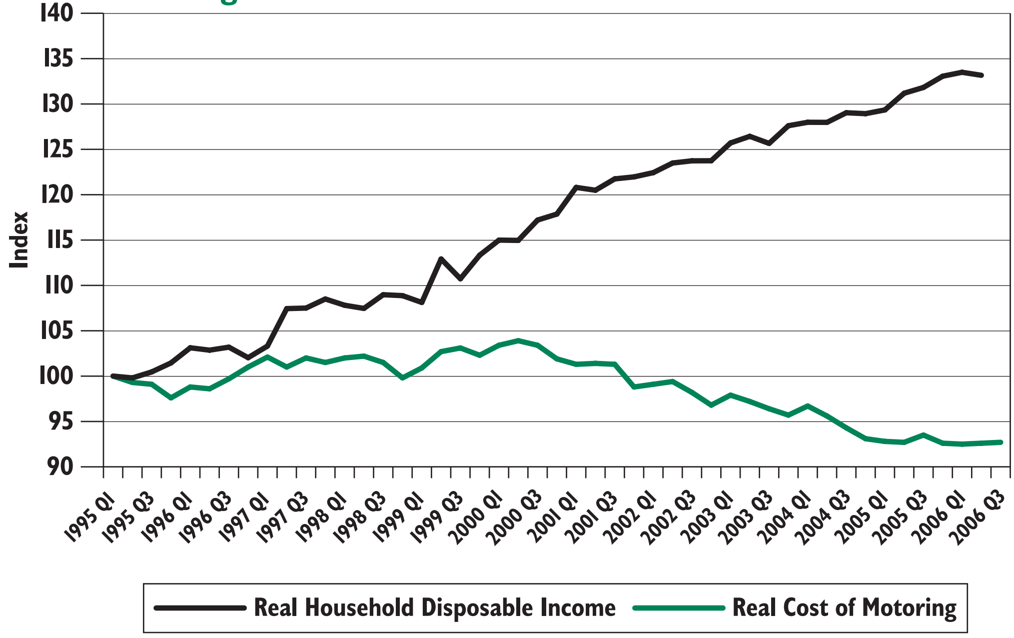
7.51 Transport is the second largest source of carbon dioxide emissions in the UK and, due in part to sustained economic growth, emissions are set to continue growing until around 2015, before falling thereafter. In addition, the sector is a significant contributor of air pollutants. However, environmental goals must be pursued alongside wider priorities. A safe, clean and efficient transport system underpins sustainable economic growth, boosts productivity, extends mobility and helps create a more inclusive society. The Government is committed to a long-term strategy of promoting lower-carbon transport including alternative fuels, improving fuel efficiency and giving economic incentives to individuals to make more sustainable transport choices. Both the Stern Review and the Eddington Study of Transport,[6] published on 1 December 2006, emphasise the importance of transport prices reflecting the costs of carbon emissions and other environmental externalities, for instance through taxation, regulation and trading mechanisms. Further details on the Eddington Study can be found in Chapter 3.

Cost of motoring

7.52 The real cost of motoring has remained broadly constant for the last decade, but has fallen since a peak in 2000, largely due to falling car purchase costs. Oil market volatility has been offset by fuel duty rates that are now as low as at any time since 1997. Real costs of motoring as a share of household disposable income have fallen considerably in the last ten years, as incomes have grown on the back of sustained economic growth, while motoring costs have remained broadly constant.

[6] *The Eddington Study of Transport*, December 2006.

Chart 7.3: Index of household disposable income and cost of motoring



Fuel duties **7.53** It is the Government's policy that fuel duty rates should rise each year at least in line with inflation as the UK seeks to reduce polluting emissions and fund public services. In Budget 2006, owing to sustained oil market volatility, the inflation-based increase in main fuel duty rates was deferred until 1 September 2006. However, with the risk of volatility remaining high, the Government announced in July that the increase would not go ahead in September and the position would be reviewed at the time of the Pre-Budget Report. Since pump prices peaked at 97 pence per litre (ppl) for petrol and 99 ppl for diesel in July 2006, they have fallen back on average by between 8 and 12 ppl. **The Government therefore announces today that main fuel duty rates will increase in line with inflation by 1.25 ppl from midnight tonight.** Rates remain 15 per cent lower in real terms than they were in 1999, when the fuel duty escalator was abolished. **The Government will also increase the duty rates for rebated oils, biofuels and road fuel gases, in line with the Budget announcement.** More details on rebated oils are in Chapter 5.

Sulphur-free fuels **7.54** Sulphur-free fuels offer local air quality benefits, while helping new engine technologies work more efficiently. **Following consultation by the Department for Transport (DfT), regulations will be brought forward early in 2007 to ensure the widespread availability of sulphur-free diesel and sulphur-free 'super' grades of petrol. In order to allow the industry the required lead time to bring forward the fuels, the regulations will enter into force in late 2007.** In advance of that, HM Revenue and Customs (HMRC) will bring forward deregulatory changes to the definition of ultra-low sulphur diesel in the Hydrocarbon Oil Duties Act 1979, to assist the industry in delivering sulphur-free fuels at lower cost.

Haulage industry **7.55** The Government recognises the important role that road haulage plays in a successful and high-productivity economy. The Haulage Industry Task Group, set up in the 2005 Pre-Budget Report to develop a stronger evidence base to inform the Government's future policy decisions, has enhanced the Government's understanding of key issues within the sector. A report from the Task Group published alongside this Pre-Budget Report summarises the evidence gathered.[7]

[7] *Haulage Industry Task Group: Summary of Evidence*, HM Treasury in conjunction with the Road Haulage Association and the Freight Transport Association, December 2006.

7.56 As part of the Task Group process, the Government received a number of policy proposals from industry. These focused on ways to deliver a 25 ppl fuel duty reduction for use by those operators most directly affected by foreign competition. After carefully considering the full implications these policies would have on revenue, fraud and the environment, and the analysis of costs and competitive differentials set out in the Task Group report, the Government does not believe that there is a case for a duty rate reduction. Quantitative restrictions on fuel carried on incoming vehicles were also suggested. However, these would contravene European single market rules.

7.57 The Task Group has drawn important conclusions in the area of enforcement. A higher proportion of foreign vehicles fail to comply with UK safety regulations concerning, for example, vehicle weights or driving hours, and non-compliant operators enjoy an unfair competitive advantage when they are not caught. As a direct result of the Task Group, the DfT has published a clear statement on cabotage rules and action has recently been taken against several long-standing cabotage operations. The recent launch of the South East International Transport Pilot will substantially improve the Vehicle and Operator Services Agency's capacity to tackle non-compliance by traffic in the south-east and new 'Weigh in Motion' sensors to identify overloaded vehicles will soon be in place at seven locations. **The DfT is also announcing the results of consultation on the reform of operator licensing which will significantly cut the administrative burdens for UK hauliers.**

7.58 Further work is now being undertaken by the Government to explore ways of delivering more targeted enforcement on foreign vehicles. This could be done by introducing a database covering all foreign hauliers entering and working in the UK. One way this could be achieved would be via a 'vignette' – a time-based charge for the use of UK roads designed to make foreign hauliers pay for some of the damage they cause on UK roads. If such a scheme were introduced it is very likely to be administered through the existing VED registration process in order to minimise the administrative burden on domestic hauliers. **The Government will undertake a detailed feasibility study into options for establishing a database, including through a vignette.**

Alternative road fuels

7.59 The challenge of climate change, alongside concerns around reliability of supply and oil market volatility, emphasises the importance of developing alternative fuels. The Alternative Fuels Framework, published in the 2003 Pre-Budget Report, affirmed the need for fiscal incentives to reflect environmental benefits and committed the Government to a three-year rolling guarantee for biofuel and road fuel gas duty rates, offering certainty to support investment.

Biofuels

7.60 Biofuels can be mixed with fossil-based fuels and offer significant benefits such as reducing life-cycle carbon emissions and contributing to security of supply. Fuel duty differentials for biodiesel since 2002, and bioethanol since 2005, have supported the growth of the market for these fuels. Having increased sixfold from 2003 to 2005, the biofuels market is expected to double again in 2006, increasing to around 250 million litres, or 0.5 per cent of road fuels.

Renewable transport fuel obligation

7.61 In November 2005 the Government announced it would introduce a Renewable Transport Fuel Obligation (RTFO) requiring transport fuel suppliers to ensure a set percentage of their sales are from a renewable source. Budget 2006 announced that the level of obligation would be set at 2.5 per cent in 2008-09 and 3.75 per cent in 2009-10, before reaching 5 per cent in 2010-11. This will deliver net savings of around 1 MtC per year by 2010. The Government intends the level of the Obligation to rise above 5 per cent after 2010-11, provided that three critical factors are met: development of robust sustainability and carbon standards; development of a new fuel quality standard at EU level to ensure existing and new vehicles can run on biofuel blends higher than 5 per cent; and the costs being acceptable to the consumer.

7.62 As announced in Budget 2006, the 20 ppl duty incentive for biofuels will be maintained until 2008-09, offering further certainty to the industry. In addition, the RFTO buy-out price – the price paid by fuel suppliers who fail to meet their obligation – for the first year of the RTFO will be set at 15 ppl. The combination of duty incentive and buy-out price is also guaranteed at 35 ppl in 2009-10 but will reduce to 30 ppl in 2010-11. The Government expects that the emphasis will move from duty incentive towards buy-out price as the principal support mechanism in future years. The DfT intends to consult further on key aspects of the RTFO early in the New Year, including the role high-blend biofuels could play in meeting RTFO targets, and will publish a draft of the related secondary legislation. Work is also underway, led by the Low-Carbon Vehicle Partnership, to develop carbon and sustainability assurance schemes for biofuels.

Enhanced Capital Allowances for biofuels

7.63 At Budget 2006 the Government applied for State aids approval for an ECA scheme to support the most carbon-efficient biofuels plant. Following discussions with the European Commission in summer 2006, the Government launched a further stakeholder discussion process with interested parties in October 2006 to update them on progress and gather views on the best way forward. The consultation process is now almost complete and the Government will update stakeholders on the position early in the New Year.

Biomass in fuel production

7.64 It is also important to support innovative types of biofuel production, especially where these could result in biofuels with greater life cycle emissions benefits, or fuels which can be mixed with fossil fuels at higher blends. The Government invited expressions of interest in a pilot project to test the use of biomass in the main refinery process. **The Government today announces that it will extend the 20 ppl fuel duty differential to enable a pilot involving the use of biomass in conventional fuel production to go ahead.**

Second generation biofuels

7.65 At Budget 2006 the Government announced that it would review the definition of biodiesel in the Hydrocarbon Oil Duties Act 1979. Following discussion with stakeholders, **the Government will amend the definition to include a new second generation biodiesel that offers potential environmental benefits, and is capable of being blended in excess of 5 per cent blends.** No further changes will be made to the definition of biodiesel in legislation at present, though the position will be kept under active review as new fuels and approaches emerge. **HMRC are today issuing further guidance on the interpretation of the definition to ensure that environmentally-friendly fuels continue to receive recognition through the duty system. HMRC will also consult stakeholders about a deregulation measure to relax return requirements for small biofuels producers.**

Extending biofuels to other uses

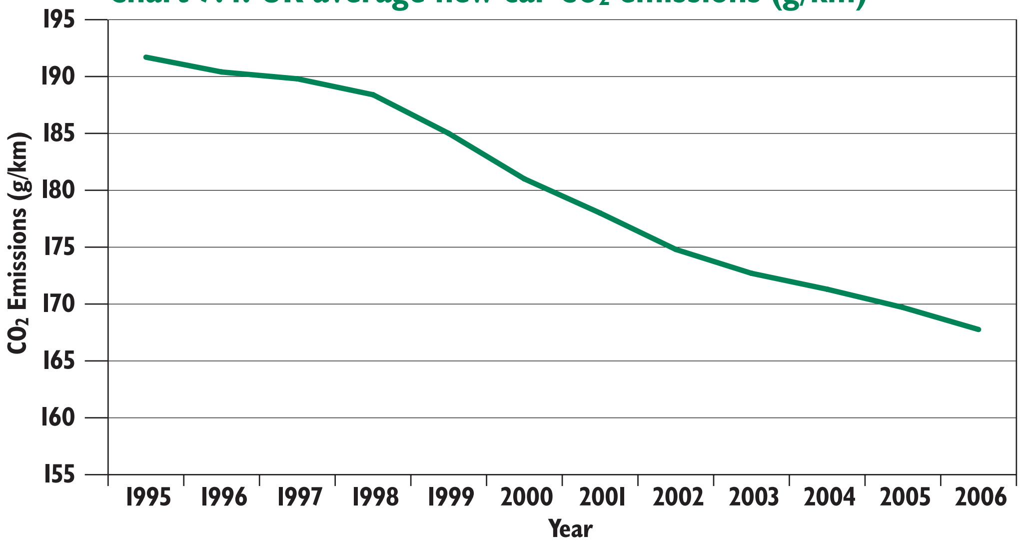
7.66 The environmental benefits of biofuels can also be realised where they are used off-road, and stakeholders from the railway sector have expressed an interest in conducting pilots which use biofuels in railway engines. **To support this, the Government will allow duty to be charged at 7.69 ppl for the purposes of these pilots.** As the pilots progress, the Government will consider what an appropriate long-term duty rate would be, while ensuring any potential risks of misuse are tackled.

Road fuel gases

7.67 In Budget 2006 the Government announced that, in line with the alternative fuels framework, it would increase the duty rates for compressed natural gas (CNG) by the equivalent of 1.25 ppl maintaining the differential with road fuels, and that it would increase the duty rate of liquefied petroleum gas (LPG) by the equivalent of 2.25 ppl, to reduce the differential with main road fuels by 1 ppl. However, rates for both CNG and LPG were frozen alongside the decision on main rates, with the position to be reviewed in the 2006 Pre-Budget Report. **The Government will now implement its Budget 2006 announcement on LPG and CNG with effect from midnight tonight. The Government will also consider the case for extending the current duty incentive for renewable natural gas (biogas), equivalent to almost 40 ppl, and will update the position at Budget 2007.**

Lower-emission vehicles **7.68** As Chart 7.4 shows, average carbon emissions from new cars have fallen every year for the last decade. Innovation in car manufacturing to improve the fuel efficiency of cars has been vital to this, supported both by a voluntary agreement between the European Commission and manufacturers to reduce emissions, and by the measures the Government has taken to incentivise the purchase and development of less polluting vehicles.

Chart 7.4: UK average new car CO_2 emissions (g/km)



Source: DfT
Note: the 2006 figure is provisional and based on new car registrations from January to June.

Vehicle excise duty **7.69** Vehicle excise duty (VED) for cars was reformed in 2001 and is now based on graduated carbon dioxide bands which give a clear signal to motorists to choose less polluting vehicles. Fuel efficiency labels – matching the graduated VED structure – were introduced into new car showrooms last year, raising consumer awareness of the potential fuel savings that can be achieved by choosing a lower carbon dioxide emission vehicle. DfT will build on this by launching a communications campaign to promote consumer information on purchasing greener cars and smarter (eco) driving on 30 January 2007, and to promote the benefits of business travel planning. To strengthen environmental incentives, the Government announced further reforms to VED in Budget 2006, including: the introduction of a new top band (band G) for the most polluting new cars; and reducing the rate for cars with the very lowest carbon emissions to zero, to support the development of the low-carbon market. The Government will continue to consider the case for improving VED incentives for fuel-efficient vehicles.

Company car tax **7.70** Company car tax (CCT) was reformed in 2002 and is now based on carbon emissions, encouraging the take up of environmentally friendlier cars. These changes are forecast to deliver significant carbon savings of between 0.4 and 0.9 MtC per year by 2020. To further promote environmentally friendly vehicles, Budget 2006 announced that from 6 April 2008 the emissions corresponding to the lower threshold rate of 15 per cent would be reduced from 140g of carbon dioxide per kilometre to 135g of carbon dioxide per kilometre. The Government also created a new lower 10 per cent band for company cars with carbon dioxide emissions of 120g per kilometre or less from 6 April 2008. At Budget 2007, the Government will set out the company car tax thresholds for 2009-10. **The Government will also consider the case for an incentive in company car tax to support the take-up of 'flex-fuel' vehicles, capable of using high-blend bioethanol E85.**

7.71 Budget 2006 announced that HMRC would review the taxation of employee car ownership schemes (ECOS) and the benefits employees derive from them, with a view to possible changes. HMRC have undertaken extensive discussions with business which have indicated that: there are a number of different ECOS schemes, some of which have been designed to provide an ongoing benefit to employees that is currently not taxed or subject to NICs; and that the carbon emissions of an average ECOS car are around 20g per kilometre higher than an average company car. Furthermore, there is a noticeable interaction between the tax treatment of ECOS, tax-free mileage allowances and rates of company car tax, which may have contributed to the popularity of ECOS. HMRC will hold further discussions with industry in early 2007. Following these discussions, the Government will consider whether changes are necessary in order to strengthen environmental incentives and protect Exchequer revenues.

Company car fuel

7.72 The company car fuel benefit charge, paid by employees who drive company cars and receive free fuel for private use, was reformed in 2003 to align it with the environmental principles of the company car tax system. The figure on which the charge is based is currently set at £14,400. As announced in the 2005 Pre-Budget Report, the VAT fuel scale charge, which is a simplified scheme for taxing the private use of road fuel, will, from 1 May 2007, be based on a car's carbon dioxide rating. HMRC will publish details of the new regime in good time to allow business to familiarise themselves with it and make any necessary computer system changes.

Capital allowances for cars

7.73 As outlined in Chapter 5, the Government has been consulting on options for modernising relief for business expenditure on cars, including the provision of incentives to business to purchase cleaner cars. This could build on the existing 100 per cent first-year allowance for very low emission cars and recent reforms to VED and company car tax. The Government will continue discussions with business, and present more detailed proposals in Budget 2007.

Vehicle emissions standards

7.74 New 'Euro V' emissions standards for cars and small vans are currently being negotiated within the European Union and the Government will consider the case for incentivising their early uptake through company car tax and other instruments, ahead of the formal requirement to fit the technology. Euro IV emissions standards for vans will become mandatory for all vans registered after 31 December 2006 and, as announced in Budget 2006, the reduced rate of VED for Euro IV vans will be removed for vans registered after that date, but remain for the lifetime of vans meeting the requirements registered before that date.

7.75 Since October 2006 the Euro IV standard for Heavy Goods Vehicles (HGVs) and buses is mandatory and newly registered vehicles are no longer eligible for a reduced pollution certificate (RPC). However, vehicles which obtained an RPC before that date will retain the benefit for the life of the vehicle, as long as they continue to meet the normal testing requirements. The incentive is also still open to those who fit pre-October 2006 registered vehicles with the qualifying technology. The Government is actively reviewing options for providing similar incentives for the early uptake of the Euro V emissions standard, before it comes into force in November 2009.

Reducing emissions from aviation

Emissions from aviation

7.76 Globally, carbon dioxide from aviation is responsible for around 1.6 per cent of total greenhouse gas emissions,[8] but this level is set to increase as other sectors reduce emissions while demand for air travel rises. The UK aviation sector currently accounts for around 5.5 per cent of the UK's total carbon dioxide output and this could rise to as much as 15 per cent by 2030. Aircraft are also responsible for high-altitude emissions of nitrogen oxides (NOx), and for the formation of cirrus clouds and contrails. The total climate change effect of all aviation emissions is estimated to be at least two to four times greater than the effect of carbon dioxide emissions alone.

7.77 Government policy on aviation needs to strike the right balance between economic, social and environmental factors. The UK aviation industry brings considerable economic benefits to the UK. It contributes around £11 billion per year to the economy, with far greater indirect contributions from other industries reliant on air transport. It also directly employs over 200,000 people and indirectly many more. Today, a third by value of all UK exports are carried by air, enabling UK companies to reach new international markets in an increasingly globalised world economy. The Government's policy, as set out in the 2003 White Paper *The Future of Air Transport*,[9] is to ensure that aviation continues to benefit the UK economy by enabling the industry to expand in an environmentally sustainable way, and that aviation should pay the external costs it imposes on society at large, in line with the 'polluter pays' principle.

7.78 The Eddington Study stresses the important role of international gateways such as airports in contributing to the productivity and competitiveness of the UK economy, and the costs imposed by congestion in and around airports. The study also supports Government policy by arguing that, as a point of economic principle, transport planning must take account of likely carbon prices and that transport prices must fully reflect environmental externalities. At the same time, the study is clear that barriers to the natural growth of aviation, once those prices are in place, would impose a significant economic cost on the UK economy.

7.79 To avoid the economic consequences of constraining aviation growth, further expansion of UK airport capacity is needed. Heathrow plays a unique role in the UK as a hub airport, and demand for capacity already significantly exceeds supply, leading to less competition, greater congestion, reduced choice and higher prices for passengers. Where there are net benefits from doing so, the Government supports the expansion of UK airports, including at Heathrow, and will identify the necessary mitigation measures to allow relevant limits on air quality and noise to be met.

Aviation in the EU ETS

7.80 The growing impact of aviation on the environment is an international issue, and, in line with the Stern Review, the Government is pressing for international action to tackle it. The Government believes the inclusion of aviation in the EU ETS is the most efficient and cost-effective way to aid the sector in meeting its external costs and playing its part in tackling climate change. The Government remains committed to this goal and continues to press at the EU level for the inclusion of aviation in EU ETS as soon as possible. The European Commission is due to publish a draft legislative proposal shortly.

7.81 However the Government is also aware of the challenges in introducing emissions trading to this sector, and recognises that these challenges may lead to delay. The Government continues to believe, as set out in previous Budgets and Pre-Budget Reports, that its focus on EU ETS does not preclude consideration of additional economic instruments to ensure aviation plays its part in meeting the challenge of climate change. In particular, the UK continues to argue for change on an international level to the exemption of aviation kerosene from fuel tax. This strategy has delivered real results, but the process will inevitably take time.

[8] *Aviation and the Global Atmosphere*, Intergovernmental Panel on Climate Change, 1999.

[9] *The Future of Air Transport*, DfT, December 2003.

Air passenger duty **7.82** In the light of this, the Government recognises the role that air passenger duty can play in tackling the climate change impact of aviation. **The Government will therefore increase air passenger duty rates (APD) with effect from 1 February 2007. The intra-EU economy rate will rise from £5 to £10 and the non-economy rate from £10 to £20. The long-haul economy rate will rise from £20 to £40 and the non-economy rate from £40 to £80.** This will deliver carbon savings of around 0.3 MtC a year by 2010-11. When the effect of non-carbon dioxide emissions is taken into account this has a climate change impact equivalent to saving around 0.75 MtC per year by 2010-11. **To ensure consistency within the air passenger duty system, the scope of the European rates of air passenger duty will also be widened to include all of the signatories to the European Common Aviation Area Agreement, with effect from 1 February 2007.**

IMPROVING WASTE MANAGEMENT

7.83 Since 1997, the Government has introduced a number of measures to develop more sustainable waste management practices, reduce the UK's reliance on landfill and ensure that waste producers consider the full costs of the disposal of waste when making decisions, including increasing the standard rate of landfill tax and introducing the Landfill Allowance Trading Scheme for local authorities. These measures aim to ensure that the UK will meet its international obligations, including the EU Landfill Directive. Defra is due to publish a review of its Waste Strategy in early 2007 and, as part of the 2007 Comprehensive Spending Review, the Government will assess the findings and consider whether there is a case for further incentives to encourage investment in more sustainable alternatives to landfill.

Landfill tax **7.84** The landfill tax increases the price of waste sent to landfill, encouraging more sustainable ways of managing waste. The standard rate of landfill tax applying to active wastes (those that give off emissions), currently £21 per tonne, has been increased by £3 per tonne in each of the last two years as part of the Government's medium to long-term aim of reaching a rate of £35 per tonne. The landfill tax has been very successful: overall quantities of waste recorded at landfill sites registered for the tax fell from around 96 million tonnes in 1997-98 to around 72 million tonnes in 2005-06, a reduction of around 25 per cent. The UK is on track to meet its 2010 targets under the Landfill Directive, although subsequent targets in 2013 and 2020 remain challenging. **The Government today announces that from 1 April 2007 the standard rate of landfill tax will increase by a further £3 per tonne to £24 per tonne. The Government will also consider whether the standard rate of landfill tax needs to increase more steeply from 2008 onwards, or go beyond the £35 per tonne already committed to for the medium to long-term, in order to encourage greater diversion of waste from landfill and more sustainable waste management options.**

Enhanced Capital Allowances for waste **7.85** The Government has continued to examine the potential to introduce an ECA scheme to support new waste management facilities. This work has focused on developing options to encourage investment in developing markets for the outputs of new waste treatment facilities (for example, refuse derived fuel). The Government continues to engage with stakeholders to assess the case and appropriate mechanism to incentivise investment in this area.

Landfill Communities Fund **7.86** The Landfill Communities Fund – formerly the Landfill Tax Credit Scheme – was introduced in 1996 to redress some of the environmental costs of landfill by improving the environment in the vicinity of landfill sites. Budget 2006 announced that the Government would increase the value of the scheme and issued a challenge to the private and voluntary sector partners in the scheme to use the additional money to fund opportunities for young people to volunteer on environmental projects.

IMPROVING WATER EFFICIENCY AND QUALITY

Investment in water-efficient technologies

7.87 *Long-term opportunities and challenges: analysis for the 2007 Comprehensive Spending Review* pointed to the need to strike the best balance between maintaining adequate supplies of water and managing consumer demand. ECAs to support business investment in designated water efficient technologies were introduced in 2003 and currently cover more than 900 approved products. The Government has also agreed to consult on a proposal to oblige water companies in areas of serious water stress to consider compulsory metering alongside other measures in drawing up long-term plans for managing water resources.

Water pollution from agriculture

7.88 The Government is currently assessing a range of possible policy options to tackle diffuse water pollution from agriculture (DWPA), and remains committed to ensuring that the costs of such pollution do not fall on water customers. The Government will consult shortly on the most cost-effective options for dealing with DWPA and continues to keep options for using economic instruments under review. The pesticides voluntary initiative remains in place and the Government continues to consider potential improvements to it.

PROTECTING THE UK'S COUNTRYSIDE AND NATURAL RESOURCES

Biodiversity

7.89 The Government is committed to ensuring that the UK's natural resources are managed prudently. In particular it aims to improve biodiversity and land use. The conservation of biodiversity is one of the goals of the Government's Environmental Stewardship scheme, a new agri-environment scheme which provides funding to farmers and other land managers in England who deliver effective environmental management on their land. Over 25,000 Environmental Stewardship agreements, covering 3.4 million hectares of English farmland, are now in place.

Aggregates levy

7.90 The aggregates levy was introduced in 2002 to ensure that the external costs associated with the exploitation of aggregates are reflected in the price of aggregate, and to encourage the use of recycled aggregate. There continues to be strong evidence that the levy is achieving its environmental objectives, with sales of primary aggregate down and production of recycled aggregate up. In Budget 2006, the Government confirmed that it expects that the levy rate will at least keep pace with inflation over time. The Government will continue to work with industry stakeholders and consider the appropriate level for future rates at Budget 2007.

Aggregates levy sustainability fund

7.91 The aggregates levy sustainability fund was introduced alongside the aggregates levy to reduce the impact of aggregates production. **The Government today announces that the fund will be extended for a further year (2007-08).** Decisions on the future of the fund beyond 2007-08 will be taken as part of the 2007 Comprehensive Spending Review.

Table 7.1: The Government's policy objectives and Budget measures

Sustainable Development Indicator and recent trend data	Recent Government measures / announcements
Tackling climate change	
Targets Joint Defra/DTI/DfT PSA – reduce greenhouse gas emissions to 12.5 per cent below 1990 levels in line with Kyoto commitment and move towards a 20 per cent reduction in carbon dioxide emissions below 1990 levels by 2010. *Progress* UK greenhouse gas emissions were 14.6 per cent below 1990 levels in 2005[1] Carbon dioxide emissions fell by 5.3 per cent during this period.	• Climate Change Programme, DETR, November 2000. • UK Emissions Trading Scheme, Defra, August 2001. • Energy Efficiency Commitment, Defra, April 2002 and April 2005. • Renewables Obligation, Defra, April 2002 and December 2003. • Energy White Paper, DTI, 2003. • Energy Efficiency – the Government's Plan for Action, Defra, April 2004. • EU ETS Phase 1 began January 2005, EU ETS Phase II consultation in July 2005. EU ETS Phase II NAP agreed in November 2006. • Energy Efficency Commitment Two introduced April 2005. • Energy Efficiency Innovation Review, December 2005. • Energy Review, DTI, July 2006. • Climate Change Programme Review, March 2006. • Package of fiscal measures, including climate change levy (see Table 7.2).
Air quality	
Targets Joint Defra/DfT PSA – to improve air quality by meeting the Air Quality Strategy for seven key air pollutants between 2003 and 2010. *Progress* Results for 2005 show average UK urban background levels of particulate pollution (PM_{10}) decreased from 31 micrograms per cubic metre in 1996 to 22 micrograms in 2005. Urban ozone levels increased from 48 micrograms per cubic metre to 57 micrograms over the same period, due to the reduction in other urban pollutants which tend to suppress ozone. The average number of days with moderate or higher air pollution decreased from 48 to 22 in urban areas and from 41 to 40 in rural areas between 1996 and 2005[2].	• Air Quality Strategy DETR January 2000 and Addendum, Defra February 2003, and Review, Defra, 2004-06. Review of Air Quality Strategy, April 2006. • Implementation of Integrated Pollution, Prevention and Control regime, Defra, 2002-2007. • Air Transport White Paper, DfT, December 2003. • Ten Year Plan for Transport, DETR July 2000, and Future of Transport White Paper, July 2004. • Continued support for local air quality management system. • Negotiation and implementation of EU air quality directives and international agreements 2004-06. • Review of the Transport Energy Grant Programmes, DfT 2004-06. • Fiscal measures including fuel differentials for less polluting fuels (see Table 7.2).
Improving waste management	
Targets Defra PSA – enable at least 25 per cent of household waste to be composted or recycled in 2005-06. Landfill Directive target to reduce the volumes of biodegradable municipal waste disposed of at landfill to 75 per cent of 1995 levels by 2010, 50 per cent by 2013, and 35 per cent by 2020. *Progress* Around 27 per cent of household waste in England was recycled or composted in 2005-06. Active waste disposed to landfill has fallen from 50.4 million tonnes in 1997-98 to 47.3 million tonnes in 2005-06.	• Waste Strategy 2000, DETR, May 2000. • Waste Implementation Programme, Defra, 2002. • Reform of the Waste Minimisation and recycling challenge fund. • Landfill allowance (trading) schemes enacted by the Waste and Emissions Trading (WET) Act 2003. • Business resource and efficiency waste programme (BREW) 2004. • Waste Strategy review consultation published by Defra in February 2006. • Landfill tax and related measures (see Table 7.2).
Regenerating the UK's towns and cities	
Targets DCLG PSA 5: 60 per cent of housing development to be on previously developed land. DCLG PSA 1: Work with departments to help meet PSA floor targets to deliver neighbourhood renewal and tackle social inclusion. DCLG PSA 8: Deliver cleaner, safer and greener public spaces. *Progress* In 2004, 72 per cent of new housing was on previously developed land, including conversions, increasing from around 54 per cent in 1990.[3] Latest data shows the gap between the most deprived areas and the rest of the country has narrowed on several key indicators, including health, crime and education. There are currently 22 Urban Regeneration Companies in the UK.	• Sustainable Communities "building the future" launched in February 2003. • Planning Policy Statement 1 placed sustainability for the first time as a core principle of the planning system, February 2005. • SR04 made available £525 million a year through the Neighbourhood Renewal Fund to tackle deprivation in the most deprived areas and maintained commitment to New Deal For Communities programmes. • SR04 announced Safer and Stronger Communities Fund providing single funding stream to improve liveability. • National Nuisance Vehicle Strategy launched in November 2004. • English Partnerships launched pilot programme with 12 local authorities to tackle England's legacy of derelict and brownfield land, to bring 66,000 hectares of brownfield land into beneficial use, February 2005. • Budget 2005 announced the Local Enterprise Growth Initiative to increase investment and enterprise in the most deprived areas. • Package of fiscal measures including contaminated land tax credit (see Table 7.2).
Protecting the UK's countryside and natural resources	
Targets Defra PSA – positive trends in the Government's headline indicators of sustainable development (includes wildlife, river water quality, land use). Water Framework Directive – requires achievement of good chemical and ecological status in surface water by 2015. *Progress* • Farmland birds almost halved between 1977 and 1993. However, declines have reduced in recent years and 2004 populations were virtually unchanged from 1993. • Woodland birds fell by about 24 per cent between 1975 and 1992. Since then, however, populations have remained broadly constant. • In 2005 about 64 per cent of rivers in England were rated as having good chemical quality and approximately 71 per cent of English rivers were of good biological quality. • In 2006, Sites of Special Scientific Interest land in target condition rose to 72 per cent.	• Rural White Paper, DETR, November 2000. • Strategy for Sustainable Farming and Food, Defra, December 2002. • Regulations transposing the Water Framework Directive came into Force January 2004. • Developing measures to promote catchment-sensitive farming (Defra-HMT consultation), June 2004. • Defra consulting on pesticides strategy. • England Rural Development Programme. • Environmental Stewardship, England's new agri-environment scheme, launched March 2005. • Aggregates levy and aggregates levy sustainability fund (see table 7.2). • Pesticides Strategy, 2006.

[1] *The six main greenhouse gases are: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons and sulphur hexafluoride.*

[2] *Air quality indicator for sustainable development:* Defra, 2006.

[3] *Land use change in England. Residential Development to 2004 (January 2006).*

Table 7.2: The environmental impacts of Budget measures

Budget measure	Environmental impact
Climate change and air quality	
UK's National Allocation Plan for EU Emissions Trading Scheme	The UK's plan for Phase One of the EU ETS will deliver around 4.6 MtC reductions from installations covered by 2007. The UK's plan for Phase Two (from 2008–2012) will deliver emissions savings of 8 MtC compared with business as usual.
Climate change levy package	Climate change levy is estimated to deliver annual emissions savings of over 3.5 million tonnes of carbon (MtC) by 2010.[1] Climate change agreements are estimated to deliver annual emissions savings of 2.8 MtC by 2010. Total CCL package, including the Carbon Trust, is estimated to deliver annual emissions savings of over 7.5 MtC a year by 2010.
Fuel duty	Revalorising fuel duty rates reduces emissions by around 0.1 MtC per year compared to freezing rates.
Fuel duty differentials including: – to facilitate a market switch: • from leaded to unleaded; • from low sulphur to ultra-low sulphur diesel (ULSD); • from low sulphur to ultra-low sulphur petrol (ULSP). – to encourage growth in the use of more environmentally-friendly fuels: • road fuel gases; • biodiesel (20 ppl differential); • bioethanol (20 ppl differential).	The shift to ULSP from ordinary unleaded is estimated to have reduced emissions of nitrogen oxide by 1 per cent, carbon monoxide by 4 per cent and volatile organic compounds by 1 per cent per year.[2] 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. The road fuel gas differential has reduced emissions of particulates and nitrogen oxides, which has helped to improve local air quality. The increased use of biodiesel and bioethanol will reduce CO_2 emissions typically by around 50 per cent per litre of biofuel used. Biofuels are projected to account for around 0.5 per cent of road fuels in 2006, reducing carbon emissions by around 0.1 MtC a year.
The Renewable Transport Fuel Obligation (RTFO)	RTFO introduced from 2008-09 is expected to save 1 MtC per year by 2010.[3]
Rebated fuels	Maintaining the differential with main road fuels supports the strategy to reduce fraud, and will deliver small CO_2 and local air pollution benefits through increased use of less polluting fuels and less use of rebated fuels, which are more polluting.
Vehicle excise duty (VED)	Sharpening of environmental signals will help deliver small reductions in CO_2 emissions. Numbers of vehicles in 3 lowest CO_2 emission graduated VED bands is forecast to grow significantly in the longer term in part due to VED reform.
Company car tax (CCT)	CO_2 emissions savings of reformed CCT system estimated to be 0.2 to 0.3 MtC in 2005, forecast to rise to between 0.4 and 0.9 MtC per year.[4]
Company car fuel benefit charge	The number of company car drivers getting free fuel for private use has fallen by around 600,000 since 1997, partly as a result of changes to the company car tax system in April 2002 and changes to the fuel benefit rules in April 2003, helping to reduce levels of CO_2 emissions, local air pollutants and congestion.[5] Increasing the rate in line with fuel prices in 2007-08 will deliver a small additional reduction in CO_2 emissions.
VAT fuel scale charge	Reforms are expected to deliver small reduction in CO_2.
Air passenger duty (APD)	Changes to rates will result in a reduction of 0.2 to 0.5 MtC per year by 2010-11, with a central estimate of 0.3 MtC. When the effect of non-CO_2 emissions at high altitude is taken into account the changes have a climate change impact equivalent to saving 0.4 to 2.0 MtC a year emitted on the ground, with a central estimate of 0.75 MtC per year by 2010-11.
Landlords Energy Saving Allowance (LESA)	The extension of LESA will lead to a small reduction of carbon emissions.
Reduced rate of VAT on professionally-installed energy saving materials and microgeneration (from 17.5% to 5%)	Small reduction of carbon emissions.
Reduced rate of VAT on domestic fuel and power (from 8% to 5%)	Estimated to increase carbon emissions by 0.2 MtC by 2010.[6]

[1] Modelling the Initial Effects of the Climate Change Levy, Cambridge Econometrics, available at www.hmrc.gov.uk.
[2] Using NETCEN emissions models – further detail on methodology used is provided in NETCEN's January 2000 report 'UK Road Transport Emissions Projections'.
[3] Department for Transport modelling.
[4] HMRC modelling.
[5] HMRC modelling.
[6] HMRC modelling.

Table 7.2: The environmental impacts of Budget measures (continued)

Budget measure	Environmental impact
Energy Efficiency Commitment (EEC)	Phase 1 (2002-2005) is estimated to have reduced emissions by 0.35 MtC per year by 2010. Phase 2 (2005-2008) is expected to bring in an additional 0.62 MtC annual saving by 2010.
Warm Front (previously called the Home Energy Efficiency Scheme)	Estimated annual carbon savings of 0.32 MtC a year by 2010.
Voluntary initiative on consumer electronics	Annual emissions from household goods are estimated to be 1 MtC. An early estimate suggests savings of up to 65 per cent can be achieved at low cost to manufacturers, retailers and consumers, with 0.1-0.2 MtC potentially saved in 2010. Actual savings will depend on final agreement.
Microgeneration – £50 million to enable the installation of microgeneration technologies in 30,000 buildings	Carbon savings by 2010 of around 0.01 MtC per year.
'Smart' meter pilot	An estimated 0.2 MtC could be saved in 2010 from better metering and billing.
Improving waste management	
Landfill tax	Between 1997-98 and 2005-06, the total quality of waste disposal to landfill sites registered for landfill tax fell by 25 per cent, while the amount of active waste disposal to landfill by 14 per cent.[7]
Landfill communities fund	Landfill tax credits scheme (now the landfill communities fund) has provided £730 million for projects since its introduction.
Regenerating the UK's towns and cities	
Contaminated land tax credit	Bringing forward remediation of contaminated land.
Capital allowances for flats over shops	Bringing empty space over shops back into the residential market, while reducing the pressure for new greenfield development.
Reforms to VAT on conversion and renovation	Reduced pressure on greenfield site development.
Protecting the UK's countryside and natural resources	
Aggregates levy and aggregates levy sustainability fund	An 8 per cent reduction in sales of aggregates between 2001 and 2003. Reductions in noise and vibration, dust and other emissions to air, visual intrusion, loss of amenity and damage to wildlife habitats.
Enhanced capital allowances for water efficiency technologies	More sustainable use of water by business.

[7] Data at www.uktradeinfo.com, in calendar years.

A THE ECONOMY

Growth of the UK economy since Budget 2006 has been higher than forecast, with slightly above-trend growth narrowing the output gap. Domestically, growth has been driven by higher than expected business investment. Externally, the recovery in the euro area has boosted export growth. Together, these developments have further helped to rebalance UK economic growth.

GDP growth strengthened through 2005, and there have now been five consecutive quarters of non-oil growth at above or in line with trend rates. The economy has expanded for 57 consecutive quarters, the longest unbroken expansion on record in the UK and the longest ongoing expansion in any OECD economy. Domestically-generated inflationary pressures have remained in check despite energy and food prices pushing overall inflation higher. Total employment in the UK reached 29 million for the first time in 2006. Labour supply growth has been particularly strong this year, boosted by a sharp fall in inactivity adding to continued strong growth in the population of working age. These developments further demonstrate the payoff to the Government's macroeconomic policy framework and promotion of flexible and open labour, product and capital markets.

The world economy is in the midst of its strongest period of growth for more than 30 years. While Asia continues to lead the way, growth rates across Latin America and Africa have been strong. Growth in the G7 has become more balanced with stronger growth in the euro area and Japan offsetting moderation in the US. Since Budget 2006, global inflationary pressures have increased, prompting central banks across the OECD to tighten monetary policy.

In light of new evidence published since Budget 2006, the Treasury has reviewed the underpinning assumptions for its post-2006 neutral trend output growth projection, which it has revised to continue at 2¾ per cent a year, consistent with the neutral rate since 2001. This revised 2¾ per cent trend rate of output growth anchors the Pre-Budget Report economic forecast:

- **GDP is forecast to grow by 2¾ per cent in 2006, above the Budget 2006 forecast range, rising to 2¾ to 3¼ per cent in 2007 when the output gap is expected to close. Growth is expected to remain close to trend in 2008 and 2009; and**
- **CPI inflation is expected to average 2½ per cent in late 2006 reflecting increases in energy and food prices, but to return to target during the second half of 2007 as oil price induced pressures recede and inflation expectations remain firmly anchored.**

INTRODUCTION[1,2]

A.1 This chapter discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2009. It begins with an overview of developments and prospects in the world economy, which sets the global context for recent developments and prospects in the UK. It then outlines the UK economic forecast, before concluding with a more detailed discussion of sectoral issues, the components of growth and risks surrounding the forecast.

THE WORLD ECONOMY

Overview

A.2 The world economy is now in its third consecutive year of GDP growth of around 5 per cent. Continued buoyancy in emerging markets, particularly in Asia, is expected to sustain global growth at similar rates in 2007, as growth in the G7 moderates somewhat. This would represent the first time since the early 1970s that world growth had averaged close to 5 per cent over a four-year period, and compares with an average growth rate through the 1980s and 1990s of 3¼ per cent.

A.3 Since 2003, world growth has been driven by the US and Asia, particularly China. Strong domestic demand in the US has been one of the drivers of export and investment growth in Asia. Through 2006, growth in the US has moderated, largely due to lower residential investment. This has been offset by a broadening of the recovery in the euro area, an improvement in growth in Japan and continued momentum in the rest of Asia and other emerging economies. In 2007, slower G7 growth at the whole economy level masks continued robust investment underpinned by strong corporate profitability.

Table A1: The world economy

	Percentage changes on a year earlier, unless otherwise stated					
			Forecast			
	2004	2005	2006	2007	2008	2009
World GDP	4¾	4¾	5	4¾	4½	4½
Major 7 countries[1]						
Real GDP	3	2½	2¾	2¼	2½	2½
Consumer price inflation[2]	2½	2½	2½	2¼	2	2
Euro area GDP	1¾	1½	2½	2	2¼	2¼
World trade in goods and services	10	7¼	8¾	7½	7½	7
UK export markets[3]	8	5¾	7¾	6½	6¼	6¼

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

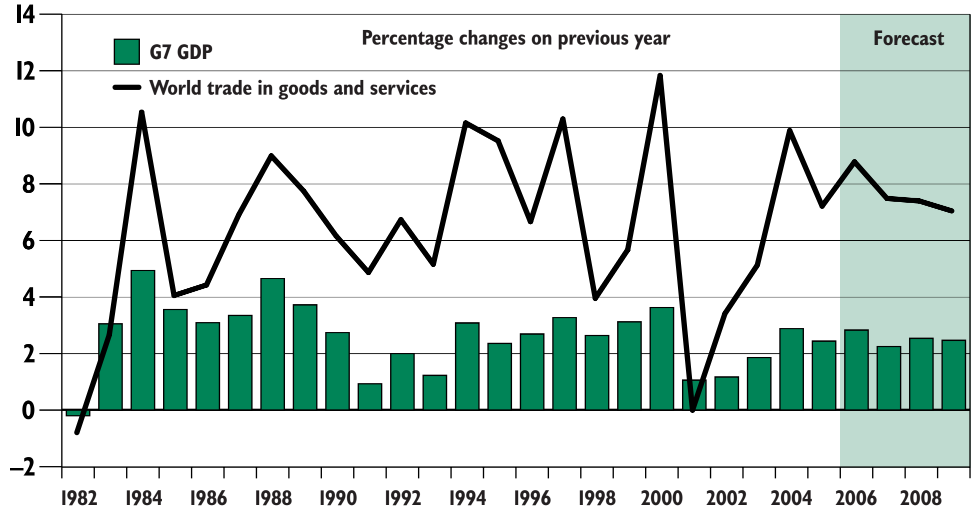
[1] The UK forecast is consistent with National Accounts and balance of payments statistics to the second quarter of 2006 released by the Office for National Statistics (ONS) on 27 September 2006, and output, income and expenditure data for the third quarter of 2006 released on 24 November 2006. A fully consistent National Accounts dataset for the third quarter will be published by the ONS on 21 December. 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). 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.

A.4 Asia accounted for more than half of world growth in 2005, with two fifths coming from China and India alone, and is expected to maintain this share of world growth over the forecast horizon. This reflects Asia's large and growing role as a global manufacturing hub, which has led to the regionalisation of production systems where parts and semi-finished products frequently cross national borders before the production process is complete. Asia accounts for over half of the world's population, with 38 per cent in China and India. So, while the region is already a significant source of world output growth, rising income levels in these economies mean they are likely to become an even more significant source of demand in the future.

A.5 Persistent differences in the growth of domestic demand across the world have coincided with the widening of current account imbalances. In particular, the US current account deficit has risen above $6^1/_2$ per cent of GDP this year, while across Asia, and in parts of Europe and the Middle East, surpluses have continued to grow. Governments have channelled these surpluses into foreign exchange reserves in order to reduce upward pressure on exchange rates, particularly in Asia. A gradual shift towards more domestic demand driven growth in current account surplus countries could play some role in the smooth rebalancing of global current account positions.

A.6 World trade has recovered strongly, with growth rising from zero in 2001 to 10 per cent in 2004. Following a $7^1/_4$ per cent increase in 2005, world trade is expected to grow by $8^3/_4$ per cent in 2006 and $7^1/_2$ per cent in 2007. Growth in world trade remains heavily orientated towards Asia.

Chart A1: G7 GDP and world trade



A.7 Despite robust G7 growth rates reducing spare capacity, and the rising price of oil and some other commodity prices, G7 inflation has remained broadly stable over the past two years. To ensure inflation continues to remain contained, G7 central banks have moved to re-align monetary policy, with interest rate increases starting in the US in the second half of 2004 becoming more widespread in 2005 and 2006. Interest rates have been raised this year in all the G7 economies and all but three of the 30 OECD countries – see Box A3.

G7 activity

United States **A.8** The US expansion remained resilient during 2005 and early 2006 in the face of a range of potentially growth-dampening factors. These included a significant increase in gasoline prices caused by rising oil prices and the hurricane-related disruption to refining capacity in September 2005, and monetary policy tightening with interest rates rising from 1 per cent in June 2004 to 5 $^{1}/_{4}$ per cent by June 2006.

A.9 US GDP growth has moderated since the first quarter of 2006, primarily due to a contraction in residential investment. This adjustment is likely to continue in the first half of 2007. Strong business investment growth and healthy private consumption growth are likely to drive domestic demand, and demand for imports, through 2007. US growth rates in 2006 and 2007 are expected to compare well with other major advanced economies, with the strong labour market and solid productivity gains reflecting the flexibility and resilience of the economy. Risks to the outlook for US growth centre on the ongoing correction in the housing market.

Euro area **A.10** Stronger growth up to the third quarter of 2006 has sustained the euro area recovery. Economic activity has broadened through higher business investment and stronger domestic consumption. Solid export growth has also contributed positively. The acceleration of quarterly GDP in 2006 has put the euro area on an above-trend growth path, narrowing the negative output gap. A gradual recovery in the labour market should continue to support private consumption, helping to rebalance growth further. However, growth may be temporarily dampened by weaker private consumption in the first half of 2007 resulting from pre-announced fiscal tightening measures, notably an increase in Germany's value-added tax (VAT) rate in January 2007. Overall, continued momentum of business investment, and moderate private consumption growth, are expected to drive euro area domestic demand growth in 2007.

A.11 Euro area growth in 2006 has been more evenly distributed than in 2005 in terms of individual countries' performance. In particular, economic activity in Germany picked up, with consensus expectations for growth of 2.3 per cent in 2006, the fastest rate of expansion since 2000. Cross-country differences in the sources of growth have persisted, with growth in Germany and Italy largely led by net exports and business investment, while the expansions in France and Spain have been mainly driven by private consumption.

Japan **A.12** Growth in Japan is now on a more sustainable footing after a decade of weak growth, deflation and significant structural difficulties. GDP growth picked up firmly during 2004 and 2005, and is expected to remain strong in 2006, with consensus expectations around 2$^{3}/_{4}$ per cent. This contrasts with an average rate of growth of less than 1 per cent a year between 1992 and 2002. Strong export growth has continued to provide a key stimulus, while business investment has grown firmly in response to restructuring in the corporate and financial sectors and improving profitability. Looking ahead, a recovery in the labour market should support private consumption. Growth is expected to moderate somewhat in 2007, though to remain above trend as the expansion becomes more entrenched.

Box A1: 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 economic tests was published in June 2003, which 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."

As part of the policy of "prepare and decide", the Government coordinates appropriate euro preparations across the UK economy. The Government also supports business in dealing with the euro as a foreign currency. Further information is available on the Treasury's euro website www.euro.gov.uk.

On the Stability and Growth Pact, the Government continues to emphasise the need for a prudent interpretation of the Pact as described in Budget 2005. The reforms to the Pact agreed in March 2005 rightly place a greater focus on the avoidance of pro-cyclical policies, and on achieving low debt levels and thereby enhancing the long-term sustainability of public finances, with the flexibility for low debt countries such as the UK to invest in the provision of much needed public services. The Government continues to work closely with Member States and EU institutions as the success of the reforms will depend on how they are implemented. It is also essential to recognise the importance of national frameworks and national ownership of fiscal policy.

The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the June 2003 assessment, the latest progress report on which was made in Budget 2006. While the Government did not propose initiating a euro assessment at the time of Budget 2006, the Treasury will again review the situation at Budget time next year as required by the Chancellor's June 2003 statement.

Emerging markets and developing economies

A.13 Emerging market economies have continued to perform well, buoyed by strong global growth and improving domestic economic fundamentals. A period of financial market volatility and a degree of uncertainty in May and June 2006 proved to be short-lived, with equity prices and exchange rates subsequently recovering most of the lost ground. While 2007 should continue to see solid growth, this would moderate in the event of a sharper than expected US slowdown. A rebalancing of growth towards domestic demand would serve to mitigate the external risks.

China and India **A.14** China outperformed expectations in the first three quarters of 2006, growing by almost 11 per cent on a year earlier. Government measures aimed at reining back the economy, and in particular investment, appear to have had an impact over the summer. However, the current account surplus has remained at record levels. Growth in China continues to outpace the rest of Asia, but growth across the whole region has been strong. The Indian economy expanded by 9 per cent in the first three quarters of 2006, propelled by strong growth in both services and manufacturing.

Emerging Europe **A.15** Growth in emerging Europe was above 5½ per cent in 2004 and 2005, driven by increased exports to the euro area and robust domestic demand, supported by expanding domestic credit. Looking ahead, growth of economic activity in the region is expected to moderate as external demand slows and the monetary policy response to rising inflation begins to feed through. Continued progress on structural reform is required in existing Member States and in countries aspiring to join the European Union.

Latin America **A.16** Growth in Latin America continues to be in the range of 4 to 5 per cent. Commodity prices have supported trade surpluses and domestic demand has strengthened. A number of countries have taken steps to reduce their external vulnerabilities by reducing foreign currency denominated debts, building up reserves, and issuing local currency bonds.

Africa **A.17** Africa's GDP is expected to grow by 5½ per cent in 2006, which would be the third successive year that growth has exceeded 5 per cent. The IMF expects growth to increase to nearly 6 per cent in 2007. Oil-exporting countries in Africa have contributed significantly to the strongest run of growth in four decades, while increases in a range of other commodity prices have benefited a number of African economies.

World trade

A.18 Compared with the Budget 2006 forecast, world trade growth was stronger in 2005, growing by 7¼ per cent. World trade growth is expected to pick up in 2006 to 8¾ per cent, reflecting a higher contribution from Asia and Europe, before easing to rates of around 7½ per cent over the forecast horizon.

A.19 Growth of UK export markets has been revised lower in 2004 and 2005 due to lower import estimates in the US and Middle East. In 2006, stronger than expected growth in Europe, which is the destination of around 50 per cent of total UK exports, has provided a boost to UK export markets. While Asia contributes significantly to world trade growth, it directly accounts for a relatively low share of demand for UK exports.

A.20 The UK, like many developed economies, has lost market share in the export of goods in recent years. Between 1998 and 2005, the UK's share of world goods exports fell from 5 per cent to 3¾ per cent, while the US share of world goods exports fell from 12½ per cent to 8½ per cent. This reflects faster growing emerging market economies becoming more integrated in world trade, the competitiveness of low-cost countries in high-volume production, and the increase in intra-Asia trade in parts and semi-processed goods. In contrast, the UK plays a larger role in world trade of services, with a share of exports that has remained around 8 per cent over the period. Focusing on business and finance services, which account for a third of UK output, the UK's share has remained around 11 to 12 per cent, second only to the US at 16 per cent.

A.21 The positive impact of free trade on global growth and prosperity makes increasing protectionist reactions to global competitive pressures a concern. To ensure the benefits of world trade growth continue to accrue, the challenges presented by the changing structure of world production need to be met through the adoption of domestic policies that enhance flexibility and facilitate the movement of resources between sectors. Erecting barriers to trade is costly to consumers in developed economies, while simultaneously blocking a route to improved living standards in the developing world.

Oil and commodity prices

A.22 Oil prices have increased sharply since the beginning of 2004, although in real terms they have remained below historic peaks. The price of Brent crude oil, the European standard, rose from a low of $10 in 1999 to a peak of over $78 a barrel in early August 2006. Prices have since declined to around $60 a barrel.

A.23 Rapid growth in global demand for oil, particularly from emerging economies, and limited investment in production and refining, as well as risks of supply disruptions, were the primary causes of the initial rise in oil prices. While demand for oil remains high, the recent decline in the oil price can be attributed to a reduction in underlying supply risks from somewhat less geo-political uncertainty and the relatively calm passing of the US hurricane season.

A.24 Looking ahead, high nominal oil prices are expected to be sustained into the medium term. Oil futures prices have remained high, reflecting continued, predominantly upside, risks and spare capacity below historical norms. Geo-political uncertainties, particularly in the Middle East and Nigeria, and the weather, may contribute to supply disruptions. In addition, OPEC cut production by 1.2 million barrels per day in order to defend an oil price of $60 a barrel. The impact of this cut on oil prices is partly offset by the market's reaction to a corresponding increase in OPEC spare capacity, which other things equal reduces the associated risk premium. The International Energy Agency's latest demand and supply projections suggest that market tightness will ease in the second half of 2007.

A.25 Non-fuel commodity prices rose in 2006 reflecting strong demand for industrial inputs and some supply constraints. The largest increases came in base metals such as copper, lead and iron ore, though prices of food, beverages and agricultural commodities such as timber also rose. There was some volatility in non-fuel commodity prices during May and June 2006.

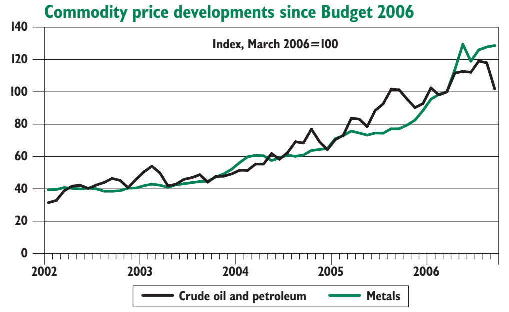
Box A2: Oil, non-fuel commodities and global demand

Fuel and many non-fuel commodity prices have increased significantly over the past four years. In some cases, notably many base metals, the increase has been rapid. The rise in metals prices has largely been demand driven, particularly from China and other emerging markets, but has been exacerbated by supply constraints stemming from low investment in productive capacity in the 1990s and early 2000s. The combined effect has been to reduce global inventories, creating tighter market conditions.

Iron ore, zinc, lead and copper prices have risen by between 113 and 255 per cent since 2003.[a] Futures prices have also risen substantially, though markets and external forecasters expect some moderation from current high prices as new supply comes on line.

Changes in metals prices tend to be positively correlated with the business cycle and can provide a useful indicator for tracking changes in global demand. Historically, most periods of large rises in metals prices have been associated with strong world growth. Notably, the recent decline in energy prices has not been matched by metals prices, suggesting that global demand growth is likely to remain strong.

Commodity price developments since Budget 2006



Source: IMF and HM Treasury calculations

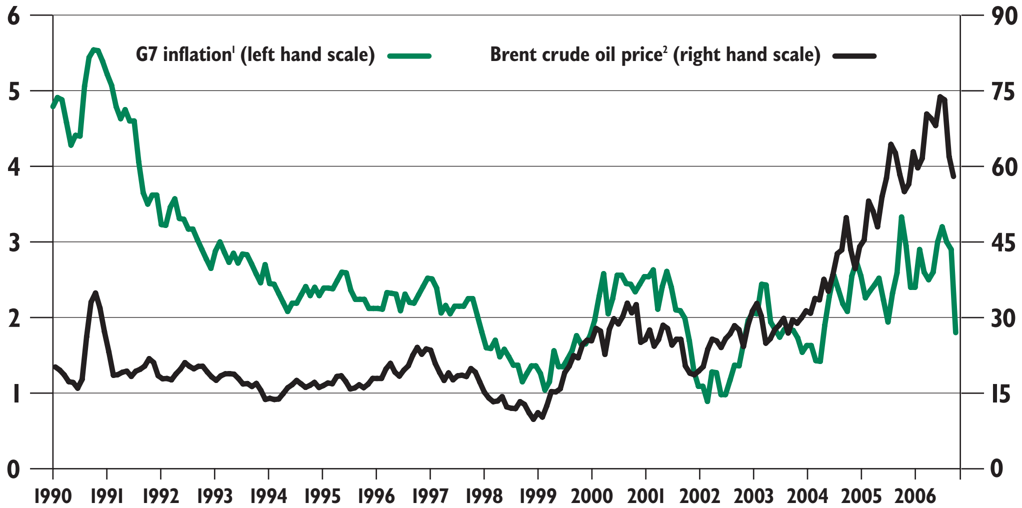
[a] Based on IMF data from the September 2006 *World Economic Outlook* database, including IMF forecasts to the end of 2006.

G7 inflation

A.26 G7 headline inflation rates continue to be dominated by energy price developments. The rise in headline inflation during the course of 2006 was arrested by the decline in energy prices since the summer. Headline inflation rates have reacted most to energy prices in the US, where energy makes up a larger part of the price index. In Japan, the headline inflation rate moved above zero in 2006, but some deflationary pressures remain.

A.27 In the G7 the core rate of inflation, which excludes food and energy prices, remained stable to March 2006 but has risen slightly thereafter, reflecting in particular developments in the US. Given the sharp rise and continued high level of energy prices, as well as some other commodity prices, the pick-up in G7 core inflation to just 2 per cent is modest. This has been attributed to a number of factors, including the greater credibility of monetary authorities and frameworks in helping to anchor inflation expectations, the competitive pressures on prices and wages from an increasingly integrated world economy, and the declining energy intensity of world output.

Chart A2: G7 inflation and oil prices



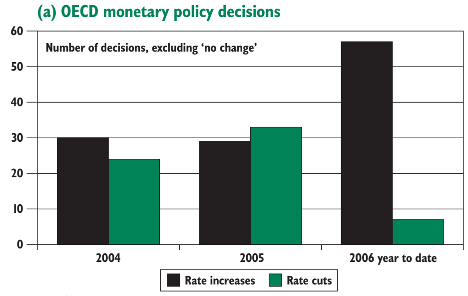
[1]*Consumer price index, percentage change on a year earlier*
[2]*US dollar per barrel*

Box A3: Inflation and monetary policy in advanced economies

Since March 2006, headline inflation across the OECD countries has risen from 2.5 to 3.0 per cent while core inflation, excluding energy and food, has risen from 1.8 to 2.1 per cent. Although these increases are relatively small, they follow a decade in which the inflation rate has steadily fallen. Growth of broad monetary aggregates, which some central banks follow, most explicitly the European Central Bank, has remained high.

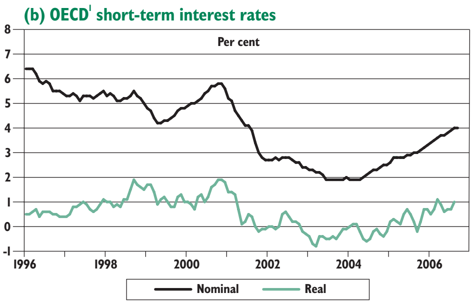
In response to increasing inflationary pressures arising from energy prices and tighter capacity constraints and, particularly in Europe, rapid broad money growth, 2006 has seen a broad-based tightening of monetary policy across the OECD. Of the 64 interest rate moves decided by OECD central banks in the year to November, almost 90 per cent have been increases; only in Poland and Mexico have rates been cut (chart a). As a result, nominal short-term interest rates have risen to their highest level since 2001. However, with inflation also higher, real interest rates have risen by less (chart b) and remain at low levels.

(a) OECD monetary policy decisions



Source: Central bank website

(b) OECD[1] short-term interest rates



Source: Bloomberg, OECD and HM Treasury calculations
[1]*Excluding Turkey*

THE UK ECONOMIC FORECAST

The Treasury's approach to macroeconomic forecasting

A.28 The Treasury's approach to forecasting macroeconomic developments accords with the 'growth cycle approach' favoured by many policymakers. At the heart of this approach is the estimate of the economy's 'trend' rate of growth, which provides the foundation for analysis of cyclical movements around that trend, the output gap, and developments in the components of demand. The Treasury's analysis of trend growth and the output gap is therefore central to the economic forecast that underpins the setting of fiscal policy. The trend growth assumption provides the medium-term anchor for the forecast. The current output gap estimate, and assessment of the economy's momentum through analysis of the individual income and expenditure components, inform judgement on the short-term path of the economy back to trend.

A.29 The Treasury assesses trend growth in the economy on the basis of non-oil gross value added (GVA) rather than overall GDP because, while the oil and gas sector affects output, it has little direct impact on capacity pressures in the rest of the economy, and hence the sustainable level of non-oil activity or employment.

A.30 The Office for National Statistics (ONS) compiles estimates of non-oil GVA in the National Accounts, but its trend level is not directly observable and must therefore be estimated. A wide variety of methods are available for decomposing the level of output into its trend and cyclical components.[3] The Treasury's approach begins with the identification of 'on-trend' points, drawing on evidence from a broad range of economic indicators.[4] The rate of trend output growth in completed past cycles is then estimated as the average growth rate between adjudged start and end-of-cycle on-trend points.

A.31 A different approach is required for estimating trend growth during the latest incomplete cycle and over the forecast horizon because the end-of-cycle on-trend point is unknown. The Treasury's approach is to decompose the change in trend output over past cycles into changes in four components: output per hour; average hours worked per worker; the employment rate; and working-age population. The next section contains a discussion of developments in these components and how they inform the overall trend growth estimate since the 2001 on-trend point.

A.32 For any assumed trend rate of growth and trend level of output at a previous on-trend point, it is straightforward to calculate the size of the output gap implied by the latest National Accounts data on actual output. So it is important to evaluate to what extent this output gap estimate is plausible by assessing whether the output gap implied by this 'trend growth arithmetic' is consistent with evidence from a broad range of cyclical indicators. Recent economic developments and an assessment of the cyclical indicators are discussed in the following sections.

[3] See *Trend growth: recent developments and prospects*, HM Treasury, April 2002, and *Evidence on the UK economic cycle*, HM Treasury, July 2005, for further details on Treasury's approach to estimating trend growth and a discussion of alternative approaches, including statistical filtering techniques and more explicit economic model-based methods.

[4] Details of the indicators monitored by the Treasury can be found in the *Technical note on cyclical indicators*, HM Treasury, December 2005.

A.33 The estimates of trend growth and the latest output gap provide the foundation for the detailed economic forecast. In the short term, the Treasury's judgement on the speed with which the economy will return to trend is informed by analysis of momentum in the key components of growth and their determinants, including assessment of the signals from private sector business survey-based indicators. In the medium term, once the economy is judged to have returned to trend, growth is generally held at its trend rate and the output gap at zero. That is not to suggest that the growth rate will actually be constant in later years of the forecast, but rather that future shocks to the economy are as likely to be positive as negative so that, on average, the best forecast of growth once present shocks have worked through will be the underlying trend rate.

Assessment of trend growth

New evidence since Budget 2006

A.34 In the light of new evidence published since Budget 2006, the Treasury has reviewed its trend output growth projections. Analysis of the new evidence, set out in *Trend growth: new evidence and prospects* published alongside the Pre-Budget Report,[5] provides the basis for upward revision to the contribution of net inward migration to working-age population growth post-2006 by a $^1/_4$ percentage point a year compared with the contribution assumed at the time of Budget 2006. This is a demographic rather than cyclical effect, and so can be properly reassessed before the end of the cycle. Recent new data on output, productivity and employment reinforce confidence in the Treasury's post-2001 projections for the other components of trend output growth. So the Treasury has revised the neutral estimate of trend output growth for the post-2006 period in line with the $^1/_4$ percentage point upward revision to working-age population growth. Instead of falling to $2^1/_2$ per cent a year, for the 2006 Pre-Budget Report the trend output growth projection will continue at the same $2^3/_4$ per cent rate as since 2001.

A.35 Consistent with past practice, projections of the public finances are based upon the lower end of the economic forecast ranges, which are anchored around the deliberately cautious assumption of trend output growth a $^1/_4$ percentage point below the neutral view. The upward revision to the neutral estimate implies an equal upward revision to the cautious estimate from $2^1/_4$ to $2^1/_2$ per cent a year in the post-2006 projection period. As required by the *Code for fiscal stability,* the National Audit Office (NAO) has audited this change to a key assumption underlying the fiscal projections.[6] The NAO has concluded that, in light of external forecasts and other information, the assumption remains reasonable and cautious.[7]

[5] *Trend growth: new evidence and prospects*, HM Treasury, December 2006.

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

[7] *Audit of assumptions for the 2006 Pre-Budget Report*, NAO, December 2006.

A.36 Table A2 presents historical estimates of trend output growth and its decomposition for the first half of the current cycle and the previous cycle, together with the forward-looking assumptions for trend growth based on projections of its components to the end of this cycle and beyond.

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	Unadjusted				
	(1)	(2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1						
Budget 2006	2.22	2.04	–0.11	0.36	0.24	**2.55**
Latest data	2.10	1.92	–0.11	0.36	0.24	**2.43**
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	2.14	1.96	–0.37	0.36	0.66	**2.63**
PBR 2002 and Budget 2003	2.35	2.14	–0.47	0.43	0.50	**2.61**
PBR 2003 and Budget 2004	2.65	2.44	–0.47	0.42	0.54	**2.94**
PBR 2004 and Budget 2005	2.70	2.50	–0.43	0.41	0.58	**3.06**
PBR 2005 and Budget 2006	2.79	2.59	–0.44	0.42	0.58	**3.15**
Latest data	2.81	2.60	–0.44	0.42	0.58	**3.16**
Projection[5]						
2001Q3 to 2006Q4						
Budget 2002	2.10	2.00	–0.1	0.2	0.6	**2¾**
PBR 2002, Budget/PBR 2003, Budget/PBR 2004 and Budget 2005	2.35	2.25	–0.1	0.2	0.5	**2¾**
PBR 2005 and Budget 2006	2.25	2.15	–0.2	0.2	0.6	**2¾**
PBR 2006[6,7]	2.25	2.15	–0.2	0.2	0.7	**2¾**
2006Q4 onwards						
PBR 2004 and Budget 2005	2.35	2.25	–0.1	0.2	0.3	**2½**
PBR 2005 and Budget 2006	2.25	2.15	–0.2	0.2	0.4	**2½**
PBR 2006[6]	2.25	2.15	–0.2	0.2	0.6	**2¾**

[1] Treasury analysis based on 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: new evidence and prospects', HM Treasury, December 2006.
[2] The underlying trend rate is the unadjusted 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. Hours worked and the employment rate are measured on a working-age basis.
[4] UK resident household basis.
[5] Neutral case assumptions for trend from 2001Q3.
[6] Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006Q3 are anchored.
[7] The projection of working-age population is consistent with average growth since 2001Q3. This may change as a result of population data revisions.

Box A4: External estimates of UK trend output growth

To enhance further the transparency of the Treasury's economic forecast, the National Audit Office (NAO) recommended that the Treasury should report on its regular internal monitoring of external estimates of trend growth.[a] When considering these external estimates, it should be taken into account that most external organisations' trend estimates are made on a whole economy GDP basis, whereas the Treasury's estimate is based on non-oil GVA. Due to the ongoing reduction in the size of the North Sea oil and gas sector, the Treasury's post-2006 non-oil GVA trend output growth estimate is equivalent to a whole economy GDP-based estimate approximately 0.1 percentage points lower. Prospects for North Sea oil and gas output, including the arithmetic behind this 0.1 percentage point difference, are discussed in paragraph A.93.

Since Budget 2006, many external institutions have revised up their estimates of the UK's trend rate of output growth in the post-2006 period.[b] These include the Organisation for Economic Cooperation and Development (OECD), National Institute of Economic and Social Research (NIESR), Oxford Economics and Goldman Sachs. The Treasury's 2¾ per cent neutral trend output growth estimate for the post-2006 period lies within the 2.6 to 2.9 per cent range of external estimates cited in the table below. The Treasury's deliberately cautious trend output growth assumption of 2½ per cent, used for the purposes of projecting the public finances, is below the range of external estimates. Adjusting from a non-oil to a more comparable whole economy basis, the Treasury's cautious assumption would be 2.4 per cent, and so materially below the range of external estimates. The NAO has audited the post-2006 cautious trend growth assumption and has concluded that, in light of external forecasts and other information, it remains reasonable and cautious.

Estimates of trend growth for the UK (per cent, per annum)

Organisation	Estimated trend rate of growth	Period
HM Treasury neutral estimate	**2¾**	2007-2011
HM Treasury cautious assumption for the public finance projections	**2½**	2007-2011
OECD [1]	2.7	2006-2008
EU Economic Policy Committee [2]	2.8	2004-2011
EC [3]	2.7	2006-2007
IMF [4]	2.6	2006-2011
Oxford Economics [5]	2.7	2006-2010
NIESR [6]	2.6	2006-2014
Goldman Sachs [7]	2.9	2005-2010

[1] *Economic Outlook 80, OECD, November 2006.*

[2] *The 2005 projections of age-related expenditure (2004-2050) for the EU25 Member States: underlying assumptions and projection methodologies, Economic Policy Committee and European Commission, November 2005.*

[3] *Autumn forecast, European Commission, 2006.*

[4] *Article IV Staff Report on the UK, IMF, March 2006. The IMF estimate dates from early 2006 and therefore may not reflect recent strong growth in labour supply.*

[5] *UK Weekly, Oxford Economics, October 2006.*

[6] *Economic Review No: 198, NIESR, October 2006.*

[7] *UK Economics Analyst, Goldman Sachs, November 2006.*

[a] *Audit of assumptions for the 2005 Pre-Budget Report*, NAO, December 2005.

[b] For a detailed discussion of external estimates of trend growth refer to *Trend growth: new evidence and prospects* published alongside the Pre-Budget Report.

Productivity growth

A.37 At the time of Budget 2006, National Accounts and labour market data suggested a degree of weakness in productivity growth from the middle of 2004 that was difficult to explain. Subsequent upward revisions to output growth, coupled with strong growth during 2006, indicate that productivity growth since 2004 has been more consistent with the projections set out in Table A2 than was the case at Budget time. The latest data shows that actual growth in output per hour worked has averaged 2.4 per cent a year since the on-trend point in 2001, compared with its unadjusted trend projection of 2.15 per cent, enhancing confidence in the trend projection.

Labour market developments

A.38 Total employment in the UK reached 29 million for the first time ever in 2006, having increased by almost 200,000 in the year to the third quarter. Growth has slowed slightly from 1 per cent in 2005 to $^3/_4$ per cent in the first three quarters of 2006, with the slowdown more than fully explained by the level of public sector employment having plateaued. Private sector employment growth has picked up from $^3/_4$ per cent in 2005 to 1 per cent in the first half of 2006. With employment among older workers up more than 9 per cent on a year earlier so far in 2006, working-age employment growth has been below that of total employment. Favourable supply-side conditions are expected to support GDP growth in 2007 and beyond, leading to a reversal of the recent rise in unemployment – see Box A5. This is consistent with some slack in the labour market.

A.39 As the economy moved below trend in 2002 and 2003, average hours worked per week fell from $32^1/_2$ to 32. Since late 2003, average hours have stabilised. Thus, recent movements in average hours show reversion towards their projected downward trend of 0.2 per cent a year. Currently, average hours are estimated to be only slightly below trend, and appear consistent with the trend assumption.

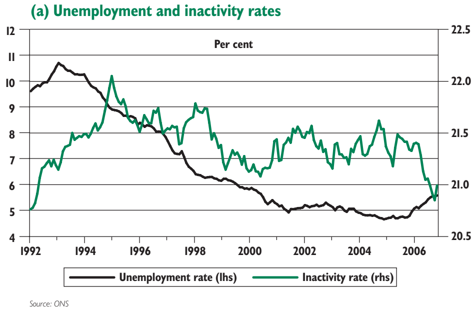
A.40 A key ongoing uncertainty affecting labour market data relates to the measurement of migration flows and growth in the working-age population. Official population data, to which the Labour Force Survey (LFS) sample is grossed, are based on the UN definition of a migrant as an individual who changes their country of residence for a period of at least one year. As such, temporary foreign workers are not properly picked up in the LFS employment data. The ONS has a work programme aimed at improving migration statistics.

Box A5: Labour supply

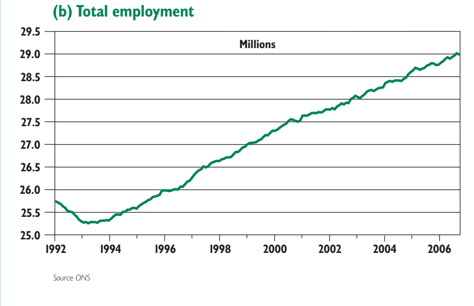
The employment rate has recently held relatively steady during a period in which the labour force has been boosted by strong working-age population growth. Labour supply has been further boosted this year by a significant fall in the working-age inactivity rate, which has fallen by ½ a percentage point since the beginning of 2006 to its lowest since 1992 (chart a). Up until then the inactivity rate had remained broadly flat over recent years, although excluding the strong rise in the number of students there has been a significant downward trend for some time.

In the UK's flexible labour market, the boost to the labour supply experienced in 2006, together with subdued growth in earnings and unit wage costs, bodes well for further growth in employment. These favourable supply-side conditions are expected to support GDP growth in 2007 and beyond, leading to a reversal of the recent rise in unemployment.

(a) Unemployment and inactivity rates



(b) Total employment



Overview of recent developments

A.41 The Government's macroeconomic framework and promotion of flexible and open labour, product and capital markets has continued to deliver an unprecedented period of sustained economic growth with low inflation. UK GDP has now expanded in 57 consecutive quarters, the longest unbroken expansion since quarterly National Accounts began in 1955, and the longest ongoing expansion among all OECD countries – see Box 2.1. So far this decade, the UK has successfully achieved lower inflation and higher growth than most of its major competitors. In the past five years, the UK has enjoyed the second lowest rate of inflation in the G7, after Japan, which has until recently struggled with deflation, and growth rates similar to those in the US and Canada, and significantly stronger than in the euro area.

GDP growth

A.42 UK GDP growth has been stronger than expected at the time of Budget 2006. GDP has expanded by 0.7 per cent in each of the past four quarters. Non-oil GVA, which is the basis for the Treasury's trend growth and output gap estimates, has grown slightly faster than GDP, at above or in line with trend rates, for the past five quarters.

Table A3: Quarterly GDP and non-oil GVA growth

	Percentage changes on previous quarter						
	2005				2006		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
GDP	0.2	0.5	0.5	0.7	0.7	0.7	0.7
Non-oil GVA	0.4	0.5	0.7	0.7	0.7	0.8	0.7

A.43 Budget 2006 forecast a rebalancing of growth away from consumption towards investment and exports. Revised data suggest that rebalancing was already underway to a greater degree than estimated at the time of Budget 2006. Revisions to past data show that total investment has been growing faster than GDP since the middle of 2005, while private consumption has been growing slightly slower. Outturn data in 2006 have also been stronger than expected. In particular, business investment in the third quarter of 2006 was up 7 per cent on a year earlier. There has been some rebalancing on the output side of the economy too, where ongoing service sector growth has been supported by some recovery in the manufacturing sector. Finally, there has been some rebalancing between domestic and external sources of demand, supported by a strengthening in euro area growth this year.

Inflation

A.44 Consumer price inflation has risen since Budget 2006, from 1.8 per cent in March to 2.4 per cent in October. The rise has been largely due to increases in energy, particularly domestic gas and electricity, and food price inflation. Core inflation, as measured by the CPI excluding food, alcoholic beverages, tobacco and energy, has been broadly stable since the Budget. With energy and food prices driving overall inflation higher, there has been a significant narrowing in the gap between goods and services price inflation. Goods prices excluding energy and food have continued to fall at annual rates of between 1 and 2 per cent.

A.45 The majority of the recent increase in CPI inflation is not accounted for by domestically-generated inflationary pressures, which have remained subdued, in particular average earnings growth. Import prices fell consistently between 2001 and 2004, but since 2005 have risen, primarily due to high oil prices. In turn, higher import prices pushed producer input price inflation to 18 per cent by the end of 2005. The impact on output price inflation was muted as producers absorbed most of the increase in margins. Producer output price inflation averaged $3^1/_4$ per cent in the first half of 2006, and slowed to $2^1/_2$ per cent in the third quarter.

Monetary and fiscal policy

A.46 Against a backdrop of above-trend UK GDP growth, the Monetary Policy Committee (MPC) of the Bank of England pre-emptively raised interest rates on five occasions between November 2003 and August 2004. As GDP growth slowed to below trend rates in 2005, the interest rate was cut by 25 basis points in August 2005. This year, as growth has strengthened and CPI inflation has moved above target, the MPC has acted by raising the Bank rate by 25 basis points in both August and November. Fiscal policy has been moderately tightened since 2004-05.

Assessment of the output gap

A.47 Since Budget 2006, estimates of growth in non-oil GVA have been revised up by around a $^1/_4$ percentage point in each of 2003, 2004 and 2005. Although it now appears that the economy may have temporarily moved slightly above trend in 2004, this is not assessed to be an end-cycle point because output did not move decisively through trend and quickly moved back below trend.[8] The revised profile through 2005 shows growth rising to its trend rate by the third quarter, in contrast to the below-trend rates reported at Budget time. That momentum has been carried into 2006, with non-oil GVA growth slightly above trend in each of the first three quarters of the year. Revisions to past data and stronger than expected growth in 2006, together with the Treasury's trend output assumptions, imply a smaller negative output gap of around -$^1/_4$ per cent at present, narrower than the -1$^1/_4$ per cent implied at Budget 2006.

Evidence from cyclical indicators

A.48 In assessing the cyclical position of the economy, the Treasury considers a range of economic indicators, including private sector business surveys, labour market indicators and price data. At the time of Budget 2006, the result of this assessment was to highlight tensions between the output gap estimate implied by the trend growth arithmetic and the evidence from the cyclical indicators. So there was considerable uncertainty about the extent to which the economy had been operating below trend over the recent past. Following National Accounts revisions and latest outturns since Budget 2006, there is now closer coherence between the current output gap estimate and the latest evidence from the cyclical indicators. This increases confidence in the current assessment although there are still considerable uncertainties, mainly associated with labour supply and the possibility that there could be more slack than currently estimated.

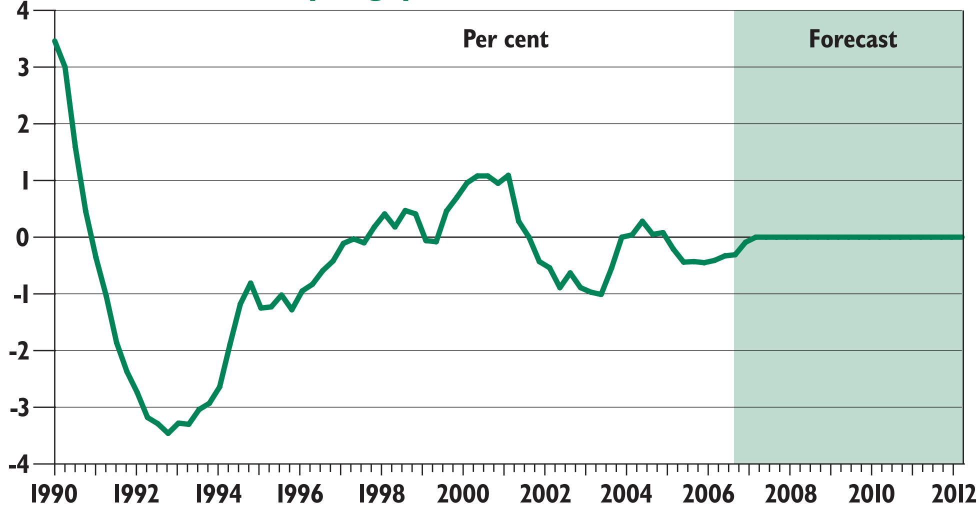
A.49 Private sector business surveys indicate that capacity utilisation in the services sector has risen towards levels consistent with on-trend output, while utilisation in the manufacturing sector has moved marginally above such levels. Given the service sector's greater contribution to total output, this evidence is consistent with the economy being below, but close to, trend.

A.50 Despite robust employment growth, recent labour market developments and survey indicators suggest some ongoing slack in the economy. These indicators also point to a differential impact of growth in the labour force on the availability of specific types of labour. In both the services and manufacturing sectors, employers have been reporting tighter conditions in the hiring of professional, managerial and clerical labour, compared with semi- and unskilled workers. In line with ongoing labour market slack, average earnings growth has remained subdued, with the whole economy rate excluding bonuses consistently below 4 per cent since summer 2005, and recently falling to just 3$^1/_2$ per cent in the third quarter of 2006.

[8] This is wholly consistent with the approach set out in *Evidence on the UK economic cycle*, HM Treasury, July 2005.

A.51 Domestically-generated pressures arising from the cyclical position of the economy have not driven the rise of CPI inflation above target since Budget 2006. Rather, the hot summer pushed food prices higher; energy prices have risen due to high oil prices and, more recently, the lagged effects of high wholesale gas prices; and, import price developments have contributed to a slowing in the rate of deflation in durable goods. Indicators of domestically-generated inflation, most notably average earnings growth and services prices, have not picked up, consistent with the economy close to, but remaining below, trend.

Chart A3: The output gap[1]



[1] *Actual output less trend output as a per cent of trend output (non-oil basis)*

GDP and inflation forecasts

Table A4: Summary of forecast[1]

		Forecast			
	2005	**2006**	**2007**	**2008**	**2009**
GDP growth (per cent)	1¾	2¾	2¾ to 3¼	2½ to 3	2½ to 3
CPI inflation (per cent, Q4)	2¼	2½	2	2	2

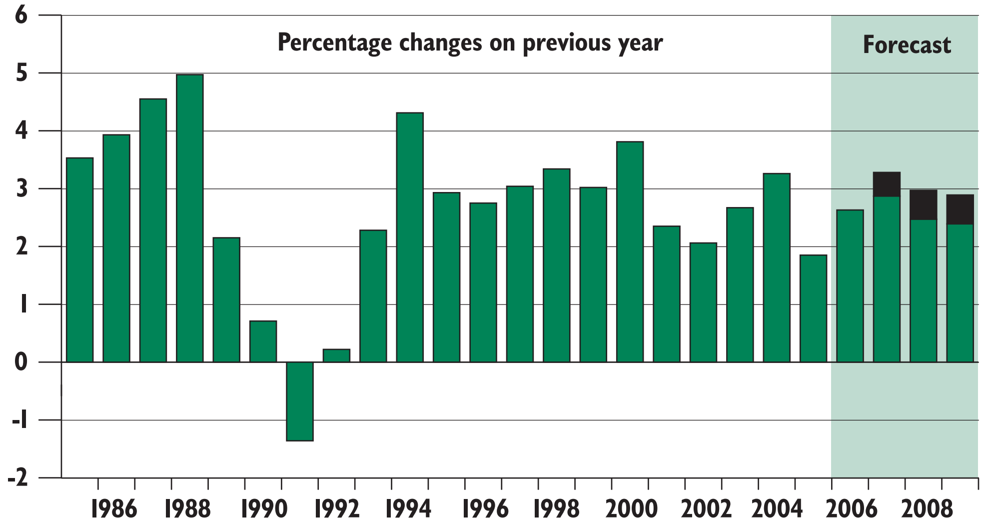
[1] *See footnote to Table A10 for explanation of forecast ranges.*

GDP and the composition of demand

A.52 With growth in recent years having been stronger and more balanced than was estimated at the time of Budget 2006, and that pattern having continued in 2006, the Pre-Budget Report economic forecast is for growth to continue at close-to-trend rates throughout the forecast horizon. The output gap is currently estimated to be around -¼ per cent and is expected to close early in 2007.

A.53 Growth in 2006 is expected to be $2^3/_4$ per cent, above the Budget 2006 forecast range. Growth in 2007 as a whole is expected to reach $2^3/_4$ to $3^1/_4$ per cent, in line with the Budget forecast, reflecting above-trend growth in the second half of 2006 and early 2007. The recent momentum of business investment in particular is expected to carry through into 2007, and private sector business surveys point to strong output growth in the near term. Favourable supply-side conditions, with subdued growth in earnings and unit wage costs, should also support GDP growth next year. With the output gap closing early in 2007, and in the absence of clear evidence that momentum in the economy will carry output above trend during 2007, the Pre-Budget Report forecast is for growth to be close to trend in the second half of 2007 and to remain at $2^1/_2$ to 3 per cent in 2008 and 2009. The forecast shows continued rebalancing of growth, as discussed from paragraph A.56 onwards.

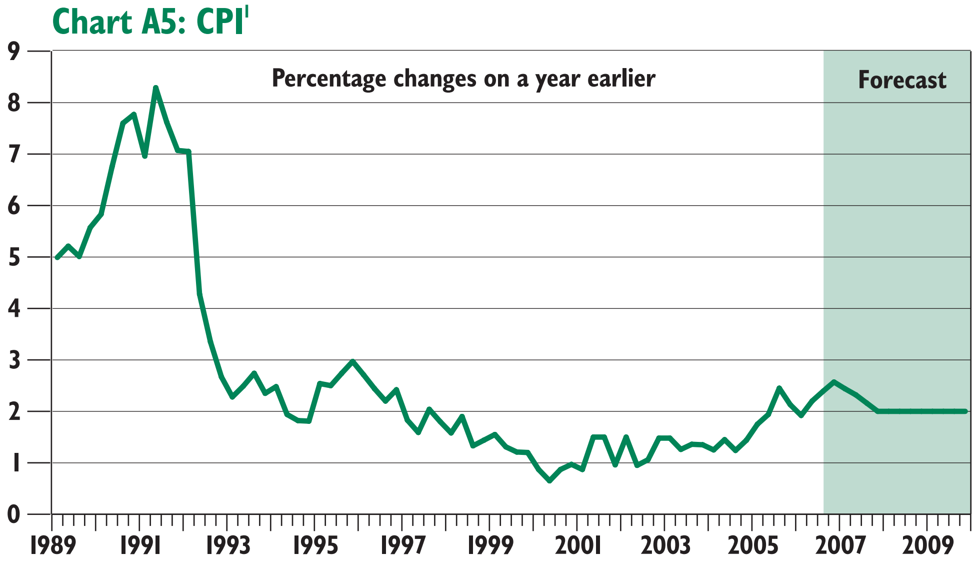
Chart A4: Gross domestic product (GDP)



Inflation

A.54 The recent rise in CPI inflation has not been driven by domestic cyclical factors, but by energy and food prices. The impact of higher energy prices, particularly domestic utility tariffs discussed in Box A6, and food prices are expected to unwind during 2007. Import price inflation is expected to slow slightly in 2007 driven by oil prices, which are expected to remain below the levels experienced in late summer 2006. Excluding oil, strong world growth is expected to keep import price inflation positive at close to recent rates. Producer output price inflation is expected to slow in 2007 but, with input price inflation falling more quickly, producers' margins are expected to recover.

A.55 Against this background, CPI inflation is expected to remain above target into the first half of 2007, before quickly returning to target, with monetary policy keeping inflation expectations firmly anchored. The lack of evidence of any second-round effects on other prices supports the view that the recent rise in inflation will be temporary. It is notable that producers of energy-intensive manufactured goods have passed very little of the rise in input prices on to customers, absorbing the impact in margins. Similarly, average earnings growth has remained subdued. The absence of second-round effects reflects the credibility of the Government's monetary policy framework in successfully anchoring inflation expectations.



[1]Outturns until 2006Q3; forecasts for every second quarter from 2006Q4 to 2009Q4

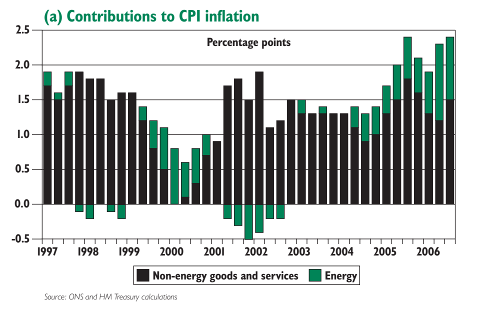
Box A6: Energy prices and UK inflation

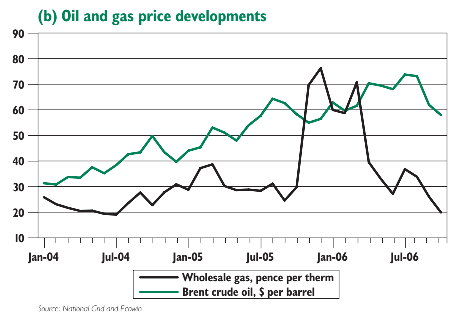
Increases in oil and energy prices have been the key driver of the recent increase in inflation. Excluding the impact of energy prices, annual CPI inflation has remained stable below 2 per cent (chart a). The price of crude oil reached record highs over the summer and wholesale gas prices increased sharply during the winter of 2005/2006 (chart b). Respectively, these developments fed through swiftly to a substantial rise in petrol prices and with a lag to domestic utility prices.

The tight demand-supply balance in the wholesale gas market that pushed prices higher was caused by: expectations of a cold winter; high US demand for liquefied natural gas in the aftermath of Hurricane Katrina; lower than expected North Sea gas production; the closure of the UK's largest gas storage facility due to a technical failure; and, low flows of gas through the interconnector from Europe.

An expected increase of at least 30 per cent in the UK's gas import capacity this year should ease supply constraints. A large new pipeline from Norway opened in October; steps to increase supplies through the interconnector have already been made; a new pipeline from the Netherlands is due to be fully operational in December; and, storage capacity and levels have been restored. As a result, wholesale gas prices have fallen in recent months. While some weather-related uncertainty remains over prospects for gas prices this winter, recent upward pressure on utility prices is expected to abate. For crude oil prices, the average of independent forecasts for 2007 is currently for Brent to average $60.3 per barrel, almost 10 per cent below 2006 levels.

Given the expected developments in these key determinants of consumer energy prices, their contribution to CPI inflation is expected to fall during 2007.





UK DEMAND AND OUTPUT IN DETAIL

A.56 The rebalancing of growth that has taken place since the beginning of 2005 is expected to continue, and supply-side conditions are expected to remain supportive of growth. Private consumption is forecast to grow at slightly slower rates than the overall economy, reflecting the lagged effect of higher than expected inflation on real incomes, the effect of recent interest rate increases and a higher propensity to save. Business investment is expected to carry some of its current momentum into 2007 as corporate profitability is expected to remain strong and the cost of capital low by historical standards. Net trade made a neutral contribution to GDP growth in 2005 and is expected to make small negative contribution in 2006. With solid underlying export growth and somewhat slower import growth, the impact of net trade on GDP growth is expected to be broadly neutral from 2007. In line with developments in 2005 and 2006, GDP growth is forecast to be significantly more balanced than in earlier years of this decade, with a weaker contribution from consumption and stronger contributions from business investment and net trade.

Table A5: Contributions to GDP growth[1,2]

	Percentage points, unless otherwise stated					
	Average		Forecast			
	2000 to 2004	2005	2006	2007	2008	2009
GDP growth, per cent	**2¾**	**1¾**	**2¾**	**2¾ to 3¼**	**2½ to 3**	**2½ to 3**
Main contributions						
Private consumption	2¼	1	1½	1½	1½	1½
Business investment	¼	¼	½	½	½	½
Government[3]	¾	½	½	¾	½	½
Change in inventories	0	0	0	0	0	0
Net trade	–½	0	–¼	0	0	0

[1] *Components may not sum to total due to rounding and omission of private residential investment, transfer costs of land and existing buildings and the statistical discrepancy.*

[2] *Based on central case. For the purpose of projecting the public finances, forecasts are based on the bottom of the GDP forecast range.*

[3] *The sum of government consumption and government investment.*

Households and consumption[9]

A.57 Household consumption is the largest expenditure component of UK GDP. After two decades of almost continuous increase, the share of nominal consumption expenditure in GDP drifted downwards between 2001 and 2004. Volume growth has been relatively stronger reflecting falling import prices and the effects of strong price competition in retail and other consumer markets. The ratio of nominal consumer spending to GDP stabilised from early 2005 at around 64½ per cent before declining again in the third quarter of 2006.

[9] In the National Accounts, private consumption is comprised of final consumption expenditure by households and non-profit institutions serving households (NPISH). Throughout this section, the terms 'household consumption' and 'private consumption' always refer to total final consumption expenditure by households and NPISH.

Table A6: Household sector[1] expenditure and income

	Percentage changes on previous year, unless otherwise stated				
		Forecast			
	2005	2006	2007	2008	2009
Household consumption[2]	1½	2	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
Real household disposable income	2¼	2	2¼ to 2½	2¼ to 2¾	2 to 2½
Saving ratio[3] (level, per cent)	5	5½	5¾	5¾	5¾

[1] *Including non-profit institutions serving households.*

[2] *Chained volume measures.*

[3] *Total household resources less consumption expenditure as a per cent of total resources, where total resources comprise households' disposable income plus the increase in their net equity in pension funds.*

Disposable income

A.58 Real household disposable income growth slowed to 1¾ per cent in 2004, but picked up to 2¼ per cent in 2005 and continued at that rate of growth in the first half of 2006. Subdued real income growth reflects a number of factors, initially the effects of the 125 basis point increase in interest rates between November 2003 and August 2004 and, more recently, the impact of high energy and rising food prices on real purchasing power. Relatively steady growth in employment and average earnings have led to aggregate wages and salaries at the whole economy level registering stable growth rates over the past two years. Real disposable income growth is expected to be broadly stable at around 2 to 2½ per cent over the forecast period.

Household spending

A.59 Real private consumption growth slowed to 1½ per cent in 2005 from 3¼ per cent in 2004. In both years, growth has been revised down by a ¼ percentage point since Budget 2006. The quarterly profile of latest ONS data for consumption growth now shows a fairly smooth slowdown from the beginning of 2004 to the second quarter of 2005 followed by a similarly smooth pick-up to the second quarter of 2006. Growth in the third quarter slowed, perhaps reflecting some of the temporary factors discussed in the next paragraph. Growth in 2006 is expected to reach 2 per cent, consistent with steady growth in disposable income.

A.60 Over the past year, retail sales data have been difficult to interpret, with particularly strong growth rates in the fourth quarter of 2005 and second quarter of 2006 followed by much weaker growth rates in the first and third quarters of 2006. Temporary factors including the timing of Easter, hot weather in the early summer and the football World Cup may all have affected the short-term time profile of consumers' spending. They are, though, unlikely to have affected trends in the overall volume of spending. Six-month on previous six months growth rates have picked up steadily since the middle of 2005. After declining through 2005, consumer confidence has stabilised and currently stands at a level close to its long-run average.

A.61 Between 2001 and 2004, the household consumption deflator increased more slowly than the overall GDP deflator, and so the relative price of household consumption fell. Since the beginning of 2005, the relative price has risen slightly, driven by rising prices of non-durable goods, mainly energy, and services, in particular housing. Durable and semi-durable goods prices have continued their recent downward trend reflecting the ongoing boost to household purchasing power from strong domestic and global competition in these markets.

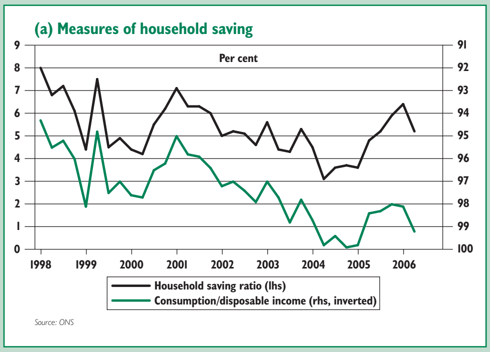
Saving ratio

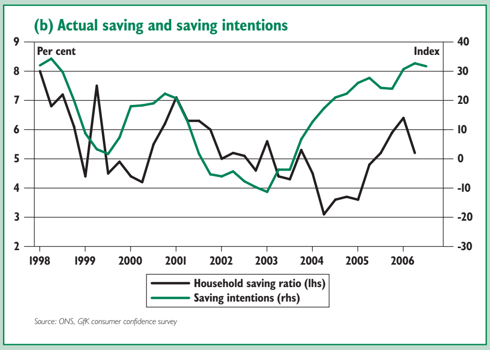
A.62 With growth in consumption lagging changes in income, there was a significant impact on the household saving ratio, which fell from 5 per cent in 2003 to 3¾ per cent in 2004, before rising to 5 per cent again in 2005. The saving ratio is forecast to rise a little further, largely accounted for by households' net equity in pension funds. As explained in Box A7, the possibility of a larger increase represents a downside risk to the consumption forecast.

Box A7: Developments in household saving

Over the two years to the beginning of 2006, the household saving ratio doubled to just under 6½ per cent, before falling in the second quarter. The increase has been driven first by a small drop in the share of disposable income used for consumption expenditure and, more recently, by an increase in households' net equity in pension funds. The contribution of this pension-related saving to the overall household saving ratio has risen to its highest for 16 years, reflecting the increase in employers' contributions to funded pension schemes (chart a).

Despite a rising saving ratio, survey evidence suggests that households' desire to save has risen proportionately more (chart b). To the extent that households view pension-related saving, which has been predominantly driven by employers' contributions, differently to saving from current disposable income, this may explain some of the discrepancy between survey responses and the measured saving ratio.





House prices **A.63** At Budget 2006, recent evidence was assessed to be consistent with a smooth realignment in the housing market from annual inflation rates in excess of 20 per cent that prevailed until the summer of 2003, to rates of around 4 to 5 per cent. So far in 2006, house price inflation has strengthened to more than 8 per cent. Some historically reliable short-term indicators[10] suggest a small further increase through the end of 2006. During this period, 12-month growth rates are likely to be boosted by the effects of relatively low monthly rates of increase a year earlier.

A.64 There is some evidence that the recent strength of house price inflation may be linked to supportive financing conditions related to developments in the bond market and the growth of fixed-rate mortgages. In line with global bond market developments, between March and July 2005 the 2-year bond yield in the UK fell by 80 basis points while the Bank rate remained stable at 4¾ per cent. As a result, the price of fixed-rate mortgages, which are priced using bond yields, fell relative to standard variable rate mortgages, which are priced using the Bank rate. In response, the share of fixed-rate mortgages in new borrowing rose sharply, indicative of the flexibility of the UK's financial services industry. The impact of these developments was to provide a stimulus to the housing market during 2005 that would not have occurred if all mortgages were priced off the Bank rate. That stimulus is expected to have been temporary and, looking further ahead, with tighter financing conditions house price inflation is likely to moderate again to rates in line with income growth.

A.65 Investment in dwellings, around 90 per cent of which is carried out by households, is an important component of whole economy investment, accounting for just under a quarter of the total. Having expanded by 2¼ per cent in 2005, growth picked up strongly in the first half of 2006 to 7¾ per cent on a year earlier. On the back of this momentum, growth is forecast to remain strong in 2007 before moderating in line with housing market fundamentals.

[10] For example, the ratio of property sales to the stock of properties reported by chartered surveyors in the RICS *Housing Market Survey*, which shows a strong positive correlation with house price inflation.

Companies and investment

A.66 The role of corporate sector investment in the economy extends far beyond the 10 per cent of GDP accounted for by business investment. Investment also affects future growth through the accumulation of physical capital available to each worker with which to produce goods and services. Rising capital intensity is an important driver of labour productivity growth. The contribution of investment to productivity and long-run economic growth is discussed in detail in Chapter 3 and *Productivity in the UK 6: Progress and new evidence.*[11]

Company finances

A.67 Companies can finance investment either internally, using the cashflow generated by their operations, or externally, through bank lending or by issuing equity or debt to investors. In recent years, both sources have created a supportive environment for business investment.

A.68 In terms of profitability, the net rate of return on assets in the non-financial corporate sector rose to a record high of 14 3/4 per cent in the second quarter of 2006. That was driven by record highs in the service sector and near-record highs for companies operating in the North Sea oil and gas sector.

A.69 Turning to external financing conditions, the cost of capital remains low by historical standards. A combination of low inflation, domestic macroeconomic stability and strong global liquidity has helped to keep government bond yields low and the spread charged to corporate borrowers small. The FTSE 100 index of leading shares has risen from around 6,000 at the time of Budget 2006 to an average of 6,168 in November. The relatively low cost of capital has encouraged companies to take on more debt in recent years. This has led to an increase in the ratio of corporate debt liabilities to gross operating surpluses to historically high levels. Taken in isolation, such an increase could be seen as a potential drag on investment, but the ratio of interest payments to gross operating surpluses, income gearing, remains well below the levels reached in the early 1990s. Companies have been accumulating financial assets and liabilities at a similar rate, which has left the ratio of total assets to liabilities broadly stable. Furthermore, the build-up of financial assets has largely been in the form of deposits, so that the ratio of liquid assets to total liabilities, a common measure of balance sheet health, has improved significantly in recent years.

Business investment

A.70 With internal and external financing conditions broadly supportive, the relatively subdued growth of business investment in recent years has been somewhat surprising. Stronger business investment was identified as a key upside risk to the Budget 2006 economic forecast. Revisions to past data and relatively strong outturns so far in 2006 have partly crystallised that risk. Compared with the data at Budget time, annual business investment growth in 2004 has been revised down from 3 1/4 to 2 1/4 per cent while growth in 2005 has been revised up from 1 1/2 to 3 1/4 per cent. Investment in the manufacturing sector was particularly strong in 2005, growing by 12 1/2 per cent. Business investment gathered momentum in the first three quarters of 2006, growing by 5 1/4 per cent on a year earlier, significantly above the Budget forecast range for the year as a whole of 1 to 1 1/2 per cent. In the year to the third quarter of 2006, business investment grew by 7 per cent.

[11] *Productivity in the UK 6: Progress and new evidence*, HM Treasury, March 2006.

A.71 The stronger path of business investment growth since the beginning of 2005 has meant that in volume terms its ratio to GDP has risen to its highest since 2002. As a result of the ongoing fall in the price of investment goods relative to those in the whole economy, the share of business investment in nominal GDP has remained stable at around $9^1/_2$ per cent over that period.

Box A8: Intangibles and the changing nature of investment

As developed economies shift towards knowledge-based activities and higher value-added goods and services, the nature of investment may be changing. Firms are spending increasingly on research and development, branding, training and organisational change. At present, these are classified as current expenditure in the National Accounts but, given their intended purpose of raising future capacity and efficiency, might reasonably be considered as investment.

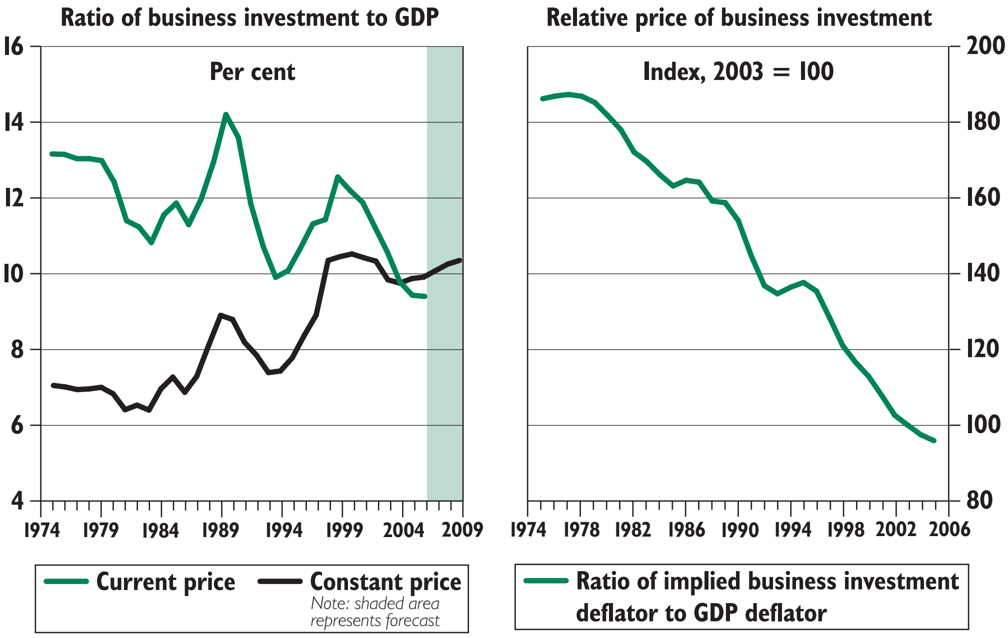
ONS estimates of UK business investment are based on the internationally-agreed System of National Accounts (SNA) definitions that are strongly focused on investment in tangible assets. Software investment is included, but presents significant measurement challenges. The ONS has estimated that improvements to the measurement of own-account, in-house software investment could raise measured total UK software investment in 2003 to around £21bn from the current estimate of £8bn. These estimates are currently experimental and will not be incorporated into the National Accounts until the summer of 2007. Even then, measured business investment will cover only a limited range of intangibles spending. Looking further ahead, the ongoing review of the SNA appears likely to conclude that research and development should be classified as investment.

Recently published academic work has investigated business investment in intangibles, including research and development, branding, training and organisational change, in the UK and US.[a] For the UK, total investment in intangibles was estimated to be £116bn in 2004, equivalent to 10 per cent of GDP. This compares with officially measured business investment in 2004 of £112bn, which includes around £15bn of intangible investment. While uncertain, these estimates suggest that a broader definition of intangible capital could roughly double UK business investment. Estimates for the US yielded similar results, with business sector investment in intangibles equivalent to around 11 per cent of GDP on average between 1998 and 2000.

Strong growth in the creative industries is indicative of the importance of intangibles in the UK economy. These industries, which among others include advertising, architecture, film, software and computer games, are some of the main producers of intangibles. Collectively they grew by an average of 5 per cent a year between 1997 and 2004, compared with 3 per cent for the whole economy. In finance and business services, the largest and fastest growing sector of the UK economy, investment in intangibles, particularly software, product development, branding and organisational change, is likely to be disproportionately important.

[a] Giorgio Marrano, M. and Haskel, J. (2006), *How much does the UK invest in intangible assets?*, Queen Mary, Department of Economics, working paper 578; and, Corrado, C., Hulten, C. and Sichel, D. (2006), *Intangible capital and economic growth*, NBER working paper 11948. Both papers note that due to difficult measurement issues their estimates must be considered exploratory, but that they do highlight the importance of intangible investment.

Chart A6: Business investment[1]



[1] Business investment includes investment by public corporations and investment under the Private Finance Initiative

A.72 The outlook for business investment is positive. Profitability is expected to remain strong and the cost of capital to remain low by historical standards. Recent private sector business surveys, particularly those of the service sector, point to further investment growth. Indeed, though the Pre-Budget Report business investment forecast for 2006 has been revised up substantially compared with Budget 2006, there are still significant upside risks in 2007 and beyond.

Table A7: Gross fixed capital formation

	Percentage changes on previous year				
		Forecast			
	2005	2006	2007	2008	2009
Whole economy[1]	2¾	6	5¼ to 5¾	3¼ to 3¾	3¼ to 3¾
of which:					
Business[2,3]	3¼	5¾	4¾ to 5½	4 to 4¾	3¾ to 4½
Private dwellings[3]	2¼	8	4½ to 5	2¾ to 3¼	2¾ to 3¼
General government[3]	–1¼	6¾	13¼	2	2

[1] Includes costs associated with the transfer of ownership of land and existing buildings.

[2] Private sector and public corporations' non-residential investment. Includes investment under the Private Finance Initiative.

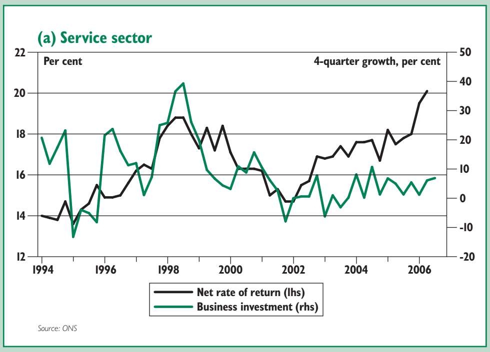
[3] Excludes purchases less sales of land and existing buildings.

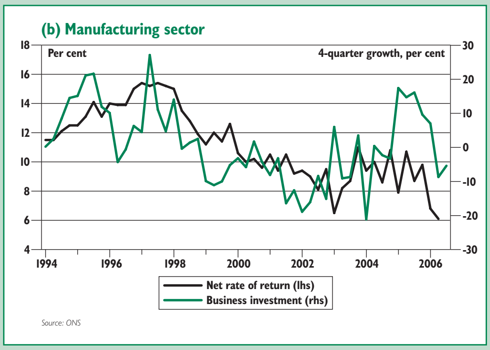
Box A9: Profitability and business investment

In the past, corporate profitability, measured by the net rate of return on assets, has been a reasonably reliable indicator of business investment growth, despite the rate of return being a backward-looking measure. In more recent years, at least until lately, the significant increase in rates of return to record high levels has been accompanied by only a relatively modest pick-up in business investment growth. Explaining this discrepancy casts light on the balance of risks surrounding the business investment forecast.

Part of the explanation is that average rates of return for the whole corporate sector have been pushed higher because of oil-related profits at companies operating on the UK Continental Shelf (UKCS), where investment growth did not turn positive until 2005. However, non-UKCS rates of return have also risen to levels that, based on historical relationships, would suggest stronger business investment growth.

Decomposing the data a step further shows that it is in the service sector that investment growth does not appear to have responded to rising profitability (chart a). Investment growth in the manufacturing sector has perhaps been a little stronger than the rate consistent with prevailing rates of return (chart b). Business surveys broadly support the suggestion that there is scope for service sector business investment, which accounts for around three-quarters of the total, to strengthen further. Nevertheless, as discussed in Box A8, large parts of spending that service sector businesses might regard as investment are not currently scored in official investment measures.





Government

A.73 Nominal government consumption has stabilised as a share of GDP in 2006 at around $22^1/_4$ per cent. The latest National Accounts data show that general government investment fell $1^1/_4$ per cent in 2005, compared with growth of $18^1/_2$ per cent reported at the time of Budget 2006, due largely to a reclassification of investment between sectors explained in Annex B.

Trade and the balance of payments

A.74 Annual growth in recorded exports and imports of goods and services has become increasingly distorted by activity related to missing trader intra-community fraud (MTIC), which has significantly inflated measured goods trade. The ONS constructs the UK's balance of payments in accordance with the European System of Accounts, which requires that trade related to fraudulent activity be included in export and import statistics.

A.75 MTIC-related activity should not, in principle, affect official estimates of net trade because the impact on export and import volumes should be equal. However, estimates of MTIC-related activity are subject to inevitable measurement difficulties, which in practice may carry over to estimates of net trade. The ONS has advised that due to the size of the changes in recent MTIC-related activity, "comparisons of [trade] volume and prices ... should be treated with a great deal of caution."[12] The ONS also publishes estimates of trade volumes excluding MTIC-related activity, which more accurately reflect underlying trends in goods trade.

A.76 The latest ONS published estimates of MTIC-related activity suggest it fell sharply in the third quarter of 2006, by around two-thirds compared with the level experienced in the first half of the year. This has a significant effect on forecast rates of growth in 2006 and 2007 because the forecast abstracts from MTIC effects by assuming that beyond the latest quarter of data export and import volumes grow in line with underlying trade, excluding MTIC-related activity. The forecast is therefore based on the neutral assumption that the level of MTIC-related activity stays flat at the latest quarterly estimate throughout the forecast.

Exports of goods and services

A.77 The overall volume of goods and services exports grew by 7 per cent in 2005, up from 4¾ per cent in 2004. Growth picked up further to over 14 per cent in the first three quarters of 2006, significantly boosted by estimates of MTIC-related activity. Excluding MTIC, export growth slowed to 4¼ per cent in 2005 from 5¾ per cent in 2004, mainly due to the slowdown in services export volume growth from 11¼ per cent to 3¼ per cent, driven by lower exports of insurance services. Export growth excluding MTIC-related activity rose to 6¼ per cent on a year earlier in the first three quarters of 2006, in part reflecting the positive impact on the UK economy of stronger growth in the euro area. The value of goods exports excluding MTIC to the EU was up 8 per cent on a year earlier in the first half of the year, and 10¾ per cent in the third quarter.[13]

A.78 The volume of oil exports peaked in 2001 at 82 million tonnes and has fallen in each year since to 50½ million tonnes in 2005 when, for the first time since 1980, the UK imported more crude oil than was exported. High oil prices have meant that the share of oil in the value of total exports actually increased from less than 8 per cent in 2001 to 9½ per cent in 2005. Looking ahead, the volume of oil exports is expected to continue to decline throughout the forecast period reflecting the trend decline in North Sea production discussed in paragraph A.93.

A.79 The underlying momentum in export growth, excluding MTIC-related activity, is expected to continue, with a forecast increase of around 6 per cent in 2006, slowing slightly to around 5 per cent in 2007. The effect of high estimated MTIC-related activity in the first half of 2006, the sharp fall in the third quarter, and the forecasting assumption thereafter means that overall export volumes are forecast to grow by almost 12 per cent in 2006, falling to less than 1 per cent in 2007.

Imports of goods and services

A.80 Growth in the volume of imports of goods and services excluding MTIC-related activity slowed to 4 per cent in 2005 from 7½ per cent in 2004. Growth in the year to the third quarter of 2006 picked up to 6¾ per cent, as underlying growth in goods imports rose to 7¾ per cent from 4 per cent in 2005. Over the same period, annual growth in services imports slowed from 3¾ per cent to 3 per cent.

[12] *First release: UK trade*, ONS, November 2006.

[13] The ONS does not publish estimates of the volume of exports excluding MTIC-related activity by region.

A.81 In line with moderate rates of private consumption growth, imports are expected to grow slightly slower than exports throughout the forecast period. However, since imports of goods and services are roughly one-eighth larger than exports, a lower percentage growth rate is equivalent to the same increase in absolute terms. As a result, the contribution of net trade to GDP growth is expected to be broadly neutral.

Table A8: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes[1]		Prices[2]			Goods and services balance
	Exports	Imports	Exports	Imports	Terms of trade[3]	
2005	4¼ (7)	4 (6½)	1¼	3¾	–2½	–45¼
Forecast						
2006	6 (11½)	6¼ (11)	2	3	-1	–53½
2007	5 to 5½ (½ to 1)	4¼ to 4¾ (¼ to ½)	2½	2¾	-¼	–54¾
2008	4¾ to 5¼	4¼ to 4¾	2¾	2¾	0	–57
2009	4½ to 5	4 to 4½	2¾	2¾	0	–59¼

[1] *Excluding MTIC-related activity. Figures in parentheses include MTIC-related activity. In 2008 and 2009, export and import growth including and excluding MTIC are the same, reflecting forcast assumptions.*

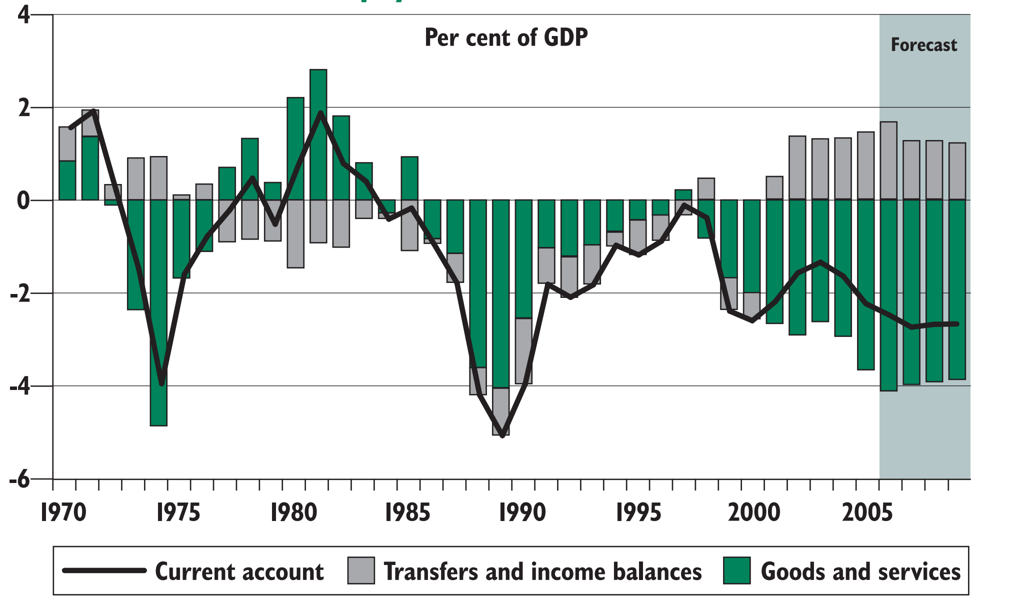
[2] *Average value indices.*

[3] *Ratio of export to import prices.*

Current account **A.82** The UK current account deficit widened from 1¾ per cent of GDP in 2004 to 2¼ per cent in 2005, as forecast in Budget 2006. The deficit in 2005 was exaggerated by the one-off impact on the insurance sector of the US hurricane season, which caused it to increase from 1 per cent of GDP in the first half of the year to 3¼ per cent in the second half. It returned to 2½ per cent of GDP in the first half of 2006. The deficit on trade in goods and services expanded to 3¾ per cent of GDP in 2005 from 3 per cent in 2004. Around a third of the increase was explained by trade in oil, which recorded a deficit.

A.83 Looking ahead, the non-oil trade deficit is expected to narrow slightly as a share of GDP throughout the forecast horizon. Due to the reversal of temporary negative factors affecting UK oil production and exports, the overall trade deficit is expected to narrow slightly in 2007 from 4¼ per cent of GDP in 2006, and to remain broadly stable in 2008 and 2009.

Chart A7: Balance of payments current account



A.84 Offsetting the trade deficit, the UK's balance of overseas earnings reached a record surplus of 2 1/2 per cent of GDP in 2005. One factor underpinning the continuing strength of net income flows to the UK is the relatively high rates of return UK investors earn on their overseas foreign direct investment (FDI) compared with those earned by foreign investors on their UK assets, particularly in the financial sector. Another is the UK's strong net asset position in sectors where rates of return have been rising, particularly in oil and gas extraction. The current account deficit is expected to remain broadly stable from 2007 at around 2 3/4 per cent of GDP.

FDI **A.85** In 2005, the UK attracted a record £87 3/4 billion gross inflow of FDI, the highest ever recorded for a European country, and making the UK the world's largest recipient of inward FDI.[14] A significant proportion of the 2005 inflows can be accounted for by the restructuring of Shell Transport and Trading and Royal Dutch Petroleum into Royal Dutch Shell. FDI inflows continued strongly into 2006, reaching £46 3/4 billion in the first half of the year.

Service sector output

A.86 The service sector accounts for a large and increasing share of activity in the UK. As a proportion of GVA, it has risen from 66 per cent to 75 per cent over the past decade. Around half of that increase has been the result of strong growth in three sectors: banking and finance; computer services; and other business services, a sector that includes activities ranging from recruitment agents to fashion design. The share of service sector activity in the UK is also high by international standards: the UK ranks fourth among OECD countries and seventh in the world.[15]

A.87 The service sector grew by 4 per cent in 2004, 3 per cent in 2005 and 3 1/2 per cent in the first three quarters of 2006 on a year earlier. Business surveys point to ongoing expansion at similar rates. For example, monthly indicators of business activity and new business in the service sector compiled by the Chartered Institute of Purchasing and Supply are currently above their long-run averages.

Business services and finance **A.88** The business services and finance sector is the largest sector of the UK economy, accounting for around a third of total activity and larger than the manufacturing and distribution sectors combined. On average over the past decade, the sector has accounted for almost half of total growth in the UK economy. As the wider economy slowed in 2005, the finance and business service sector continued to grow strongly: annual growth dipped only slightly to 4 1/4 per cent from 5 per cent in 2004. It has since picked up again to 5 per cent in the first three quarters of 2006.

Distribution **A.89** Activity in the distribution sector slowed sharply to 1 per cent in 2005 from 5 1/4 per cent in 2004. Growth recovered during 2006 to reach 2 1/4 per cent in the year to the third quarter. The slowdown in 2005 was of a similar magnitude in the wholesale, retail and motor trade sub-sectors, but developments have diverged somewhat in 2006. Retail activity has strengthened through the year while growth in the wholesale and motor trade sectors has slowed.

[14] *World Investment Report, 2006*, United Nations Conference on Trade and Development, October 2006, page 82.

[15] This global comparison is based on National Accounts data collected by the United Nations: http://unstats.un.org/unsd/snaama/Introduction.asp. To ensure offshore centres, with economies that are dominated by financial sector activity, do not skew the comparison, 53 countries with populations of less than one million were excluded from the sample. The UK ranks 30th among the full set of 207 countries.

Other services **A.90** Activity in the hotel and restaurant sector has followed a similar path to that of the wholesale sector, falling in 2005 before recovering in the first half of 2006 and then slowing more recently. Transport, storage and communications activity followed a different path, with growth picking up to 4 per cent in 2005 from $2^1/_2$ per cent in 2004. Growth in 2006 has been firm.

Manufacturing and North Sea output

Manufacturing **A.91** The manufacturing sector currently accounts for around 14 per cent of whole economy GVA. The sector contracted by 1 per cent in 2005 reflecting slower growth of UK export markets and domestic consumption. As both have recovered in 2006, especially goods exports to the EU, manufacturing output has picked up. Between January and September, output increased by $1^3/_4$ per cent, though latest private sector business surveys point to some slowdown in the fourth quarter. For the year as a whole, output is expected to grow by $1^1/_4$ per cent, slightly above the Budget 2006 forecast. Perhaps reflecting the relative strength of productivity growth and indicators of recruitment difficulty over the past year, average earnings have been rising faster in the manufacturing sector than the service sector.

North Sea **A.92** Total industrial production growth has been lower than growth in the manufacturing sector due to significant declines in oil and gas extraction. Output of the North Sea oil and gas sector fell by almost 8 per cent in the year to the third quarter of 2006, and has fallen 38 per cent since peaking in 2000. The structural decline since 2000 reflects the rundown of reserves in the North Sea and increasing extraction costs for the remaining oil and gas.

A.93 Temporary factors have acted as an additional drag on output in 2006. For example, routine maintenance that was postponed during 2004 and 2005 in response to high oil prices has taken place this year. The impact has been exacerbated by on-shore infrastructure failures. Looking ahead, a relatively large new field, 'Buzzard', is due to come on stream before the end of 2006, which, alongside a number of smaller start-ups in 2007 and 2008, should temporarily arrest the decline in output. However, barring significant new discoveries, the long-term structural decline of North Sea output is expected to continue. The Treasury is currently projecting an average rate of decline in North Sea output of about 3 per cent a year between 2006 and 2011, reflecting a stronger underlying downward trend for existing fields partly offset in 2007 and 2008 by additional output from the new fields coming on stream. Given the weight of the North Sea oil and gas sector in whole economy output – currently around $1^1/_2$ per cent - this decline implies on average that whole economy GDP will grow around 0.1 percentage points slower than non-oil GVA, the measure on which the Treasury's trend output growth estimates are based.

Independent forecasts

A.94 The average of independent forecasts for GDP growth in 2006 has risen steadily since the beginning of the year, when it stood at 2.1 per cent, to reach 2.6 per cent in November, above the Budget 2006 forecast range and just below the Pre-Budget Report forecast of $2^3/_4$ per cent. Upward revisions to expected investment growth have driven the overall change, with investment now expected to grow by 4.7 per cent in 2006. For 2007, the latest independent average for GDP growth stands at 2.4 per cent, below the Pre-Budget Report range of $2^3/_4$ to $3^1/_4$ per cent. Outside forecasts for 2008 and 2009 currently average 2.5 and 2.6 per cent respectively, at the lower end of the Pre-Budget Report range of $2^1/_2$ to 3 per cent.

A.95 The average independent forecast for CPI inflation at the end of 2006 has been revised up since March, from 1.9 to 2.6 per cent. Independent forecasters expect inflation to fall in 2007, in line with the Pre-Budget Report forecast, and to be close to target at the end of 2007.

A.96 Treasury forecasts for GDP growth since 1997 have, on average, outperformed the independent consensus. Treasury forecasts have also compared well against a sample of forecasters that includes leading international institutions (IMF, OECD, European Commission), research institutes (Oxford Economics, NIESR) and private sector forecasters (Goldman Sachs, HSBC, JP Morgan).[16]

Table A9: Pre-Budget Report and independent[1] forecasts

	Percentage changes on a year earlier, unless otherwise stated					
	2006			2007		
	December	**Independent**		**December**	**Independent**	
	PBR	Average	Range	**PBR**	Average	Range
Gross domestic product	2¾	2.6	2.2 to 2.7	2¾ to 3¼	2.4	–0.1 to 2.9
CPI (Q4)	2½	2.6	2.0 to 2.8	2	2.1	1.3 to 3.1
Current account (£ billion)	–32	–31.4	–36.3 to –25.0	–37½	–32.8	–48.8 to –10.5

[1] *'Forecasts for the UK economy: A comparison of independent forecasts', November 2006.*

Forecast issues and risks

A.97 Risks to the 2006 Pre-Budget Report economic outlook are broadly balanced, both globally and domestically.

Global economy

A.98 Globally, inflationary pressures and monetary policy adjustment, and the correction in the US housing market, are attracting more attention than at Budget time. Global imbalances remain large, but high oil prices appear to present less of an immediate risk.

A.99 Growth in the US economy has slowed, and the potential global impact of further moderation presents a key downside risk. By contrast, the euro area economy has performed well and potentially presents an upside risk in 2007, given the cautious view taken on the impact of measures to tighten fiscal and monetary policy. The strength of growth in Asia, and China in particular, surprised forecasters once more in 2006, and could do so again.

A.100 The rising inflationary pressures noted at the time of Budget 2006 have fed through to measured inflation. Central banks across the OECD have responded by raising interest rates, the impact of which presents a risk to the short-term growth outlook. While monetary policy frameworks retain a high degree of credibility and monetary policy is tighter than it has been for five years, if higher inflation were to feed through to higher inflation expectations there would be a risk that monetary authorities could have to raise interest rates further or faster than markets currently expect.

[16] Treasury analysis based on various issues of the *Comparison of independent forecasts*.

A.101 Other risks remain broadly similar to those at Budget time, including:

- risks to world trade if the multilateral approach to free trade is overtaken by bilateral and regional trade agreements or increasingly protectionist trade policies;
- actual or perceived risks to the supply of oil or gas that could result in another sharp rise in energy prices, though the recent increase in spare capacity has eased market pressures slightly; and
- the persistence of global imbalances and the risk that they unwind in a disorderly manner, potentially involving volatile exchange rates and possible sharp changes in interest rates.

A.102 A broader global forecast issue concerns the impact of major changes in the structure of the world economy on the sustainable rate of world growth. World growth has been significantly above its long-run average rate for four consecutive years, and the forecast assumes it will moderate towards what in historical terms are more sustainable rates. However, insofar as the integration of major emerging market economies, including China and India, continues to raise the world's output potential through higher utilisation and more productive employment of labour, then it is possible that higher growth rates could persist into the medium term, and should be considered more sustainable.

A.103 These changes could present significant medium-term risks in both directions. On the upside, there is potential for higher rates of world growth to continue for longer than expected; but on the downside, if emerging market economies are adding more to world supply than they are adding to world demand it could exacerbate global imbalances at a time when they are already large.

UK economy

A.104 Domestically, the key uncertainty identified in Budget 2006 concerned the tension between cyclical indicators of the degree of slack in the economy and the output gap implied by the trend growth arithmetic. Following National Accounts revisions, particularly those published in the 2006 Blue Book, the coherence between the latest output gap estimate and the cyclical indicators has improved, but considerable uncertainty remains over the extent to which official population and labour supply data adequately measure migration flows. If inflows have been higher than measured, it may imply a greater degree of slack in the economy or more scope for growth.

A.105 Domestic forecast risks are broadly balanced across the components of demand. There are, for example, potential downside risks to the private consumption forecast. Surveys of consumers' saving intentions suggest that the pick-up in the household saving ratio over the past year could continue and exceed the Pre-Budget Report forecast, and recent interest rate increases could constrain consumer spending more than expected given levels of household gearing. Offsetting that, developments in the housing market have been somewhat stronger than expected and could be associated with higher consumption growth. In recent months, survey indicators of manufacturing activity have moderated somewhat, although forward-looking indicators for manufacturing export orders remain strong.

A.106 Despite business investment growth having been revised up in the Pre-Budget Report forecast, there are still significant upside risks. In particular, corporate profitability remains strong, as explained in Box A9, and financing conditions remain benign. Both factors could support stronger growth in business investment.

A.107 Global risks to the export growth forecast are broadly balanced with upside risks in the UK's largest export market, the EU, balanced by downside risks in the second largest market, the US.

A.108 With CPI inflation currently above target and RPI inflation forecast to rise further by the end of the year, prior to a large proportion of wage settlements being negotiated, there is a risk to the forecast from rising inflation expectations and second-round effects on inflation. However, so far monetary policy has kept inflation expectations firmly anchored and earnings growth has remained subdued.

A.109 Since early 2004, annual growth of M4, a broad measure of money in the economy, has picked up from 7 per cent to 14 per cent, the highest rate since 1990. Given the long-run link between money and inflation, this growth could signal future inflationary pressures. However, M4 growth has been driven by a rapid increase in M4 liabilities to financial companies, which may be linked to structural changes in the financial system rather than to economic activity. The contribution of the household and non-financial corporate sectors to M4 growth has been broadly stable over recent years while the growth of notes and coin in circulation, a much narrower measure of money that has been more closely correlated with retail sales over the past decade, has remained below 6 per cent.

Table A10: Summary of economic prospects[1]

	Percentage changes on a year earlier, unless otherwise stated					
		Forecast[2,3,4]				Average errors from past forecasts[5]
	2005	2006	2007	2008	2009	2007
Output at constant market prices						
Gross domestic product (GDP)	1¾	2¾	2¾ to 3¼	2½ to 3	2½ to 3	½
Manufacturing output	–1	1¼	1¾ to 2	1¾ to 2¼	1¾ to 2¼	1½
Expenditure components of GDP at constant market prices[6]						
Domestic demand	1¾	2¾	2¾ to 3	2¼ to 2¾	2¼ to 2¾	¾
Household consumption[7]	1½	2	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾	1
General government consumption	2¾	2	2½	2½	2	1
Fixed investment	2¾	6	5¼ to 5¾	3¼ to 3¾	3¼ to 3¾	2½
Change in inventories[8]	0	0	0	0	0	¼
Exports of goods and services[9]	7	11½	½ to 1	4¾ to 5¼	4½ to 5	1¾
Imports of goods and services[9]	6½	11	¼ to ½	4¼ to 4¾	4 to 4½	2¼
Exports of goods and services (excluding MTIC)	4¼	6	5 to 5½	4¾ to 5¼	4½ to 5	–
Imports of goods and services (excluding MTIC)	4	6¼	4¼ to 4¾	4¼ to 4¾	4 to 4½	–
Balance of payments current account						
£ billion	–27½	–32	–37½	–38¾	–40¾	10
Per cent of GDP	–2¼	–2½	–2¾	–2¾	–2¾	¾
Inflation						
CPI (Q4)	2¼	2½	2	2	2	–
Producer output prices (Q4)[10]	2½	2¼	2	2	2	1
GDP deflator at market prices	2¼	2½	2¾	2¾	2¾	½
Money GDP at market prices						
£ billion	1224½	1287½	1360 to 1366	1431 to 1445	1505 to 1526	10
Percentage change	4	5¼	5¾ to 6	5¼ to 5¾	5¼ to 5¾	¾

[1] *The forecast is consistent with output, income and expenditure data for the third quarter of 2006, released by the Office for National Statistics on 24 November 2006. See also footnote 1 on the second page of this annex.*

[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 assumption for the trend rate of output growth of 2¾ per cent. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for projecting the public finances, which is a ¼ percentage point below the neutral assumption.*

[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 10 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 2007.*

[6] *Further detail on the expenditure components of GDP is given in Table A11.*

[7] *Includes households and non-profit institutions serving households.*

[8] *Contribution to GDP growth, percentage points.*

[9] *Figures up to and including 2007 are distorted by estimates of MTIC-related activity. Growth rates excluding MTIC are shown in subsequent lines of this table and in Table A8.*

[10] *Excluding excise duties.*

Table A11: 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[3]	Total final expenditure	*Less* imports of goods and services[3]	*Plus* statistical discrepancy[4]	GDP at market prices
2005		759.3	246.8	194.6	3.6	1203.9	320.4	1524.3	357.4	0.8	1167.8
2006		775.4	251.8	206.3	3.8	1237.3	357.3	1594.6	396.8	0.8	1198.7
2007		793.1 to 796.5	257.7	217.1 to 218.0	2.4 to 3.5	1270.3 to 1275.7	359.2 to 360.8	1629.5 to 1636.5	397.5 to 399.2	0.8	1232.9 to 1238.1
2008		810.9 to 818.3	263.9	224.1 to 226.1	1.5 to 3.9	1300.4 to 1312.3	376.6 to 380.1	1677.0 to 1692.4	414.5 to 418.3	0.8	1263.3 to 1274.9
2009		829.4 to 841.1	269.1	231.1 to 234.4	0.9 to 4.7	1330.4 to 1349.2	393.2 to 398.8	1723.7 to 1748.0	430.9 to 437.0	0.8	1293.6 to 1311.8
2005	1st half	378.3	122.5	96.0	1.7	598.4	155.6	754.0	173.7	0.4	580.7
	2nd half	381.0	124.3	98.6	1.9	605.5	164.8	770.3	183.7	0.5	587.0
2006	1st half	385.4	125.4	101.2	2.3	614.4	185.9	800.3	205.8	0.4	594.9
	2nd half	389.9	126.4	105.1	1.5	622.9	171.4	794.4	191.0	0.4	603.7
2007	1st half	394.4 to 395.6	127.7	107.7 to 108.0	1.3 to 1.7	631.1 to 633.1	177.2 to 177.8	808.4 to 810.8	196.3 to 196.9	0.4	612.5 to 614.4
	2nd half	398.7 to 400.9	130.0	109.4 to 110.0	1.1 to 1.8	639.1 to 642.6	182.0 to 183.0	821.1 to 825.7	201.2 to 202.3	0.4	620.4 to 623.8
2008	1st half	403.2 to 406.4	131.3	111.1 to 112.0	0.9 to 1.9	646.5 to 651.7	186.3 to 187.8	832.8 to 839.4	205.3 to 206.9	0.4	627.9 to 632.9
	2nd half	407.7 to 411.9	132.6	112.9 to 114.1	0.6 to 2.0	653.9 to 660.7	190.3 to 192.3	844.2 to 853.0	209.2 to 211.3	0.4	635.4 to 642.0
2009	1st half	412.3 to 417.6	133.9	114.7 to 116.2	0.5 to 2.2	661.4 to 669.9	194.5 to 197.0	855.9 to 866.9	213.3 to 216.1	0.4	643.0 to 651.2
	2nd half	417.0 to 423.4	135.2	116.4 to 118.2	0.4 to 2.4	669.1 to 679.3	198.7 to 201.8	867.8 to 881.1	217.6 to 221.0	0.4	650.6 to 660.6
		Percentage changes on previous year[5,6]									
2005		$1\frac{1}{2}$	$2\frac{3}{4}$	$2\frac{3}{4}$	0	$1\frac{3}{4}$	7	$2\frac{3}{4}$	$6\frac{1}{2}$	0	$1\frac{3}{4}$
2006		2	2	6	0	$2\frac{3}{4}$	$11\frac{1}{2}$	$4\frac{1}{2}$	11	0	$2\frac{3}{4}$
2007		$2\frac{1}{4}$ to $2\frac{3}{4}$	$2\frac{1}{2}$	$5\frac{1}{4}$ to $5\frac{3}{4}$	0	$2\frac{3}{4}$ to 3	$\frac{1}{2}$ to 1	$2\frac{1}{4}$ to $2\frac{1}{2}$	$\frac{1}{4}$ to $\frac{1}{2}$	0	$2\frac{3}{4}$ to $3\frac{1}{4}$
2008		$2\frac{1}{4}$ to $2\frac{3}{4}$	$2\frac{1}{2}$	$3\frac{1}{4}$ to $3\frac{3}{4}$	0	$2\frac{1}{4}$ to $2\frac{3}{4}$	$4\frac{3}{4}$ to $5\frac{1}{4}$	3 to $3\frac{1}{2}$	$4\frac{1}{4}$ to $4\frac{3}{4}$	0	$2\frac{1}{2}$ to 3
2009		$2\frac{1}{4}$ to $2\frac{3}{4}$	2	$3\frac{1}{4}$ to $3\frac{3}{4}$	0	$2\frac{1}{4}$ to $2\frac{3}{4}$	$4\frac{1}{2}$ to 5	$2\frac{3}{4}$ to $3\frac{1}{4}$	4 to $4\frac{1}{2}$	0	$2\frac{1}{2}$ to 3

[1] *Includes households and non-profit institutions serving households.*

[2] *Also includes acquisitions less disposals of valuables.*

[3] *Figures up to and including 2007 are distored by estimates of MTIC-related activity.*

[4] *Expenditure adjustment.*

[5] *For change in inventories and the statistical discrepancy, changes are expressed as a per cent of GDP.*

[6] *Growth ranges for GDP components do not necessarily sum to the $\frac{1}{2}$ 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 published in this Pre-Budget Report show that the Government is meeting its strict fiscal rules over the economic cycle:

- **the current budget since the start of the current economic cycle in 1997-98 shows an annual average surplus up to 2006-07 of 0.1 per cent of GDP, showing the Government is meeting the golden rule on the basis of cautious assumptions; and**
- **public sector net debt is projected to be low and stable over the forecast period stabilising below 39 per cent of GDP, below the 40 per cent ceiling set in the sustainable investment rule.**

The 2006 *End of year fiscal report* is published alongside this Pre-Budget Report, underlining the Government's commitment to transparency in fiscal policy by providing detailed information on the public finances in 2004-05 and 2005-06.

INTRODUCTION

B.1 Chapter 2 describes the Government's fiscal policy framework and shows how the projections of the public finances presented in the Pre-Budget Report are consistent with meeting the fiscal rules. This chapter explains the latest outturns and 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 for assessing the impact of fiscal policy on the economy;
- projections of the cyclically-adjusted fiscal balances; and
- detailed analyses of the outlook for government receipts and expenditure.

B.2 The fiscal projections continue to be based on deliberately cautious key assumptions audited by the National Audit Office (NAO).

B.3 The Pre-Budget Report updates the projections of the public finances contained in Budget 2006 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.

B.4 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 2004-05 and 2005-06, including their performance against the fiscal rules and against published forecasts and plans. The information set out in the *End of year fiscal report* supplements the historical and provisional outturn data published in this annex.

MEETING THE FISCAL RULES

B.5 Table B1 shows five-year projections for the current budget and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule respectively. Outturns and projections of other important measures of the public finances, including net borrowing and cyclically-adjusted fiscal balances, are also shown.

B.6 As explained in Chapter 2, the Government's judgement is that the current economic cycle started in 1997-98. Based on the assumptions used in these projections the economy will return to its trend level, ending the current cycle, in early 2007.

Table B1: Summary of public sector finances

	Per cent of GDP							
	Outturn		Estimate	Projections				
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Fairness and prudence								
Surplus on current budget	-1.6	-1.2	-0.6	-0.1	0.3	0.5	0.6	0.8
Average surplus since 1997-1998	0.3	0.1	0.1	0.0	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	-1.6	-1.0	-0.4	-0.1	0.3	0.5	0.6	0.8
Long-term sustainability								
Public sector net debt[1]	35.0	36.4	37.5	38.2	38.6	38.7	38.7	38.5
Core debt[1]	34.6	35.8	36.7	37.4	37.8	38.0	38.0	37.8
Net worth[2]	28.8	27.0	25.7	24.9	24.9	24.6	24.6	24.6
Primary balance	-1.7	-1.4	-1.1	-0.6	-0.2	0.0	0.1	0.3
Economic impact								
Net investment	1.7	1.8	2.2	2.2	2.2	2.2	2.2	2.2
Public sector net borrowing (PSNB)	3.3	3.0	2.8	2.3	1.9	1.7	1.5	1.3
Cyclically-adjusted PSNB	3.2	2.8	2.6	2.2	1.9	1.7	1.5	1.3
Financing								
Central government net cash requirement	3.2	3.2	3.2	2.5	2.1	2.1	1.8	1.9
Public sector net cash requirement	3.2	3.2	2.9	2.4	2.0	2.0	1.6	1.7
European commitments								
Treaty deficit[3]	3.2	2.8	2.7	2.2	1.9	1.7	1.5	1.3
Cyclically-adjusted Treaty deficit[3]	3.1	2.6	2.5	2.2	1.9	1.7	1.5	1.3
Treaty debt ratio[4]	40.5	42.7	43.7	44.1	44.2	44.2	44.0	43.6
Memo: Output gap	0.0	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0

[1] *Debt at end March; GDP centred on end March.*
[2] *Estimate 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.*

The golden rule

B.7 The Government's judgement is that the current cycle started in 1997-98. Based on assumptions used in these projections the economy will return to its trend level, ending the current cycle in early 2007. The projections show that the Government is meeting the golden rule, on the basis of cautious assumptions, with an average annual surplus on the current budget over this economic cycle of 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £8 billion in this cycle.

B.8 Based on cautious assumptions, the Government will continue to meet the golden rule after the end of this economic cycle with the current budget returning to surplus by 2008-09.

The sustainable investment rule

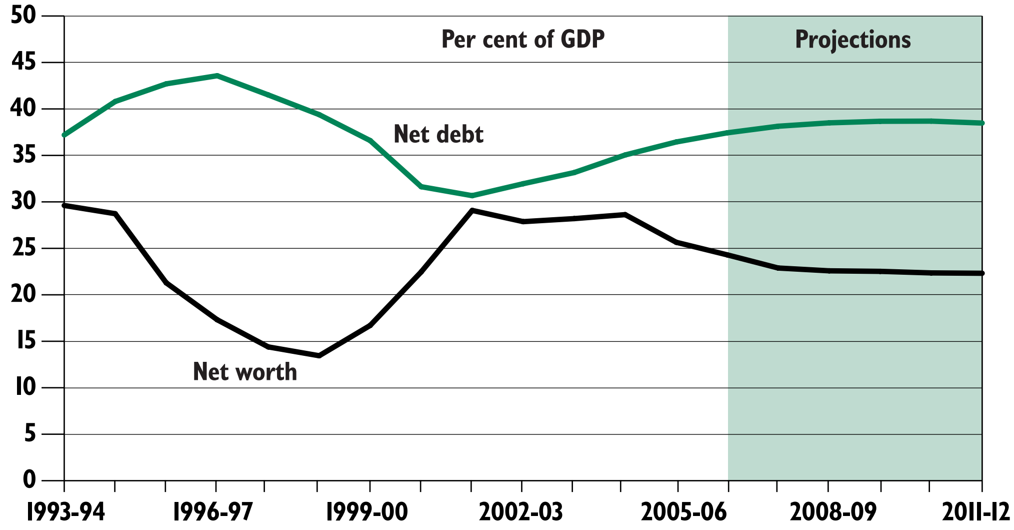
B.9 The sustainable investment rule is also forecast to be met over the current economic cycle. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and expenditure taken by the Government, including the decision to use the proceeds from the auction of spectrum licenses to repay debt, reduced net debt to just over 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, reaching 37.5 per cent of GDP by the end of the current economic cycle, £33 billion below the 40 per cent level. It remains below 39 per cent for the remainder of the forecasting period, and falls to about 38½ per cent in 2011-12. The projections for core debt, which exclude the estimated impact of the economic cycle, rise to a maximum of 38.0 per cent of GDP. This is consistent with the fiscal rules, and with the key objective of intergenerational fairness that underpins the fiscal framework.

Net worth

B.10 Net worth is the approximate stock counterpart of the current budget. Modest falls in net worth are expected for the remainder of the projection period from the high level of 28.8 per cent of GDP in 2004-05. 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.

B.11 Chart B1 shows public sector net debt and net worth as a per cent of GDP from 1993-94 to 2011-12.

Chart B1: Public sector net debt and net worth



Net investment

B.12 As a result of decisions taken in the 2004 Spending Review, public sector net investment is projected to rise from 1¼ per cent of GDP in 2003-04 to 2¼ per cent from 2006-07 onwards. This increase is 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, below 40 per cent of GDP.

Net borrowing

B.13 Public sector net borrowing is expected to fall in every year of the forecast period from 3.0 per cent of GDP in 2005-06 to 2.8 per cent in 2006-07, and then to a level of 1.3 per cent of GDP by 2011-12.

Financing **B.14** The central government net cash requirement was 3.2 per cent of GDP in 2005-06. It is projected to stay at this level in 2006-07, and to then fall to 1.9 per cent of GDP by 2011-12.

European commitments **B.15** 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 Pre-Budget Report projections meet the EU Treaty reference value for general government gross debt (60 per cent of GDP) by a considerable margin. The Treaty deficit on a cyclically-unadjusted basis fell to 2.8 per cent in 2005-06 and is forecast to fall further over the projection period. In addition, the cyclically adjusted level of general government net borrowing is 2.5 per cent of GDP in 2006-07 and is 2.2 per cent of GDP or below from 2007-08 onwards. The projections are therefore consistent with the Government's prudent interpretation of the Stability and Growth Pact.

CHANGES TO THE FISCAL BALANCES

B.16 Table B2 compares the latest estimates for the main fiscal balances with those in Budget 2006.

Table B2: Fiscal balances compared with Budget 2006

	Outturn[1]	Estimate[2]		Projections		
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Surplus on current budget (£ billion)						
Budget 2006	-11.4	-7.1	1	7	10	12
Effect of revisions and forecasting changes	*-3.7*	*-1.0*	*-5*	*-5 1/2*	*-5*	*-4*
Effect of discretionary changes	*0.0*	*0.2*	*2*	*2 1/2*	*2*	*2*
PBR 2006	**-15.1**	**-7.9**	**-1**	**4**	**7**	**10**
Net borrowing (£ billion)						
Budget 2006	37.1	35.8	30	25	24	23
Changes to current budget	*3.7*	*0.8*	*3*	*3*	*3*	*1 1/2*
Changes to net investment	*-3.3*	*0.1*	*-1*	*- 1/2*	*-1*	*-1*
PBR 2006	**37.5**	**36.8**	**31**	**27**	**26**	**24**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2006	-0.3	0.4	0.7	0.7	0.7	0.8
PBR 2006	**-1.0**	**-0.4**	**-0.1**	**0.3**	**0.5**	**0.6**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2006	2.4	1.9	1.6	1.6	1.6	1.5
PBR 2006	**2.8**	**2.6**	**2.2**	**1.9**	**1.7**	**1.5**
Net debt (per cent of GDP)						
Budget 2006	36.4	37.5	38.1	38.3	38.4	38.4
PBR 2006	**36.4**	**37.5**	**38.2**	**38.6**	**38.7**	**38.7**

[1] *The 2005-06 figures were estimates in Budget 2006*

[2] *The 2006-07 figures were projections in Budget 2006.*

B.17 The revisions to the public sector current budget in this Pre-Budget Report are due to a combination of expenditure and receipts effects. Expenditure is higher in 2005-06 and in all subsequent years. Receipts are lower in 2005-06, higher in 2006-07 and, mainly due to lower projections of North Sea revenues, lower from 2007-08 onwards.

B.18 Overall, the current budget has been revised from a deficit of £11.4 billion to a deficit of £15.1 billion in 2005-06 and from a deficit of £7.1 billion to a deficit of £7.9 billion in 2006-07. In 2007-08 the deficit is £1 billion compared to a surplus of £1 billion in the Budget 2006 projections. The current balance is projected to return to surplus in 2008-09.

B.19 Public sector net investment has been revised down by £3.3 billion in 2005-06, is unchanged in 2006-07, and is slightly lower in subsequent years. These reductions in projected net investment partially offset the reductions in the current budget, but overall net borrowing has been revised up.

FORECAST DIFFERENCES AND RISKS

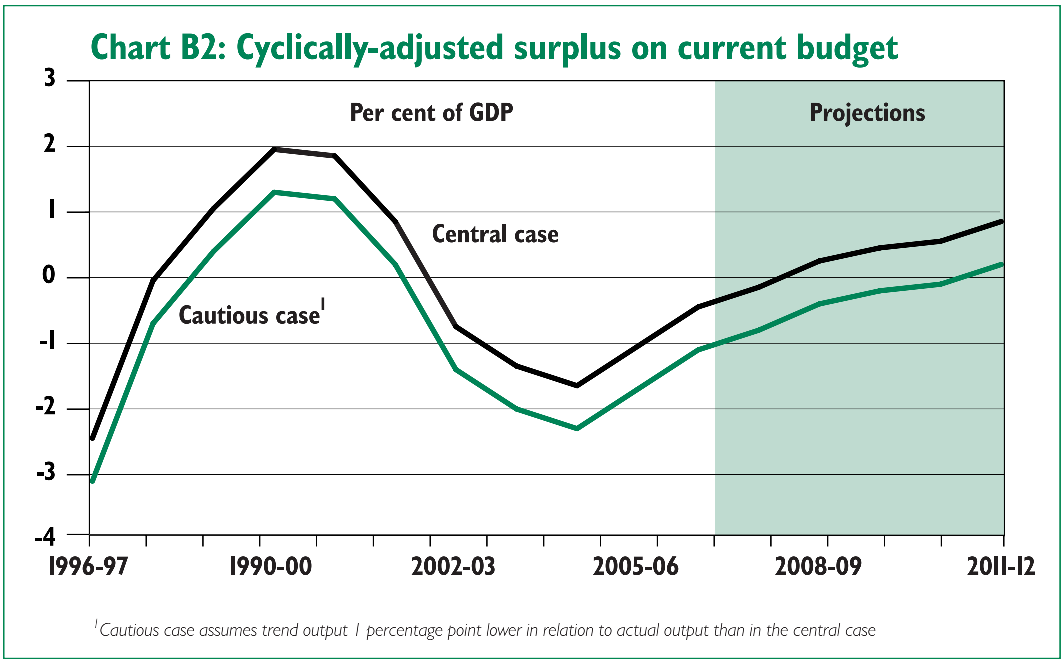
B.20 The fiscal balances represent the difference between two large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. Over the past ten years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been about 1 per cent of GDP. This difference tends to grow as the forecast horizon lengthens. A full account of differences between the projections made in Budget 2004 and Budget 2005, and the subsequent outturns is provided in the *End of year fiscal report*, published alongside the 2006 Pre-Budget Report.

B.21 As explained in Annex A, growth is forecast to continue at close-to-trend rates throughout the forecast horizon. UK GDP is expected to rise by $2^3/_4$ per cent in 2006 as a whole, above the Budget 2006 forecast range. Growth in 2007 is forecast to be above trend at $2^3/_4$ to $3^1/_4$ per cent. The rebalancing of growth that has taken place since 2005 is expected to continue with private consumption growing at rates slightly slower, and business investment slightly faster, than the economy overall.

B.22 Risks to the 2006 Pre-Budget Report economic outlook are broadly balanced. There are potential downside risks to the private consumption forecast, but significant upside risks to business investment growth. Surveys of consumers' saving intentions suggest that the pick-up in the household saving ratio over the past year could continue and exceed the 2006 Pre-Budget Report forecast. Offsetting that, developments in the housing market have been somewhat stronger than expected and could be associated with higher consumption growth. Despite business investment growth having been revised up in the Pre-Budget Report forecast, there are still significant upside risks. In particular, corporate profitability remains strong and financing conditions remain benign. Both factors could support stronger growth in business investment.

B.23 The use of cautious assumptions audited by the National Audit Office (NAO) builds a margin into the public finance projections to guard against unexpected events. One of the key audited assumptions is that for the trend rate of output growth, which is assumed to be $^1/_4$ per cent below the neutral view. This means that the rate of economic growth used to forecast the public finances is the bottom end of the projection range. For example, in this Pre-Budget Report, the forecast for economic growth used in the public finance projections over the period 2006-07 to 2011-12 averages $2^1/_2$ per cent, $^1/_4$ per cent below the central case. By 2011-12 the level of GDP used in the public finances forecast is about $1^1/_4$ per cent below the central view.

B.24 A further important source of potential error results from misjudging the position of the economy in relation to trend output. 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 B2 illustrates the Pre-Budget Report projection for this cautious case.



B.25 The Government has used the cautious case and cautious NAO audited assumptions to build a safety margin in the public finances against unexpected events. This was combined with the decision to consolidate the public finances when the economy was above trend, which has resulted in the current low debt level. This has allowed the Government to safeguard the increase in investment in priority public services, allow the automatic stabilisers to work fully during a period of global economic uncertainty, and meet in full the UK's international commitments, while continuing to meet the fiscal rules.

ASSUMPTIONS

B.26 The fiscal projections are based on the following assumptions:

- the economy follows the path described in Annex A. The fiscal projections assume that trend growth will be $2\frac{1}{2}$ per cent to 2011-12. In the interests of caution, these projections continue to be based on the assumption that trend output growth will be $\frac{1}{4}$ percentage point lower than the Government's neutral view;
- there are no tax or spending policy changes beyond those announced in or before this Pre-Budget Report, 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) are as set out in the 2004 Spending Review to 2007-08, adjusted for the impact of policy decisions and reclassifications;
- total Annually Managed Expenditure (AME) programmes to 2007-08 have been reviewed in this Pre-Budget Report;

- as is normal, HM Treasury is setting out its assumptions for public sector current expenditure for the period beyond the current Spending Review. These are unchanged from Budget 2006 and roll forward into 2011-12. Public sector current expenditure is forecast to grow by 2.0 per cent in real terms in 2008-09 and by 1.9 per cent in 2009-10, 2010-11, and 2011-12. This means that, on average, public sector current expenditure is forecast to grow by 2¼ per cent per year in real terms between 2006-07 and the end of the 2007 Comprehensive Spending Review period; and
- net investment is assumed to remain at 2¼ per cent of GDP in 2008-09 and subsequent years.

Table B3: Economic assumptions for the public finance projections

	Percentage changes on previous year						
	Outturn	Estimate			Projections		
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Output (GDP)	2	2 3/4	2 3/4	2 1/2	2 1/2	2 1/2	2 1/2
Prices							
CPI	2	2 1/2	2	2	2	2	2
GDP deflator	2	2 3/4	2 3/4	2 3/4	2 3/4	2 3/4	2 3/4
RPI[1] (September)	2 3/4	3 1/2	3 1/4	2 3/4	2 3/4	2 3/4	2 3/4
Rossi[2] (September)	2	3	2 1/4	2 1/4	2 1/4	2 1/4	2 1/4
Money GDP[3] (£ billion)	1,238	1,305	1,378	1,449	1,524	1,603	1,685

[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.*

B.27 The projections for 2006-07 are based on all available data within HM Treasury and other government departments involved in producing tax and spending forecasts.

B.28 The key assumptions underlying the fiscal projections are audited by the NAO under the three-year rolling review process. Details of the audited assumptions are provided in Box B1.

The audited assumptions

B.29 For this Pre-Budget Report, the Comptroller and Auditor General audited the change to the Treasury's post-2006 cautious trend output growth assumption used for the public finances forecasts, which it has revised to continue at 2½ per cent a year. The Comptroller and Auditor General found that the Treasury's revised underlying growth rate assumption is below the range of external forecasts of the long term growth rate. It is also at or below the average of external forecasters' medium term growth projections. The review concluded that on this basis the revised Treasury assumption is reasonable and cautious.

B.30 The Comptroller and Auditor General audited the Treasury's equity price assumption and found that the assumption of linking equity price growth to that of money GDP has a theoretical and hence reasonable basis, though in practice, the relationship is unlikely to be valid at all times. The review also concluded that for the 2003 to 2006 period, the assumption proved to be a cautious one for most of the projections of the public finances made in the three years, as outturn equity prices exceeded the Treasury's forecasts.

B.31 The Comptroller and Auditor General also audited the assumption on the consistency of the price indices used to project the public finances with the CPI, which is used in the definition of the inflation target. The review confirmed that over the period 2003 to 2006 the series were, and that for the future they remain, consistent with each other and with the CPI.

Box B1: Key assumptions audited by the NAO[a]

Trend GDP growth[g]	**2½ per cent a year.**
Dating of the cycle[e]	**The end date of the previous economic cycle was in the first half of 1997.**
Privatisation proceeds	**Credit is taken only for proceeds from sales that have been announced.**
UK claimant unemployment[d]	**Rising slowly to 1.01 million in 2007-08, from recent levels of 0.96 million.[h]**
Interest rates[f]	**3-month market rates change in line with market expectations (as of 24 November).**
Equity prices[g]	**FTSE All-share index rises from 3148 (close 24 November) in line with money GDP.**
VAT[b,c,e]	**The VAT gap will rise by 0.5 percentage points per year from a level that is at least as high as the estimated outturn for the current year.**
Consistency of price indices[g]	**Projections of price indices used to project the public finances are consistent with CPI.**
Composition of GDP[c]	**Shares of labour income and profits in national income are broadly constant in the medium term.**
Funding[c]	**Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.**
Oil prices[e]	**$60.3 a barrel in 2007, the average of independent forecasts, and then constant in real terms.**
Tobacco[f]	**The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For Budget 2006, a share of 14 per cent is used for 2006-07 onwards.**

[a] For details of all NAO audits before the 2003 Pre-Budget Report, see Budget 2003, 9 April 2003 (HC500).
[b] Audit of Assumptions for the 2003 Pre-Budget Report, 10 December 2003 (HC35).
[c] Audit of Assumptions for the 2004 Budget, 17 March 2004 (HC434).
[d] Audit of Assumptions for the 2005 Budget, 16 March 2005 (HC452).
[e] Audit of Assumptions for the 2005 Pre-Budget Report, 5 December 2005 (HC707).
[f] Audit of Assumptions for the 2006 Budget, 22 March 2006 (HC937).
[g] Audit of Assumptions for the 2006 Pre-Budget Report, 6 December 2006 (HC).
[h] This is a cautious assumption based on the average of external forecasts and is not the Treasury's central economic forecast.

PRE-BUDGET REPORT POLICY DECISIONS

B.32 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 2006 Pre-Budget Report or since Budget 2006. The fiscal impact of these measures are set out in Tables B4 and B5, these include increasing air passenger duty rates, measures to protect tax revenues, and direct payments to schools.

B.33 AME expenditure measures have been added to total AME in 2006-07 and 2007-08, but in subsequent years are included within the spending envelope assumptions described in paragraph B26.

B.34 Consistent with the *Code for fiscal stability*, the projections do not take account of decisions where the impact cannot yet be quantified, of measures proposed in this Pre-Budget Report, or where final decisions have yet to be taken. These include:

- further extensions to maternity and paternity leave; and
- further reforms to incapacity benefit.

B.35 The measures in Table B4 that tackle avoidance and tax fraud represent the estimated direct Exchequer effect of the measure on existing levels of avoidance or fraud activity. Further details explaining how the Exchequer effects of measures are calculated can be found in Appendix A2 of the Financial Statement and Budget Report 2006.

Table B4: Estimated costs for Pre-Budget Report policy decisions and others announced since Budget 2006[1]

	£ million			
	2006-07	2007-08	2008-09	2009-10
Increasing employment opportunity for all				
Increase in Housing Benefit disregard	0	-5	-	-
Supporting people into work through extending the job grant	*	-5	-	-
Building a fairer society				
July renewal deadline for Child and Working Tax Credits[2]	0	+60	+20	+10
Tackling Managed Service Companies	0	+350	+450	+250
Film tax reliefs: transitional arrangements	0	-20	-20	*
Life assurance companies reform	0	-15	-20	-10
Simplification of general insurers' reserves	0	0	+130	+150
VAT: partial exemption special method	0	+20	+20	+25
Construction Industry Scheme deduction rates	0	+250	-10	-20
Increasing travellers' allowance from outside the EU	0	-15	-15	-15
Protecting revenues				
Controlled Foreign Companies: repeal of public quotation exemption[3]	+20	+125	+160	+160
Tackling avoidance using structured finance arrangements	+10	+15	+15	+15
Countering corporation tax avoidance	+110	+180	+195	+195
Life assurance companies: valuation rules	+70	+95	+95	+95
Stamp duty land tax anti-avoidance	+25	+75	+70	+70
Countering CGT avoidance	0	+70	+130	+120
Protecting the environment				
Air passenger duty rates[4]	+165	+1,000	+1,100	+1,200
Fuel duties: revalorise main rates from 7 December 2006	-190	0	0	0
Fuel duties: maintain the differential for rebated oils from 7 December 2006	-20	0	0	0
Rebated oils: changes to excepted vehicle schedule	0	-5	0	0
Extension of the Landlords Energy Saving Allowance	0	0	-10	-10
Other policy decisions				
Direct payments to schools	0	-155	-	-
TOTAL POLICY DECISIONS	**+190**	**+2,020**	**+2,310**	**+2,235**

** Negligible*

- Included within the current spending growth assumption from 2008-09 onwards.

[1] Costings shown relative to an indexed base.

[2] The savings in AME spending as a result of this measure are included within the current spending growth assumption from 2008-09 onwards.

[3] Alongside the revenue raised by this measure, forecast tax revenues have been adjusted as a result of the European Court of Justice ruling on the taxation of Controlled Foreign Companies and the Government's response to it, as described in Chapter 5. The impact on tax revenues of this adjustment is estimated as:

2006-07	2007-08	2008-09	2009-10
-15	-100	-175	-250

[4] The costing assumes revalorisation annually from 1 April 2008.

Rates and allowances

B.36 The income tax personal allowances will increase in line with inflation in 2007-08, as will the national insurance contributions (NICs) thresholds and limits. There will be no change to NICs rates for employers and employees, or to the Class 4 rate paid by the self-employed. The flat rate of Class 2 NICs paid by the self-employed and the special rates of Class 2 for share fisherman and for volunteer development workers will increase in line with inflation, as will the rate of Class 3 contributions. Tables B5 and B6 set this out in greater detail.

Table B5: National insurance contribution rates 2007-08

	Class 1 rates		Self employed NICs		
	Employee (primary)	Employer (secondary)	Profits[1]	Class 2	Class 4
Earnings[1]	NIC rate[2]	NIC rate[3]			
£ per week	per cent	per cent	£ per year	£ per week	per cent
Below 87 (LEL)	0	0	Below 4,635 (SEE)	0[5]	0
87 to 100 (PT/ST)	0[4]	0	4,635 to 5,225 (LPL)	2.20	0
100 to 670 (UEL)	11	12.8	5,225 to 34,840 (UPL)	2.20	8
Above 670	1	12.8	Above 34,840	2.20	1

[1] *The limits are defined as LEL - lower earnings limit; PT - primary threshold; ST - secondary threshold; UEL - upper earnings limit; LPL - lower profits limit; UPL - upper profits limit; SEE - small earnings exception.*

[2] *The contracted-out rebate for primary contributions in 2007-08 is 1.6 per cent of earnings between the LEL and UEL for contracted-out-salary-related schemes (COSRS) and contracted-out money purchase schemes (COMPS).*

[3] *The contracted-out rebate for secondary contributions is 3.7 per cent of earnings between the LEL and UEL for COSRS and 1.4 per cent for COMPS. For COMPS, an additional age-related rebate is paid direct to the scheme following the end of the tax year. For appropriate personal pensions, the employee and employer pay NICs at the standard, not contracted-out rate. An age and earnings-rebate is paid direct to the personal pension provider following the end of the tax year.*

[4] *No NICs are actually payable but a Class 1 NIC is treated as having been paid in respect of earnings between the LEL and PT to protect benefit entitlement.*

[5] *The self-employed may apply for exception from paying Class 2 contributions if their earnings are less than, or expected to be less than, the level of the small earnings exception.*

Table B6: Income tax allowances 2007-08

	£ per year		
	2006-07	2007-08	Increase
Personal allowance			
age under 65	5,035	5,225	190
age 65-74	7,280	7,550	270
age 75 and over	7,420	7,690	270
Married couple's allowance[1]			
aged less than 75 and born before 6 April 1935	6,065	6,285	220
age 75 and over	6,135	6,365	230
minumum amount[2]	2,350	2,440	90
Income limit for age-related allowances	20,100	20,900	800
Blind person's allowance	1,660	1,730	70

[1] *Tax relief for this allowance is restricted to 10 per cent.*

[2] *This is also the maximum relief for maintenance payments where at least one of the parties is born before 6 April 1935.*

B.37 As set out in Table B7, the child element of the Child Tax Credit will be increased by £80 to £1,845 per year from 6 April 2007, in line with earnings growth. All the elements of Working Tax Credit rise in line with inflation (the increase in the RPI in the year to September 2006), as do the disabled child elements of Child Tax Credit. The rates of Child Benefit and Guardian's Allowance will also increase in line with inflation.

Table B7: Working and Child Tax Credit rates and thresholds

	£ per year		
	2006-07	2007-08	Increase
Working Tax Credit			
Basic Element	1,665	1,730	65
Couple and lone parent element	1,640	1,700	60
30 hour element	680	705	25
Disabled worker element	2,225	2,310	85
Severe disability element	945	980	35
50 plus element, 16–29 hours	1,140	1,185	45
50 plus element, 30+ hours	1,705	1,770	65
Childcare element			
maximum eliglible cost for one child	£175 per week	£175 per week	-
maximum eligible cost for two or more children	£300 per week	£300 per week	-
per cent of eligible costs covered	*80%*	*80%*	-
Child Tax Credit			
Family element	545	545	-
Family element, baby addition	545	545	-
Child element	1,765	1,845	80
Disabled child element	2,350	2,440	90
Severely disabled child element	945	980	35
Income thresholds and withdrawal rates			
First income threshold	5,220	5,220	-
First withdrawal rate (per cent)	*37%*	*37%*	-
Second income threshold	50,000	50,000	-
Second withdrawal rate (per cent)	*7%*	*7%*	-
First threshold for those entitled to Child Tax Credit only	14,155	14,495	340
Income disregard	25,000	25,000	-

FISCAL AGGREGATES

B.38 Tables B8 and B9 provide more detail on the projections for the current and capital budgets.

Table B8: Current and capital budgets

	£ billion						
	Outturn	Estimate			Projections		
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Current budget							
Current receipts	485.3	517.9	554	586	616	647	681
Current expenditure	483.9	508.1	537	562	588	615	643
Depreciation	16.5	17.6	19	20	21	22	23
Surplus on current budget	**-15.1**	**-7.9**	**-1**	**4**	**7**	**10**	**14**
Capital budget							
Gross investment[1]	38.9	46.5	48	51	54	57	60
Less depreciation	-16.5	-17.6	-19	-20	-21	-22	-23
Net investment	22.4	28.9	30	31	33	35	36
Net borrowing	**37.5**	**36.8**	**31**	**27**	**26**	**24**	**22**
Public sector net debt - end year	**462.7**	**503.9**	**540**	**573**	**605**	**636**	**665**
Memos:							
Treaty deficit[2]	35.1	34.8	31	27	26	24	22
Treaty debt[3]	529.1	570.1	608	641	674	705	735

[1] *Includes asset sales, for a breakdown see table B21.*
[2] *General government net borrowing on a Maastricht basis.*
[3] *General government gross debt on a Maastricht basis.*

Table B9: Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate			Projections		
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Current budget							
Current receipts	39.2	39.7	40.2	40.4	40.4	40.4	40.4
Current expenditure	39.1	38.9	38.9	38.8	38.6	38.4	38.2
Depreciation	1.3	1.4	1.4	1.4	1.4	1.4	1.4
Surplus on current budget	**-1.2**	**-0.6**	**-0.1**	**0.3**	**0.5**	**0.6**	**0.8**
Capital budget							
Gross investment[1]	3.1	3.6	3.5	3.5	3.5	3.5	3.5
Less depreciation	-1.3	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4
Net investment	1.8	2.2	2.2	2.2	2.2	2.2	2.2
Net borrowing	**3.0**	**2.8**	**2.3**	**1.9**	**1.7**	**1.5**	**1.3**
Public sector net debt - end year	**36.4**	**37.5**	**38.2**	**38.6**	**38.7**	**38.7**	**38.5**
Memos:							
Treaty deficit[2]	2.8	2.7	2.2	1.9	1.7	1.5	1.3
Treaty debt ratio[3]	42.7	43.7	44.1	44.2	44.2	44.0	43.6

[1] *Includes asset sales, for a breakdown see table B21.*
[2] *General government net borrowing on a Maastricht basis.*
[3] *General government gross debt on a Maastricht basis.*

B.39 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. These surpluses allowed the Government to use fiscal policy to support monetary policy during the economic slowdown in 2001 and 2002, and as a result the current budget moved into deficit. The current budget is expected to remain in deficit until 2007-08 and to move back into surplus in 2008-09, with increasingly larger surpluses in later years, reaching 0.8 per cent in 2011-12.

B.40 The current budget surplus is equal to public sector current receipts less public sector current expenditure and depreciation. The reasons for changes in receipts and current expenditure are explained in later sections. Depreciation is higher throughout the forecast period as a result of revisions to outturn data for 2005-06 and earlier years.

B.41 Table B8 also shows that net investment is projected to increase from £22.4 billion in 2005-06 to £30 billion in 2007-08 as the Government seeks to rectify historical underinvestment in public infrastructure. These increases are sustainable and the Government is still able to meet its strict fiscal rules, as debt is being held below 39 per cent of GDP, within the 40 per cent limit imposed by the sustainable investment rule.

RECEIPTS

B.42 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 2006, 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 2006

B.43 The forecast for public sector current receipts for 2006-07 has been revised up by £1½ billion since Budget 2006. However, before allowing for discretionary changes, receipts are lower by around £1½ billion per year from 2007-08 to 2009-10, before returning to the Budget 2006 forecast level in 2010-11. The total changes throughout the forecast are lower than would be expected given changes in the level of money GDP and its components, mostly due to lower receipts from North Sea taxes following revised production and expenditure forecasts and a stronger dollar-sterling exchange rate. Including discretionary measures, current receipts remain higher than the Budget 2006 profile throughout the forecast.

B.44 Table B10 provides a breakdown of the causes of these revisions since Budget 2006. Revisions are split between discretionary changes, and non-discretionary changes to North Sea revenues, those arising from changes to money GDP and its components, and other forecasting changes.

Table B10: Changes in current receipts since Budget 2006

	£ billion				
	Estimate	Projections			
	2006-07	2007-08	2008-09	2009-10	2010-11
Effect on receipts of non-discretionary changes in:					
North Sea taxes	0	-3	-2	-1	-1
Money GDP and components	2	2	1 1/2	1 1/2	2
Other forecasting changes	-1	- 1/2	-1 1/2	-1 1/2	-1
Total before discretionary changes[1]	**1 1/2**	**-1 1/2**	**-2**	**-1 1/2**	**0**
Discretionary changes[1]	0	2	2 1/2	2	2
Total change[2]	**1 1/2**	**1/2**	**1/2**	**1**	**2 1/2**

[1] *Includes measures announced since Budget 2006.*

[2] *Total may not sum due to rounding.*

North Sea taxes **B.45** The impacts of movements in North Sea revenues from changes in the dollar oil price, the dollar-sterling exchange rate, production, capital and operating expenditure are analysed in Box B2.

Money GDP and components **B.46** The impact of money GDP and its components is to add about £2 billion to receipts in each year of the forecast. This is largely the result of stronger employment growth assumed through the forecast period and from the government and housing components of the VAT tax base.

Other forecasting changes **B.47** A large number of different factors contribute to other forecasting changes and together are expected to reduce current receipts by an average of about £1 billion per year to the end of the forecast period.

Tax by tax analysis

B.48 Table B11 shows outturn data for cash receipts in the first seven months of 2006-07 and estimated receipts for the remainder of the year, along with percentage changes over the corresponding period in 2005-06. These growth rates can vary considerably across the year, reflecting the rules for payment of each tax and the various time lags. Table B12 shows the changes to the projections of individual taxes since Budget 2006, while Table B13 contains updated projections for the main components of public sector receipts for 2005-06, 2006-07 and 2007-08.

Table B11: Net taxes and national insurance contributions 2006-07

	£ billion			Percentage change on 2005-06		
	Outturn[1]	Estimates		Outturn[1]	Estimates	
	Apr-Oct	Nov-Mar	2006-07	Apr-Oct	Nov-Mar	Full year
HM Revenue & Customs						
Income tax, NICs and capital gains tax[2]	126.9	107.1	234.0	5.7	8.1	6.8
Value added tax	45.3	30.9	76.2	4.7	4.3	4.5
Corporation tax[2]	30.3	17.1	47.5	17.8	6.1	13.3
Petroleum revenue tax	1.6	0.7	2.3	39.1	-22.1	12.6
Fuel duties	13.8	9.9	23.7	-0.4	3.2	1.1
Inheritance tax	2.1	1.5	3.6	9.1	8.0	8.7
Stamp duties	7.6	5.1	12.7	25.6	5.7	16.7
Tobacco duties	4.9	3.2	8.0	0.7	0.8	0.7
Alcohol duties	4.6	3.4	8.0	0.3	2.3	1.2
Other Customs duties and levies	5.1	3.8	8.9	1.7	2.4	2.0
Total HMRC	**242.1**	**182.6**	**424.7**	**7.0**	**6.4**	**6.7**
Vehicle excise duties	3.1	2.0	5.1	-3.3	11.9	2.3
Business rates	14.8	6.7	21.5	6.0	13.1	8.1
Council tax	14.8	7.7	22.5	4.0	8.3	5.4
Other taxes and royalties	7.6	5.7	13.3	6.1	2.9	4.7
Net taxes and national insurance contributions	**282.4**	**204.8**	**487.1**	**6.6**	**6.6**	**6.6**

[1] *Provisional.*
[2] *Net of tax credits scored as negative tax in net taxes and national insurance contributions.*

Table B12: Changes in current receipts by tax since Budget 2006

	£ billion		
	2005-06	2006-07	2007-08
Income tax (gross of tax credits)	-1.1	2.0	1.9
Income tax credits	0.2	0.0	0.0
National insurance contributions	0.1	-1.1	-0.2
Non-North Sea corporation tax[1]	-0.3	-0.7	-0.7
North Sea revenues	0.0	0.1	-2.8
Capital taxes[2]	0.2	0.2	0.7
Stamp duty	0.0	0.6	0.5
Value added tax	-0.8	-0.3	-0.5
Excise duties[3]	-0.1	-0.5	0.1
Other taxes and royalties[4]	0.0	0.3	1.2
Net taxes and national insurance contributions	**-1.8**	**0.6**	**0.2**
Other receipts and accounting adjustments	1.0	0.8	0.4
Current receipts	**-0.8**	**1.4**	**0.6**

[1] *National accounts measure: gross of enhanced and payable tax credits.*

[2] *Capital gains tax and inheritance tax.*

[3] *Fuel, alcohol and tobacco duties.*

[4] *Includes business rates, council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*

Box B2: North Sea Revenues

The significant increase in oil prices since the start of 2004 has led to large rises in the profitability of North Sea companies. The net rate of return for UK Continental Shelf companies was close to 40 per cent in the first half of 2006, substantially above the 13 per cent return recorded by other non-financial companies. Given the upward shift in the expected price of oil in the medium term, oil and gas companies should continue to register strong profit figures over the forecast period.

North Sea revenues for 2006-07 are expected to be close to their Budget projection at just over £10 billion. Oil prices are likely to average around $9 a barrel higher than the $57.4 assumed in Budget 2006 and this would be expected to result in higher tax revenues. However, while North Sea profits remain very strong, the further boost to taxable profits from higher than expected dollar oil prices is being offset by a stronger dollar-sterling exchange rate (which reduces the rise in the sterling price of oil), lower than anticipated production, higher capital investment and increased operating expenditure.

The forecast for North Sea revenues assumes a further rise in receipts to £10.7 billion in 2007-08, but this is a much more modest increase than assumed in the Budget 2006 forecast and reflects developments in prices and production as well as continued downward pressure on profits from higher capital and operating expenditure. The projections for North Sea revenues use the NAO audited assumption on oil prices. In line with the average of independent forecasts, oil prices are expected to be $60.3 a barrel in 2007, around $2 higher than assumed in the Budget 2006 forecast. However, the stronger dollar-sterling rate means that oil prices in sterling are lower from 2007 onwards than assumed in Budget 2006.

Investment in the North Sea has continued to increase and is now substantially higher than the capital expenditure projections incorporated into the North Sea revenues forecast prior to the announcement of the increase in the Supplementary Charge. This demonstrates the continuing attractiveness and competitiveness of the North Sea as a place to invest. However, despite the highest levels of investment this decade, North Sea production has been lower than expected in 2006. This seems mainly due to rising maintenance requirements for North Sea infrastructure, with further pressure created by increased global competition for equipment and skilled personnel pushing up costs as operators everywhere try to maximise production. Production is expected to rise in 2007, with a number of new developments, including the Buzzard field coming on stream. However, the overall level of production is expected to be significantly lower than assumed in the Budget 2006 forecast reflecting the lower starting point and more modest increases expected by operators. Beyond 2007-08, production is expected to gradually return to its previously assumed levels, helped by the higher levels of capital expenditure. This reduces the shortfall in revenues relative to the Budget 2006 forecast.

Table B13: Current receipts

	£ billion		
	Outturn	Estimate	Projection
	2005-06	2006-07	2007-08
HM Revenue and Customs			
Income tax (gross of tax credits)	135.0	146.1	155.8
Income tax credits	-4.5	-4.6	-4.4
National insurance contributions	85.5	88.5	94.3
Value added tax	72.9	76.2	80.1
Corporation tax[1]	42.4	48.0	53.8
Corporation tax credits[2]	-0.5	-0.6	-0.6
Petroleum revenue tax	2.0	2.3	1.9
Fuel duties	23.4	23.7	25.2
Capital gains tax	3.0	4.0	4.9
Inheritance tax	3.3	3.6	4.1
Stamp duties	10.9	12.7	13.8
Tobacco duties	8.0	8.0	8.0
Spirits duties	2.3	2.3	2.4
Wine duties	2.3	2.4	2.5
Beer and cider duties	3.2	3.3	3.4
Betting and gaming duties	1.4	1.4	1.4
Air passenger duty	0.9	1.1	2.0
Insurance premium tax	2.3	2.3	2.4
Landfill tax	0.7	0.8	0.9
Climate change levy	0.7	0.7	0.7
Aggregates levy	0.3	0.3	0.3
Customs duties and levies	2.3	2.3	2.3
Total HMRC	**398.0**	**424.7**	**455.4**
Vehicle excise duties	5.0	5.1	5.5
Business rates	19.9	21.5	22.3
Council tax[3]	21.4	22.5	23.8
Other taxes and royalties[4]	12.7	13.3	14.5
Net taxes and national insurance contributions[5]	**457.0**	**487.1**	**521.4**
Accruals adjustments on taxes	1.6	3.2	2.3
Less own resources contribution to European Commission (EC) budget	-4.3	-4.4	-4.4
Less PC corporation tax payments	-0.2	-0.2	-0.2
Tax credits adjustment[6]	0.6	0.6	0.7
Interest and dividends	6.2	5.3	6.1
Other receipts[7]	24.4	26.2	27.9
Current receipts	**485.3**	**517.9**	**553.8**
Memo:			
North Sea revenues[8]	9.6	10.4	10.7

[1] National Accounts measure: gross of enhanced and payable tax credits.
[2] Includes enhanced company tax credits.
[3] Council tax increases are determined annually by local authorities, not by the Government. As in previous years, council tax figures are projections based on stylised assumptions and are not Government forecasts.
[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 NTNIC but expenditure in the national accounts.
[7] Includes gross operating surplus and rent; net of oil royalties and business rate payments by local authorities.
[8] Consists of North Sea corporation tax, petroleum revenue tax and royalties.

Income tax and NICs

B.49 Cash receipts of income tax and national insurance contributions (NICs) are expected to be £0.9 billion above their Budget 2006 projection. It is usually better to aggregate income tax and NICs when considering in-year trends because most employers make combined payments and a correct allocation between the receipt streams can only be made after the end of the financial year when HMRC receive the employers' end of year returns. PAYE and NIC receipts from wages and salaries are expected to be close to their Budget forecast in 2006-07. The upward revision to the projection stems from higher than expected self assessment receipts and tax on savings income, and lower income tax repayments.

B.50 PAYE and NIC receipts in 2006-07 have been constrained by the continued subdued growth in average earnings, but have benefited from a stronger rise in employment growth than anticipated and from the buoyancy of the financial sector. This sector has a higher proportion of taxpayers who pay tax at the higher rate than other sectors of the economy. With continued evidence of robust activity growth in the financial sector, strong growth in bonuses should boost income tax and NIC receipts in the latter part of 2006-07. The pick up in cash receipts growth over the remainder of the year also reflects changes in the timing of personal pension rebates. Around 90 per cent of the expected full year total in 2006-07 has already been paid out, while in 2005-06 only around 50 per cent had been paid out by October.

B.51 The strong growth in working age population in recent years which has been accompanied by a sustained rise in employment has led to an upward revision to the contribution to trend growth from the rise in the working age population. This leads to stronger future increases in employment than previously assumed. In addition to higher tax on savings income from the interest rate assumption audited by the NAO, this has helped offset negative effects in 2007-08 from slower growth in self-employment income and from the higher than anticipated increase in RPI inflation this year. This means that tax thresholds and allowances will increase by more than expected in April 2007.

Non-North Sea corporation tax

B.52 Total corporation tax receipts in the first seven months of 2006-07 were 18 per cent higher than in the comparable period a year ago. As in 2005-06, and as forecast, this is largely due to continued strong growth in receipts from the banking and oil sectors. An analysis of trends in North Sea revenues can be found in Box B2. The growth in receipts from the industrial and commercial sectors has also increased. However, non-North Sea corporation tax receipts are expected to be £0.7 billion below the Budget 2006 estimate for 2006-07, largely reflecting weaker receipts from the life assurance sector. Weaker than expected receipts from this sector are likely to be related to the fall in bond prices in early 2006.

B.53 Non-North Sea corporation tax receipts are expected to record growth of almost 15 per cent for 2006-07 as a whole. The slowdown in overall corporation tax growth over the rest of 2006-07 mainly reflects changes in the timing of instalment payments for oil companies. In January 2007, oil companies should pay a third of their liabilities on their 2006 profits, while in January 2006 oil companies paid half of their liability on 2005 profits.

B.54 The strong growth in implied 2006 liabilities also boosts 2007-08 non-North Sea receipts, which are expected to grow by 13 per cent. With the economy back on trend and profit growth in the financial sector expected to return to its long run trend from 2007 onwards, onshore corporation tax is expected to grow broadly in line with the economy from 2008-09 onwards.

Capital gains tax and inheritance tax

B.55 The forecast for capital gains tax incorporates a further year of strong receipts growth in 2006-07, helped by solid growth in equity prices in 2005-06. Most capital gains tax is collected in the final quarter of the financial year. Capital gains tax receipts rose by over 30 per cent in 2005-06, boosted by the rise in the equity and housing markets in 2004-05 and the continuing effects from the disposal of business assets following the maturing of the business asset taper relief. The rebound in the housing market during 2006 will increase receipts of both capital gains tax and inheritance tax from 2007-08, given tax payment lags.

Stamp duties

B.56 Receipts of stamp duty land tax have recorded robust year-on-year growth in the first seven months of 2006-07. This reflects both the pick up in the housing market in the UK as a whole and that price rises in London properties, which are more likely to be subject to higher rates of duty, have recently started to outpace other parts of the country. In addition, the commercial property market remains buoyant. Year-on-year growth in stamp duty land tax receipts is expected to moderate over the rest of 2006-07 and into 2007-08. In the near-term, this largely reflects that a rebound in property transactions in the latter half of 2005-06 will make the annual comparisons look less favourable. Further ahead, house price inflation is expected to moderate to rates in line with income growth as the monetary environment tightens. Receipts from stamp duty on shares have benefited from the continued rise in equity markets in 2006, but this has been partly offset by a fall in the number of equity trades subject to stamp duty.

VAT receipts

B.57 VAT receipts in 2005-06 were affected by a combination of weak consumer spending, changes in the composition of consumer spending and an increase in the VAT gap, particularly from an increase in Missing Trader Intra-Community (MTIC) fraud.

B.58 However, VAT receipts in the first seven months of 2006-07 have picked up and were 4.7 per cent higher on a year earlier. VAT receipts have benefited from the stronger than expected economy. This has helped boost the VAT tax base, particularly from the government and housing components. However, despite the pick up in consumer spending growth there has been a further fall in the proportion of consumer spending subject to VAT at the standard rate, reflecting shifts towards spending subject to reduced rates such as on energy bills, or to exempt housing costs, and away from standard rated items such as consumer durables. Changes in relative prices are likely to be part of the explanation with the prices of energy and housing rising relative to durable goods, with the latter affected by strong domestic and global competition. Although consumer durable spending has picked up from its pronounced weakness in 2005, it remains weaker than overall spending.

B.59 As noted in Chapter 5, HMRC have strengthened their strategy against MTIC fraud and operational indicators suggest this has led to a significant fall in MTIC-related activity during 2006-07. Growth in VAT receipts is expected to pick up further in 2007-08, helped by the continuation of slightly above trend growth in the economy into 2007.

Excise duties

B.60 Fuel duties are expected to be £0.3 billion lower in 2006-07 than forecast in Budget 2006. This partly reflects the delay in the revalorisation of fuel duties from 1 September until this Pre-Budget Report. In addition, high oil prices and their impact on pump prices have continued to affect the demand for fuel. This reduces fuel duty receipts, which are charged on a per litre basis. With receipts from both spirits and beer down on a year earlier in the first seven months of 2006-07, alcohol duties are expected to be £0.2 billion below their Budget 2006 projection, with stronger growth forecast to return in 2007-08. Tobacco receipts in 2006-07 are expected to be close to their Budget 2006 forecast. The forecast for 2007-08 onwards incorporates an updated estimate of the impact on receipts from the smoking ban on consumption in enclosed workplaces. The projection assumes a loss of revenues of £0.2 billion in 2007-08 and around £½ billion in each subsequent year.

Council tax **B.61** Council tax increases are determined annually by local authorities, not by the Government and the council tax figures for 2007-08 onwards are based on stylised assumptions and are not government forecasts. Increases are based on the arithmetic average of council tax increases over the past 3 years. Since changes to council tax are broadly balanced by changes to locally financed expenditure, they have little material impact on the current balance or on net borrowing.

Other taxes and receipts **B.62** Other taxes and royalties are expected to be over £1 billion higher in 2007-08 than projected in Budget 2006. This mainly reflects the rise in air passenger duties from February 2007, although VAT refunds are also expected to be higher than previously forecast. Other receipts are also expected to be higher, primarily because of the inclusion of renewable obligation certificates as receipts in the 2006 Blue Book. These add to both receipts and expenditure and hence are neutral for the overall fiscal balances.

Tax-GDP ratio

B.63 Table B14 shows projections of receipts from major taxes as a per cent of GDP, and Table B15 sets out current and previous projections of the overall tax-GDP ratio, based on net taxes and national insurance contributions. Chart B3 shows the tax-GDP ratio from 1981-82 to 2011-12.

B.64 The tax-GDP ratio is expected to be lower throughout the forecast than assumed in the Budget 2006 projections. This is primarily due to higher money GDP. Revisions in the 2006 Blue Book raised estimates of both real GDP and GDP deflator inflation for recent years.

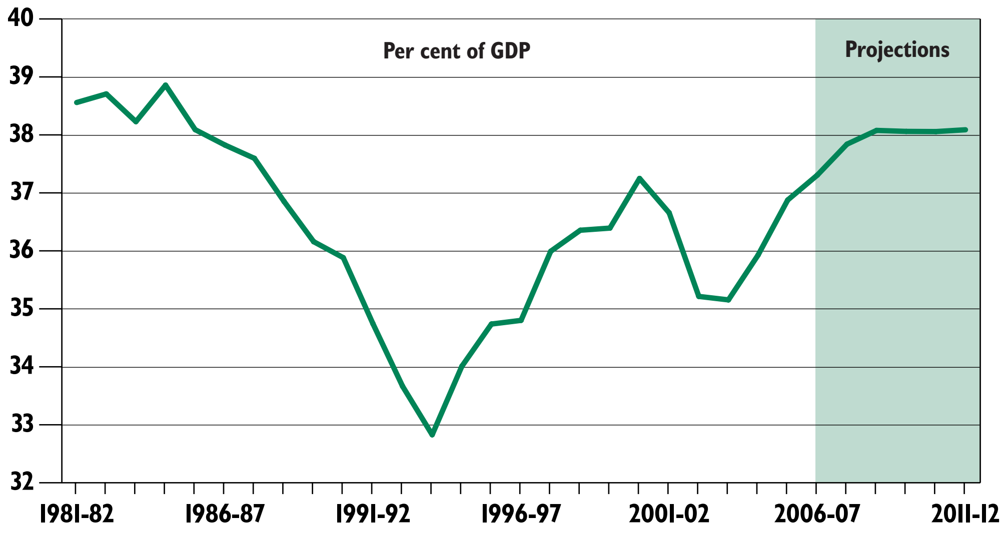
B.65 The tax-GDP ratio stabilises at 38.1 per cent from 2008-09 onwards. The rise over the next two years is mainly due to increases in the income tax and corporation tax to GDP ratios. The rise in the income tax to GDP ratio largely arises from the normal fiscal forecasting convention on tax allowances and fiscal drag. The sharp rise in the non-North Sea corporation tax to GDP ratio in recent year reflects the recovery in profitability, particularly in the financial sector. The ratio is expected to flatten off during 2008-09, with both the overall economy and financial company profitability expected to grow in line with trend.

Table B14: Current receipts as a proportion of GDP

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Income tax (gross of tax credits)	10.9	11.2	11.3	11.5	11.6	11.7	11.8
National insurance contributions	6.9	6.8	6.8	6.9	6.9	6.9	6.9
Non-North Sea corporation tax[1]	2.8	3.1	3.3	3.4	3.3	3.4	3.4
Tax credits[2]	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3
North Sea revenues[3]	0.8	0.8	0.8	0.8	0.8	0.7	0.7
Value added tax	5.9	5.8	5.8	5.8	5.8	5.7	5.7
Excise duties[4]	3.2	3.0	3.0	2.9	2.9	2.8	2.8
Other taxes and royalties[5]	6.9	7.0	7.2	7.2	7.1	7.1	7.2
Net taxes and national insurance contributions[6]	**36.9**	**37.3**	**37.8**	**38.1**	**38.1**	**38.1**	**38.1**
Accruals adjustments on taxes	0.1	0.2	0.2	0.2	0.1	0.1	0.1
Less EU transfers	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Other receipts[7]	2.5	2.4	2.5	2.5	2.5	2.5	2.5
Current receipts	**39.2**	**39.7**	**40.2**	**40.4**	**40.4**	**40.4**	**40.4**

[1] National accounts measure, gross of enhanced and payable tax credits.
[2] Tax credits scored as negative tax in net taxes and national insurance 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] Mainly gross operating surplus and rent, excluding oil royalties.

Chart B3: Tax-GDP ratio[1]



[1] Net taxes and national insurance contributions as defined in Table B15.

Table B15: Net taxes and national insurance contributions[1]

	Per cent of GDP						
	Outturn[2]	Estimate[3]	Projections				
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Budget 2006	37.5	38.0	38.5	38.7	38.7	38.7	
PBR 2006	**36.9**	**37.3**	**37.8**	**38.1**	**38.1**	**38.1**	**38.1**

[1] *Cash basis. Uses OECD definition of tax credits scored as negative tax.*

[2] *The 2005-06 figures were estimates in Budget 2006.*

[3] *The 2006-07 figures were projections in Budget 2006.*

PUBLIC EXPENDITURE

B.66 This section looks in detail at the projections for public expenditure. The spending projections cover the whole of the public sector, using the National Accounts aggregate Total Managed Expenditure (TME).

B.67 For fiscal aggregates purposes, TME is split into National Accounts components covering public sector current expenditure, public sector net investment and depreciation. For budgeting and other purposes, TME is split into DEL (firm three-year limits for departments' programme expenditure), and AME (expenditure that is not easily subject to firm multi-year limits). Departments have separate resource budgets for current and capital expenditure.

Changes in TME since Budget 2006

B.68 The main forecasting changes to TME in the 2004 Spending Review period since Budget 2006 are to AME, where the totals for 2006-07 and 2007-08 have been revised up as a result of changes to the forecasts of individual AME components.

B.69 Discretionary changes to TME since the Budget 2006 forecast reflect the Pre-Budget Report spending measures listed in Table B4. In total these measures increase spending by £0.1 billion in 2007-08. The main change is an increase to DEL on direct payments to schools.

B.70 The provisional outturn for public sector net investment in 2005-06 was lower than estimated in Budget 2006. This is due to higher depreciation figures in the National Accounts, an adjustment to remove capital grants to London and Continental Railways from overall public spending following its reclassification to the public sector, and departmental capital underspends. Projected capital spending for departmental budgets will be updated at the time of the budget.

Table B16: Total Managed Expenditure 2005-06 to 2007-08

	£ billion		
	Outturn	**Estimate**	**Projection**
	2005-06	**2006-07**	**2007-08**
Departmental Expenditure Limits			
Resource Budget	277.1	294.5	309.9
Capital Budget	35.8	42.6	45.7
Less depreciation	-10.3	-11.8	-11.5
Total Departmental Expenditure Limits	**302.6**	**325.3**	**344.2**
Annually Managed Expenditure			
Social security benefits[1]	127.4	132.1	139.5
Tax credits[1]	15.4	16.0	15.8
Net public service pensions[2]	0.3	0.9	0.9
National Lottery	1.8	1.7	1.5
BBC domestic services	3.2	3.3	3.4
Other departmental expenditure	3.6	3.3	2.8
Net expenditure transfers to EU institutions[3]	4.4	4.1	6.0
Locally-financed expenditure[4]	25.4	26.4	27.8
Central government gross debt interest	25.8	27.4	28.3
Public corporations' own-financed capital expenditure	6.1	7.0	4.3
AME margin	0.0	0.0	0.0
Accounting adjustments[5]	6.8	7.2	10.6
Total Annually Managed Expenditure	**220.3**	**229.3**	**240.9**
Total Managed Expenditure	**522.8**	**554.6**	**585.1**
of which:			
Public sector current expenditure	483.9	508.1	536.6
Public sector net investment	22.4	28.9	29.8
Public sector depreciation	16.5	17.6	18.6

[1] For 2005-06 to 2007-08, 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.

[2] Net public service pensions expenditure is reported on a National Accounts basis.

[3] AME spending component only. Total net payments to EU institutions also include receipts scored in DEL, VAT based contributions which score as negative receipts and some payments which have no effect on the UK public sector in the national accounts. Latest estimates for total net payments, which exclude the UK's contribution to the cost of EU aid to non-Member States (which is attributed to the aid programme), and the UK's net contribution to the EC Budget, which includes this aid, are (in £ billion):

	2005-06	2006-07	2007-08
Net payments to EU institutions	3.8	2.1	3.8
Net contribution to EC Budget	4.4	2.8	4.5

[4] This expenditure is mainly financed by council tax revenues. See footnote to table B13 for an explanation of how the council tax projections are derived.

[5] Excludes depreciation.

B.71 Chart B4 shows TME as a per cent of GDP from 1971-72 to 2007-08

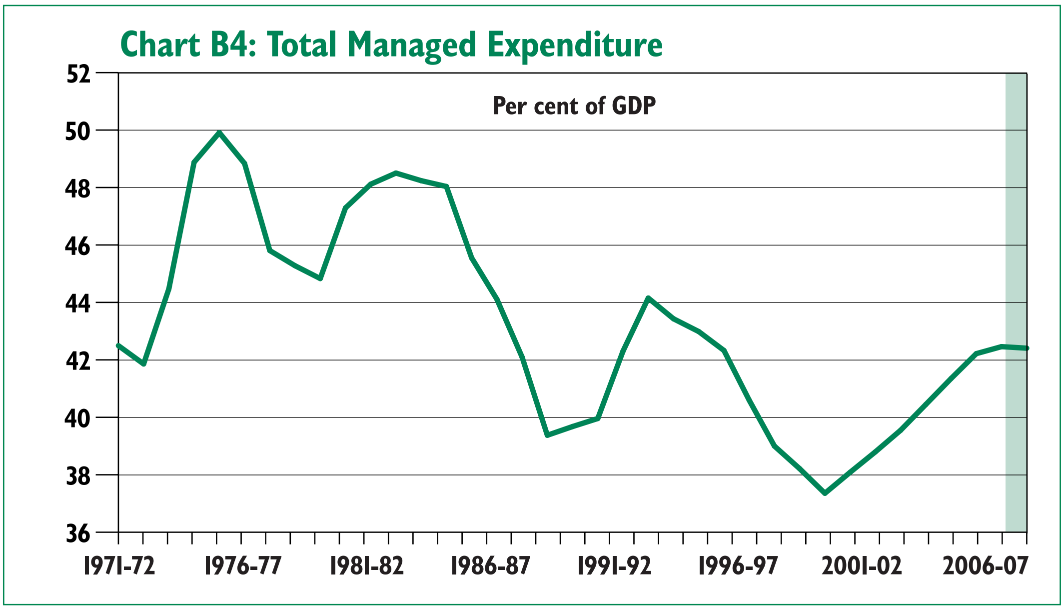


Table B17: Changes to Total Managed Expenditure since Budget 2006

	£ billion		
	Outturn	Estimate	Projections
	2005-06	2006-07	2007-08
Departmental Expenditure Limits			
Resource Budget	-0.5	0.0	0.2
Capital Budget	-1.6	0.1	0.1
Less depreciation	1.7	0.0	0.0
Total Departmental Expenditure Limits	**-0.4**	**0.1**	**0.4**
Annually Managed Expenditure			
Social security benefits	0.0	0.5	1.2
Tax credits	0.0	0.4	0.6
Net public service pensions	-0.1	0.5	0.6
National Lottery	0.0	0.0	0.0
BBC domestic services	0.1	0.0	0.0
Other departmental expenditure	-0.7	-0.3	-0.4
Net expenditure transfers to EU institutions	0.0	-1.3	-0.5
Locally-financed expenditure	-1.2	-1.2	-1.5
Central government gross debt interest	0.1	1.1	0.4
Public corporations' own-financed capital expenditure	3.3	4.0	1.3
AME margin	0.0	-1.0	-2.0
Accounting adjustments	-1.4	-0.5	2.1
Total Annually Managed Expenditure	**0.1**	**2.2**	**1.9**
Total Managed Expenditure	**-0.3**	**2.3**	**2.3**
of which:			
Public sector current expenditure	2.0	1.4	2.4
Public sector net investment	-3.3	0.1	-1.1
Public sector depreciation	0.9	0.8	0.9

Central Government spending in 2006-07

B.72 Monthly spending information is only available for central government. Provisional outturn for current expenditure in the first seven months of 2006-07 is 7.1 per cent higher than in the corresponding period in 2005-06. Growth is higher in the year to date than the 2006 Pre-Budget Report estimate for 2006-07 as a whole, as a result of factors which affect the pattern of spending across the year.

B.73 Debt interest payments for the year to date are 2.1 per cent higher than the same period last year, and are expected to grow more rapidly over the remainder of the year. This is due to the lagged impact of RPI inflation on the uplift of index-linked gilt payments.

B.74 Provisional outturn data for net social benefit expenditure for the first seven months of 2006-07 show growth of 4.4 per cent over the same period in 2005-06. Growth is expected to moderate over the remainder of the year.

B.75 Other current expenditure is 8.7 per cent higher for the year to date, above the Pre-Budget Report estimate of 5.3 per cent growth for the year as a whole. Growth is expected to be much lower over the rest of the year, largely because of changes to the timing of grant payments in respect of education and social care. A much higher proportion of these grants scored in the first four months of 2006-07 than in 2005-06, and a much lower proportion will fall in the last two months.

DEL and AME analysis

B.76 Table B16 sets out projected spending on DEL and the main components of AME to the end of the 2004 Spending Review period in 2007-08. Table B17 shows changes since Budget 2006.

B.77 The detailed allocation of DEL is shown in table B18. In line with previous practice, resource and capital DEL in 2006-07 includes an allowance for shortfall, which reflects likely underspending against departmental provision.

B.78 The main economic assumptions underpinning the AME projections are set out in Box B1 and Table B3. In particular it is assumed that UK claimant count unemployment rises from current levels. This is a cautious assumption for the purposes of the public finances forecast and does not represent the Treasury's central economic forecast. Many of the changes in the forecasts of AME components since Budget 2006 are attributable to higher RPI inflation in 2006.

B.79 Social security expenditure, before taking discretionary measures into account, is forecast to be higher than expected at Budget 2006. Part of this increase reflects a change in the definition of spending included within the social security heading, to include additional spending of around £0.2 billion per year, which is offset by a reduction in accounting adjustments. In 2006-07 the upward effect on spending caused by higher unemployment has been partly offset by revised estimated profiles of benefit claim figures for the year to date. There are similar effects in 2007-08 but the primary reason for increased spending is the higher than expected RPI level for September 2006 which is used to uprate 2007-08 benefit levels. This is partly offset by a downward adjustment on forecast spending on Pension Credit, reflecting a revision of predicted growth in caseload.

B.80 Projected expenditure on the Child and Working Tax Credits has been revised upwards since Budget 2006. New information about 2005-06 shows higher levels of entitlement than forecast, which resulted from a number of factors including lower earnings growth among low-income households. This increases subsequent years' expenditure.

B.81 Net public service pensions figures are reported on a National Accounts basis, which reflects the differences between the payments to pensioners paid out during the year and contributions received for the main unfunded public service pension schemes. Spending is expected to be slightly higher than forecast at Budget 2006. The higher spending in 2007-08 partly reflects the impact of higher than expected RPI inflation in 2006.

B.82 National lottery figures reflect the latest view on the timing of drawdown by the distributing bodies. The estimates are broadly unchanged from Budget 2006.

B.83 The decrease in other departmental expenditure largely reflects a change to the budgeting regime, whereby grants to local authorities that were previously classified as financial transactions have now been removed from departments' budgets. This change is offset by a change to accounting adjustments.

B.84 Net expenditure transfers to EU institutions include the GNI based contribution less the UK abatement. These transfers are expected to be lower in 2006-07 and 2007-08 than expected at Budget 2006. This is explained by downward revisions to the size of the 2006 and 2007 EC budgets, which reduce the contributions required from Member States. The latest EC Budget for 2006 also increases projections of revenue from other sources in 2006, further reducing the contributions required from Member States.

B.85 Changes to forecasts for local authority self-financed expenditure (LASFE) reflect recent outturns and an improved understanding of the trends in data, reflecting work done with the ONS and the Department for Communities and Local Governement (DCLG) to improve data quality. The reclassification of net capital expenditure on housing by the Housing Revenue Account (HRA) to the public corporations (PC) sector has also been a contributing factor. The council tax projections used to derive the LASFE projections for 2007-08 onwards are based on stylised assumptions and are not government forecasts. Forward projections are simply an arithmetic average of national council tax increases for the last three years.

B.86 Estimates for central government debt interest payments in 2006-07 are greater than at Budget 2006, mainly due to higher RPI inflation affecting the uplift on index-linked gilts and National Savings and Investments savings certificates. Higher than expected interest rates have, to a lesser extent, also increased debt interest payments in 2006-07. Payments in 2007-08 have increased by less than in 2006-07 because the inflationary impact is lower.

B.87 Public corporations' own financed capital expenditure forecasts have been revised in line with public corporations' latest spending plans. They take account of the effect of the reclassification of HRA capital expenditure to the PC sector, as referred to in paragraph B85. The increase in 2006-07 also reflects the write-off of Nigerian debt agreed with the Paris Club. This is scored as a capital grant by the Export Credits Guarantee Department (ECGD) in the National Accounts at the time the write-off was implemented. It is also scored this way in OECD's Official Development Assistance (ODA) figures, but this does not reflect the underlying trend path of ODA, or the fact that the benefit to Nigeria is spread over several years. The Government is therefore considering with international colleagues whether there is a more appropriate way to report Nigerian debt relief over several years in the ODA figures to enable more accurate monitoring of trends.

Table B18: Departmental Expenditure Limits - resource and capital budgets

	£ billion		
	Outturn	Estimate	Projection
	2005-06	2006-07	2007-08
Resource Budget			
Education and Skills	24.7	53.3	56.8
Health	76.5	82.0	89.1
of which : NHS	74.3	80.0	87.1
Transport	6.3	6.9	6.7
Department for Communities and Local Government	3.4	3.6	4.3
Local Government	46.2	22.5	22.8
Home Office	12.7	13.1	13.5
Departments for Constitutional Affairs	3.9	4.0	4.0
Law Officers' Departments	0.6	0.7	0.7
Defence	32.3	33.8	32.7
Foreign and Commonwealth Office	1.9	1.9	1.7
International Development	4.5	5.0	5.3
Trade and Industry	5.1	5.8	6.0
Environment, Food and Rural Affairs	2.7	2.9	3.0
Culture, Media and Sport	1.5	1.5	1.6
Work and Pensions	7.8	7.8	7.7
Scotland[1]	20.8	22.3	23.5
Wales[1]	10.9	11.8	12.4
Northern Ireland Executive[1]	6.7	7.2	7.6
Northern Ireland Office	1.2	1.2	1.1
Chancellor's Departments	5.0	5.1	5.0
Cabinet Office	2.2	2.3	2.3
Invest to Save Budget	0.0	0.0	0.0
Reserve	0.0	0.5	2.1
Unallocated special reserve[2]	0.0	0.0	0.0
Allowance for shortfall	0.0	-0.9	0.0
Total Resource Budget DEL	**277.1**	**294.5**	**309.9**
Capital Budget			
Education and Skills	5.7	6.3	7.0
Health	2.2	5.3	6.3
of which : NHS	2.1	5.2	6.2
Transport	5.8	7.4	6.7
Department for Communities and Local Government	5.7	5.8	6.2
Local Government	0.3	0.3	0.2
Home Office	1.0	1.3	1.3
Departments for Constitutional Affairs	0.1	0.2	0.1
Law Officers' Departments	0.0	0.0	0.0
Defence	6.8	7.4	7.6
Foreign and Commonwealth Office	0.1	0.2	0.1
International Development	0.0	0.0	0.0
Trade and Industry	1.4	1.3	1.1
Environment, Food and Rural Affairs	0.9	0.9	0.9
Culture, Media and Sport	0.1	0.4	0.2
Work and Pensions	0.4	0.2	0.1
Scotland[1]	2.3	3.0	3.1
Wales[1]	1.2	1.4	1.6
Northern Ireland Executive[1]	0.9	0.9	1.0
Northern Ireland Office	0.1	0.1	0.1
Chancellor's Departments	0.4	0.3	0.3
Cabinet Office	0.3	0.4	0.3
Invest to Save Budget	0.0	0.0	0.0
Reserve	0.0	0.3	1.3
Allowance for shortfall	0.0	-0.6	0.0
Total Capital Budget DEL	**35.8**	**42.6**	**45.7**
Depreciation	**10.3**	**11.8**	**11.5**
Total Departmental Expenditure Limits	**302.6**	**325.3**	**344.2**
Total education spending	67.7	70.6	75.8

[1] For Scotland, Wales and Northern Ireland, the split between resource and capital budgets is indicative and reflects the consequentials of the application of the Barnett formula to planned changes in UK departments' spending.

[2] This represents provision for the costs of military operations in Iraq and Afghanistan, as well as the UK's other international obligations.

B.88 The accounting adjustments reflect the latest adjustments needed to reconcile the budgeting aggregates DEL and AME with the National Accounts definition of TME, removing items that score in DEL or AME but not in TME, and adding in items included in TME but not in DEL or AME. Changes in accounting adjustments reflect classification changes made to TME by the ONS, and budgeting regime changes or changes in the presentation of the AME components, as described above. Recent classification changes that have increased the accounting adjustments include adjustments in respect of renewable obligation certificates and passport fees. Adjustments that have reduced the accounting adjustments include the reclassification of contributions to international development organisations, which are elements of DEL that are now treated as financial transactions, not included in TME, and an adjustment to remove capital expenditure included in the Department for Transport's capital DEL in respect of capital grants to London and Continental Railways (LCR), which since the reclassification of LCR to the public corporation sector of National Accounts, are intra-public sector transactions and so consolidate out in TME. The latter particularly reduces the accounting adjustments in 2005-06 and 2006-07, as shown in the public corporations component of the accounting adjustments in Table B19.

Table B19: Accounting adjustments

	£ billion		
	Outturn	Estimate	Projection
	2005-06	2006-07	2007-08
Central government programmes	1.0	1.1	1.2
VAT refunds	10.2	11.0	12.6
Central government non-trading capital consumption	6.1	6.6	7.1
Non-cash items in resource budgets and not in TME	-8.7	-8.9	-9.6
Expenditure financed by revenue receipts	1.3	0.6	0.5
Local authorities	4.6	4.2	5.0
General government consolidation	-6.3	-6.3	-6.5
Public corporations	-0.9	-0.5	0.4
Financial transactions	0.2	0.4	0.5
Other accounting adjustments	-0.8	-0.9	-0.5
Total accounting adjustments	**6.8**	**7.2**	**10.6**

B.89 Table B20 shows public sector capital expenditure from 2005-06 to 2007-08.

Table B20: Public sector capital expenditure

	£ billion		
	Outturn	Estimate	Projection
	2005-06	2006-07	2007-08
Capital Budget DEL	35.8	42.6	45.7
Locally-financed expenditure	1.2	1.5	1.0
National Lottery	1.0	1.0	0.9
Public corporations' own-financed capital expenditure	6.1	7.0	4.3
Other capital spending in AME	0.6	-0.3	-0.2
AME margin	0.0	0.0	0.0
Accounting adjustments	-5.8	-5.2	-3.2
Public sector gross investment[1]	**38.9**	**46.5**	**48.4**
Less depreciation	16.5	17.6	18.6
Public sector net investment	**22.4**	**28.9**	**29.8**
Proceeds from the sale of fixed assets[2]	5.9	5.6	5.6

[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.*

B.90 Table B21 shows estimated receipts from loans and sales of assets from 2005-06 to 2007-08. Since Budget 2006, the ONS has reclassified local authority HRA assets to the public corporation sub-sector. Receipts from these assets continue to be included in this table in order to show a consistent measure over time of sales of public sector fixed assets. The figures for sales of financial assets include proceeds in the final quarter of 2005-06 of £0.3 billion from the sale of part of the Government's shareholding in QinetiQ (formerly the Defence Evaluation and Research Agency). The table only covers general government and so does not include the sale by British Nuclear Fuels Limited (BNFL) of its Westinghouse subsidiary, which was finalised in October 2006. The proceeds from this sale are included in the public corporation column of Table B25. It is anticipated that there will be a public sector neutral transfer of the proceeds to central government. A £0.5 billion BNFL debenture has already been repaid to government from the proceeds.

Table B21: Loans and sales of assets

	£ billion		
	Outturn 2005-06	Estimate 2006-07	Projection 2007-08
Sales of fixed assets			
Central government	1.7	1.4	1.4
Local authorities	1.8	1.8	1.8
Housing Revenue Account[1]	2.4	2.4	2.4
Total sales of fixed assets	**5.9**	**5.6**	**5.6**
Total loans and sales of financial assets	**-2.7**	**-2.9**	**-3.3**
Total loans and sales of assets	**3.2**	**2.7**	**2.3**

[1] *Capital transactions by local authorities' Housing Revenue Accounts are no longer statistically classified to the local authority subsector and so are shown separately.*

PRIVATE FINANCE INITIATIVE

B.91 Under the Private Finance Initiative (PFI) the public sector contracts to purchase services on a long-term basis so as to take advantage of private sector management skills incentivised by having private finance at risk. The private sector has always been involved in the building and maintenance of public infrastructure, but PFI ensures that contractors are bound into long-term maintenance contracts and shoulder responsibility for the quality of the work they do. With PFI, the public sector defines what is required to meet public needs and ensures delivery of the outputs through the contract. Consequently, the private sector can be harnessed to deliver investment in better quality public services while frontline services are retained within the public sector. The Government's position on PFI is set out in *PFI: Strengthening Long Term Partnerships.*

B.92 The Government only uses PFI where it is appropriate and where it expects it to deliver value for money. This is based on an assessment of the lifetime costs of both providing and maintaining the underlying asset, and of the running costs of delivering the required level of service. In assessing where PFI is appropriate, the Government's approach is based on its commitment to efficiency, equity and accountability, and on the principles of public service reform. PFI is only used where it can meet these requirements, and where the value for money it offers is not at the expense of the terms and conditions of staff. The Government is committed to securing the best value for its investment programme by ensuring that there is no inherent bias in favour of one procurement option over another.

B.93 Table B22 shows a breakdown by department of the estimated capital investment in public services resulting from signed PFI contracts. Table B23 shows the estimated total capital value of contracts that are at preferred bidder stage and are expected to reach financial close within the next three years. Under PFI, the public sector contracts for services, including the availability and management of facilities, and not assets. Capital investment is only one of the activities undertaken by the private sector in order to supply these services. The figures in Tables B22 and B23 report the capital value of projects in order to show investment on a basis comparable with conventional capital procurement.

Table B22: Departmental estimate of capital spending by the private sector (signed deals)[1,2,3]

	£ million	
	Projections	
	2006-07	2007-08
Education and Skills[4]	650	295
Health	1,022	1,005
Transport[5]	1,428	1,097
Department for Communities and Local Government	80	80
Home Office	23	20
Constitutional Affairs	15	2
Defence	556	643
Foreign and Commonwealth Office	5	5
Trade and Industry	2	5
Environment, Food and Rural Affairs	65	63
Culture, Media and Sport	38	12
Work and Pensions	55	55
Scotland	545	472
Wales	0	0
Northern Ireland Executive	86	116
Chancellor's Departments	2	2
Total	**4,570**	**3,869**

[1] *Investment in assets scored on the public sector balance sheet also score as public sector net investment.*

[2] *PFI activity in local authority projects is included under the sponsoring central government department.*

[3] *Figures do not include PFI projects undertaken by public corporations.*

[4] *Excludes private finance activity in educational institutions classified to the private sector.*

[5] *Includes estimates of the capital expenditure for the London Underground Limited Public Private Partnership (LUL PPP) PFI contracts in the years that investments are expected to take place.*

Table B23: Estimated aggregated capital value of projects at preferred bidder stage[1,2]

	£ million	
	Projections	
	2006-07	2007-08
Education and Skills	270	0
Health	1,014	1,290
Transport	20	48
Department for Communities and Local Government	292	0
Defence	2,850	0
Environment, Food and Rural Affairs	609	0
Culture, Media and Sport	63	0
Scotland	1,038	0
Wales	32	29
Northern Ireland Executive	122	44
Total	**6,360**	**1,411**

[1] *Figures based on Departmental returns.*

[2] *These figures are the total capital value of projects; the actual annual capital spending figures will be lower, as capital spending on large projects is typically spread over several years.*

B.94 Table B24 shows a forecast of the estimated payments for services flowing from signed PFI projects. Actual expenditure will depend on the details of the payment mechanism for each contract. Payments may be lower than those estimated as a result of deductions that can be applied if the supplier fails to meet required performance standards. Variances may also occur as a result of agreed changes to the service requirements that are made during the course of the contract, or because of contractual arrangements that trigger compensation on termination. The fact that capital investment only represents one element of the overall contract means that the figures presented in this table should not be taken to be directly comparable with a public sector debt liability.

Table B24: Estimated payments under PFI contracts - December 2006 (signed deals)[1]

£ billion			
Projections			
2006-07	6.6	2019-20	5.6
2007-08	7.0	2020-21	5.7
2008-09	7.4	2021-22	5.4
2009-10	7.7	2022-23	5.3
2010-11	8.0	2023-24	5.3
2011-12	7.9	2024-25	5.3
2012-13	8.0	2025-26	5.2
2013-14	8.2	2026-27	4.9
2014-15	8.2	2027-28	4.7
2015-16	8.3	2028-29	4.3
2016-17	8.3	2029-30	4.0
2017-18	7.5	2030-31	3.7
2018-19	5.5	2031-32	3.4

[1] *The figures between 2006-07 and 2017-18 include estimated payments for the LUL PPP PFI contract. These contracts contain periodic reviews every 7.5 years and therefore the service payments are not fixed after 2009-10.*

FINANCING REQUIREMENT

B.95 Table B25 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 B25: Public sector net cash requirement

	£ billion							
	2006-07				2007-08			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing	**34.1**	**0.8**	**1.9**	**36.8**	**30.3**	**0.5**	**0.5**	**31.3**
Financial transactions								
Net lending to private sector and abroad	2.7	0.1	-2.3	0.5	3.1	0.1	0.0	3.2
Cash expenditure on company securities	0.1	0.0	-2.6	-2.5	0.1	0.0	0.0	0.1
Accounts receivable/payable	6.0	0.1	-0.1	6.1	2.5	0.2	0.0	2.7
Adjustment for interest on gilts	-1.3	0.0	0.0	-1.3	-4.0	0.0	0.0	-4.0
Miscellaneous financial transactions	-2.3	0.0	1.2	-1.1	-0.2	0.0	-0.6	-0.7
Own account net cash requirement	39.4	1.0	-1.9	38.5	31.8	0.8	0.0	32.6
Net lending within the public sector	1.8	-2.0	0.2	0.0	2.8	-2.0	-0.8	0.0
Net cash requirement[1]	**41.2**	**-1.0**	**-1.7**	**38.5**	**34.7**	**-1.2**	**-0.9**	**32.6**

[1] *Market and overseas borrowing for local government and public corporation sectors.*

B.96 Table B26 updates the financing arithmetic for 2006-07 in line with the updated fiscal forecasts. The central government net cash requirement (CGNCR) for 2006-07 is unchanged, at £41.2 billion, from the Budget 2006 forecast. However, the impact of other factors set out below reduces the net financing requirement for 2006-07 to £59.0 billion, a decrease of £5.5 billion from the revised forecast published on 24 April 2006 that reflected publication of outturn CGNCR for 2005-06.

B.97 In order to meet the decrease in the financing requirement, the Debt Management Office's (DMO) remit has been revised as follows:

- forecast gross gilt issuance has decreased by £0.5 billion to £62.5 billion. The lower issuance will be met through a reduction in the 'unallocated' gilt issuance programme for the final quarter of 2006-07; and
- the stock of Treasury bills will be reduced by £3.5 billion instead of the increase of £1.5 billion announced on 24 April 2006.

B.98 The latest financing arithmetic set out in Table B26 also takes account of:

- an increase in the forecast net contribution to financing of £2.2 billion in 2006-07 from National Savings & Investments relative to the forecast at the time of the Budget;
- proceeds of £3.8 billion from the disposal of the Nuclear Liabilities Investment Portfolio (NLIP) held by BNFL. Around half of the NILP has already been liquidated, and the remainder, consisting of index-linked gilts, will be sold by the DMO into the secondary market by 31 March 2007;
- buy-backs of illiquid gilts in the secondary market by the DMO of £0.2 billion; and
- a reduction of £0.3 billion in the planned short-term financing adjustment for 2006-07.

B.99 In Budget 2006, the DMO's remit included temporary changes intended to allow greater responsiveness in gilt issuance by the DMO during 2006-07 whilst retaining the Government's firm commitment to transparency and predictability in debt management policy. This remit consisted of: (i) a 'core' gilt issuance programme of £53.0 billon pre-allocated by maturity and type of gilt and which has remained unchanged since Budget; and (ii) an 'unallocated' gilt issuance programme of £10.0 billion to be allocated between maturity and type of gilt each quarter during 2006-07.

B.100 £7.5 billion of the original 'unallocated' gilt issuance programme has already been allocated, comprising £2.5 billion in each of the first three quarters of 2006-07 (to long-dated conventional gilts and/or index-linked gilts). The remaining £2.0 billion of the revised programme of £9.5 billion will be allocated to long-dated conventional gilts in the fourth quarter of 2006-07.

B.101 Details of changes to the financing arithmetic and a revised financing table for 2006-07 together with information on the progress of gilt sales so far this year against the DMO's financing remit can be found on the DMO's website at www.dmo.gov.uk.

Table B26: Financing requirement forecast

	£ billion 2006-07		
	Original Remit March 2006	Revised Remit April 2006[1]	Pre-Budget Report
Central government net cash requirement	**41.2**	**41.2**	**41.2**
Gilt redemptions	29.9	29.9	29.9
Restructuring nuclear liabilities[2]	0.0	0.0	-3.8
Financing for the Official Reserves	0.0	0.0	0.0
Buy-backs[3]	0.0	0.0	0.2
Planned short-term financing adjustment[4]	-3.1	-3.6	-3.3
Gross Financing Requirement	**68.0**	**67.5**	**64.2**
less			
Assumed net contribution from National Savings and Investments	3.0	3.0	5.2
Net Financing Requirement	**65.0**	**64.5**	**59.0**
Financed by:			
1. Debt issuance by the Debt Management Office			
(a) Treasury bills	**2.0**	**1.5**	**-3.5**
(b) Gilts	**63.0**	**63.0**	**62.5**
2. Other planned changes in short-term debt[5]			
Change in Ways & Means	0.0	0.0	0.0
3. Unanticipated changes in short-term cash position[6]	0.0	0.0	0.0
Total financing	**65.0**	**64.5**	**59.0**
Short-term debt levels at end of financial year			
Treasury bill stock in market hands	21.1	20.6	15.6
Ways & Means	13.4	13.4	13.4
DMO net cash position[7]	0.2	0.2	0.5

[1] *The financing arithmetic in Budget 2006 was revised on 24 April 2006 to reflect outturn data for 2005-06.*
[2] *Proceeds from the disposal of financial assets in the Nuclear Liabilities Investment Portfolio (NLIP) held by British Nuclear Fuels Limited. Around half of the NLIP has already been liquidated, and the remainder, consisting of index-linked gilts, will be sold by the DMO into the secondary market by 31 March 2007.*
[3] *Purchases of "rump" gilts which are older, small gilts, declared as such by the DMO and in which Gilt-edged Market Makers (GEMMs) are not required to make two-way markets. The Government will not sell further amounts of such gilts to the market but the DMO is prepared, when asked by a GEMM, to make a price to purchase such gilts.*
[4] *To accommodate changes to the current year's financing requirement resulting from: (i) publication of the previous year's outturn CGNCR; (ii) an increase in the DMO's cash position at the Bank of England; and / or (iii) carry over of unanticipated changes to the cash position from the previous year.*
[5] *Total planned changes to short-term debt are the sum of: (i) the planned short-term financing adjustment; (ii) Treasury bill sales; and (iii) changes to the level of the Ways & Means advance.*
[6] *A negative (positive) number indicates an addition to (reduction in) the financing requirement for the following financial year.*
[7] *There is an increase in the DMO's net cash position at the Bank of England of £0.3 billion (reflecting a move from an end-day target balance of £0.2 billion prior to the implementation of the Bank of England's money market reforms to an average daily target balance of £0.5 billion).*

B.102 Table B27 below sets out the split of gilt issuance between maturity and type of gilt.

Table B27: Gilt issuance split 2006-07

		£ billion					
			Allocation of supplementary gilt issuance				Updated financing programme
			Quarter 1	Quarter 2	Quarter 3	Quarter 4	2006-07
Planned gilt sales		**62.5**					
Pre-allocated gilts issuance		**53.0**					
Of which minimum:							
Conventional	Short	10.0					10.0
	Medium	10.0					10.0
	Long	17.0	2.5	1.3	2.5	2.0	25.3
Index-linked		16.0		1.3			17.3
Total allocated gilt issuance[1]		**53.0**	**2.5**	**2.5**	**2.5**	**2.0**	**62.5**

[1] *Totals may not sum due to rounding.*

CASH MANAGEMENT PERFORMANCE

B.103 The Government's cash management objective is to ensure that sufficient funds are always available to meet any net daily central government cash shortfall and, on any day when there is a net cash surplus, to ensure this is used to best advantage for the Exchequer. The Treasury and the DMO work together to achieve this.

B.104 The role of the Treasury in this regard is to forecast the daily net flows into or out of the National Loans Fund (NLF) and provide the DMO with timely and accurate forecasts of the expected net cash position over time. The DMO's role is to manage by funding and placing as appropriate the net cash positions, primarily by carrying out market operations in light of the forecast. Its objective is to minimise the costs of cash management while operating within a risk appetite approved by Ministers.

B.105 This risk appetite defines objectively the bounds of appropriate activity in accordance with the Government's approach to cash management as cost minimising rather than profit maximising. The DMO also seeks to avoid actions or arrangements that would undermine the efficient functioning of the sterling money markets, or conflict with the operational requirements of the Bank of England for monetary policy implementation. The combination of the Treasury cash flow forecasts and the DMO market operations characterises the active approach to Exchequer cash management.

B.106 The Treasury and the DMO jointly reviewed the cash management function in 2004-05.[1] Implementation of the review recommendations began in June 2005 with the development of a quantified internal performance measure to capture the value added from active cash management. No conceptual problems with this quantitative approach, which captures performance against a neutral passive strategy, have been encountered so far.[2] However a quantitative indicator should not be looked at in isolation, since active cash management performance must be evaluated against a series of key performance indicators that together reflect the principles and objectives of the Government. These objectives are:

- the DMO must supply sufficient cash each day to enable the Government to meet its payment obligations. This is fundamental and unconditional;
- cash management operations and arrangements should be conducted in a manner that does not interfere with monetary policy operations;
- cash management operations and arrangements should be conducted without impeding the efficient working of the sterling money markets;
- cash should be raised, or surplus cash placed, as cost effectively as possible subject to policy objectives and constraints;
- the DMO should maintain a system in which costs and risks are transparent, measured and monitored, and the performance of government cash management assessed. The DMO maintains an ethos of cost minimisation rather than profit maximisation; and

[1] The findings and recommendations of this review and the Government's preference for risk are set out in Chapter 5 of the DMO's Annual Review 2004-05, available on the DMO's website www.dmo.gov.uk/gilts/public/annual/gar0405.pdf.

[2] As a precursor to formal adoption of the quantitative approach, a further Cash Management Project was undertaken in October 2005, overseen by a joint HMT and DMO steering group. This was tasked with reviewing the implementation of the earlier review recommendations; ensuring that the new cash management framework continued to support HMT objectives; and with strengthening HMT oversight of the cash management function and placing it on a structured basis. The Project report concluded that the quantitative framework and risk limits proposed in the original Cash Management Review remained valid.

- DMO should establish a credible reputation in the market that leads to both lower costs in the long term and a system that is sustainable.

B.107 A series of agreed key performance indicators and controls are used to monitor and assess overall performance in meeting the Government cash management objectives. Formal reporting and publication of the performance of active cash management against the key performance indicators will begin with the 2007-08 outturn, and will be considered for the 2006-07 outturn.

ANALYSIS BY SUB-SECTOR AND ECONOMIC ACTIVITY

B.108 Table B28 shows a breakdown of general government (GG) transactions by economic category for 2005-06 to 2007-08. Table B29 shows a more detailed breakdown for public sector transactions by sub-sector and economic category. The latest data published by the ONS for 2005-06 reflect imputed transactions in respect of the restructuring of nuclear liabilities and changes to the classification of capital expenditure from the local authorities' Housing Revenue Accounts. These changes have led to significant switches between different parts of the public sector.

B.109 Liabilities for nuclear decommissioning were transferred from BNFL to the Nuclear Decommissioning Authority (NDA). The NDA took over the tangible fixed assets (reactors etc.) that had a negative value of £15 billion. For the Nuclear Liabilities Investment Portfolio (NLIP) transfer, a capital grant was imputed from BNFL in the PC sub-sector to the Secretary of State for Trade and Industry (in the CG sub-sector) to enable the Secretary of State to "buy" the NLIP. This imputed purchase, though, is a financial transaction, and so does not offset the imputed grant within either CG or GG net borrowing. The transfer of the tangible assets is reflected in National Accounts by imputing a negative capital grant from BNFL to the NDA to enable the NDA to "buy" the reactors. The imputed purchase is negative fixed capital formation, and so the imputed transactions net off within net investment and net borrowing for all sub-sectors. As the reactors have a large negative value, the imputed transaction makes CG fixed capital formation negative.

B.110 The reclassification of the investment transactions of local authorities' HRA from the local authority to the PC sub-sector has affected the growth rate of GG investment because HRA investment was negative in 2004 and positive in 2005. Its reclassification thus reduced GG investment growth in 2005 with an offsetting positive impact on PC investment growth. This revision largely explains why the latest National Accounts data show that GG investment fell $1^1/_4$ per cent in 2005, compared with growth of $18^1/_2$ per cent reported at the time of Budget 2006, as referred to in Annex A. Government investment is expected to grow strongly in 2006 and 2007, consistent with the Government's aim to deliver world-class public services through sustained investment and far-reaching reform.

Table B28: General government transactions by economic category

	£ billion		
	Outturn	Estimate	Projection
	2005-06	2006-07	2007-08
Current receipts			
Taxes on income and wealth	180.3	197.8	213.2
Taxes on production and imports	159.6	167.8	178.2
Other current taxes	28.7	30.1	31.8
Taxes on capital	3.3	3.6	4.1
Compulsory social contributions	85.4	89.9	95.5
Gross operating surplus	12.1	13.1	14.0
Rent and other current transfers	2.1	2.1	2.1
Interest and dividends from private sector and abroad	4.5	4.1	5.5
Interest and dividends from public sector	2.5	4.8	5.3
Total current receipts	**478.3**	**513.3**	**549.6**
Current expenditure			
Current expenditure on goods and services	274.6	289.5	307.5
Subsidies	6.8	7.4	7.4
Net social benefits	143.6	149.6	156.5
Net current grants abroad	-0.5	0.5	-0.2
Other current grants	32.7	32.8	36.2
Interest and dividends paid	26.2	27.8	28.8
AME margin	0.0	0.0	0.0
Total current expenditure	**483.5**	**507.7**	**536.2**
Depreciation	12.1	13.1	14.0
Surplus on current budget	**-17.2**	**-7.5**	**-0.5**
Capital expenditure			
Gross domestic fixed capital formation	7.1	27.8	31.4
Less depreciation	-12.1	-13.1	-14.0
Increase in inventories	0.0	0.1	0.1
Capital grants (net) within public sector	13.2	1.4	0.4
Capital grants to private sector	11.4	12.6	13.8
Capital grants from private sector	-1.5	-1.5	-1.5
AME margin	0.0	0.0	0.0
Net investment	**18.0**	**27.4**	**30.2**
Net borrowing[1]	**35.2**	**34.9**	**30.7**
of which:			
Central government net borrowing	32.2	34.1	30.2
Local authority net borrowing	3.1	0.8	0.5
Gross debt (Maastricht basis)			
Central government	469.0	511.0	549.9
Local government	60.1	59.1	57.8

[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 B29: 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	180.3	0.0	-0.2	180.1
Taxes on production and imports	159.3	0.2	0.0	159.6
Other current taxes	8.1	20.5	0.0	28.7
Taxes on capital	3.3	0.0	0.0	3.3
Compulsory social contributions	85.4	0.0	0.0	85.4
Gross operating surplus	6.1	6.0	7.9	20.0
Rent and other current transfers	2.0	0.0	0.0	2.1
Interest and dividends from private sector and abroad	3.4	1.0	1.7	6.2
Interest and dividends from public sector	3.8	-1.3	-2.5	0.0
Total current receipts	**451.9**	**26.4**	**7.0**	**485.3**
Current expenditure				
Current expenditure on goods and services	166.3	108.4	0.0	274.6
Subsidies	5.0	1.7	0.0	6.8
Net social benefits	128.1	15.5	0.0	143.6
Net current grants abroad	-0.5	0.0	0.0	-0.5
Current grants (net) within public sector	102.1	-102.1	0.0	0.0
Other current grants	32.7	0.0	0.0	32.7
Interest and dividends paid	25.8	0.4	0.4	26.7
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**459.5**	**23.9**	**0.4**	**483.9**
Depreciation	6.1	6.0	4.4	16.5
Surplus on current budget	**-13.8**	**-3.5**	**2.1**	**-15.1**
Capital expenditure				
Gross domestic fixed capital formation	-6.2	13.2	22.0	29.0
Less depreciation	-6.1	-6.0	-4.4	-16.5
Increase in inventories	0.0	0.0	0.0	0.0
Capital grants (net) within public sector	21.3	-8.1	-13.2	0.0
Capital grants to private sector	9.8	1.6	0.1	11.5
Capital grants from private sector	-0.4	-1.1	0.0	-1.5
AME margin	0.0	0.0	0.0	0.0
Net investment	**18.4**	**-0.4**	**4.4**	**22.4**
Net borrowing	**32.2**	**3.1**	**2.3**	**37.5**

Table B29: Public sector transactions by sub-sector and economic category

	£ billion			
	2006-07			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	197.8	0.0	-0.2	197.5
Taxes on production and imports	167.6	0.2	0.0	167.8
Other current taxes	8.5	21.7	0.0	30.1
Taxes on capital	3.6	0.0	0.0	3.6
Compulsory social contributions	89.9	0.0	0.0	89.9
Gross operating surplus	6.6	6.5	8.5	21.6
Rent and other current transfers	2.1	0.0	0.0	2.1
Interest and dividends from private sector and abroad	3.5	0.6	1.1	5.3
Interest and dividends from public sector	3.5	1.3	-4.8	0.0
Total current receipts	**482.9**	**30.3**	**4.6**	**517.9**
Current expenditure				
Current expenditure on goods and services	175.7	113.8	0.0	289.5
Subsidies	5.5	1.9	0.0	7.4
Net social benefits	133.2	16.4	0.0	149.6
Net current grants abroad	0.5	0.0	0.0	0.5
Current grants (net) within public sector	107.2	-107.2	0.0	0.0
Other current grants	32.8	0.0	0.0	32.8
Interest and dividends paid	27.4	0.4	0.4	28.3
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**482.4**	**25.3**	**0.4**	**508.1**
Depreciation	6.6	6.5	4.5	17.6
Surplus on current budget	**-6.0**	**-1.5**	**-0.4**	**-7.9**
Capital expenditure				
Gross domestic fixed capital formation	13.0	14.8	5.0	32.8
Less depreciation	-6.6	-6.5	-4.5	-17.6
Increase in inventories	0.1	0.0	0.0	0.1
Capital grants (net) within public sector	11.0	-9.6	-1.4	0.0
Capital grants to private sector	10.9	1.8	2.4	15.1
Capital grants from private sector	-0.3	-1.2	0.0	-1.5
AME margin	0.0	0.0	0.0	0.0
Net investment	**28.1**	**-0.8**	**1.5**	**28.9**
Net borrowing	**34.1**	**0.8**	**1.9**	**36.8**

Table B29: Public sector transactions by sub-sector and economic category

	£ billion			
	2007-08			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	213.2	0.0	-0.2	213.0
Taxes on production and imports	178.0	0.2	0.0	178.2
Other current taxes	9.0	22.9	0.0	31.8
Taxes on capital	4.1	0.0	0.0	4.1
Compulsory social contributions	95.5	0.0	0.0	95.5
Gross operating surplus	7.1	6.9	9.0	23.0
Rent and other current transfers	2.1	0.0	0.0	2.1
Interest and dividends from private sector and abroad	4.0	1.4	0.7	6.1
Interest and dividends from public sector	3.5	1.8	-5.3	0.0
Total current receipts	**516.3**	**33.3**	**4.1**	**553.8**
Current expenditure				
Current expenditure on goods and services	185.7	121.8	0.0	307.5
Subsidies	5.4	2.0	0.0	7.4
Net social benefits	138.9	17.5	0.0	156.5
Net current grants abroad	-0.2	0.0	0.0	-0.2
Current grants (net) within public sector	114.2	-114.2	0.0	0.0
Other current grants	36.2	0.0	0.0	36.2
Interest and dividends paid	28.3	0.4	0.4	29.2
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**508.5**	**27.7**	**0.4**	**536.6**
Depreciation	7.1	6.9	4.6	18.6
Surplus on current budget	**0.8**	**-1.3**	**-0.9**	**-1.5**
Capital expenditure				
Gross domestic fixed capital formation	15.0	16.3	4.6	36.0
Less depreciation	-7.1	-6.9	-4.6	-18.6
Increase in inventories	0.1	0.0	0.0	0.1
Capital grants (net) within public sector	11.3	-10.8	-0.4	0.0
Capital grants to private sector	11.9	1.9	0.1	13.9
Capital grants from private sector	-0.2	-1.3	0.0	-1.5
AME margin	0.0	0.0	0.0	0.0
Net investment	**31.0**	**-0.8**	**-0.4**	**29.8**
Net borrowing	**30.3**	**0.5**	**0.5**	**31.3**

HISTORICAL SERIES

Table B30: 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 national insurance contributions	Public sector current receipts	Public sector net debt[1]	Public sector net worth[2]
1970-71	6.9		-0.6		1.2	36.5	43.5		
1971-72	4.2		1.1		1.4	35.2	41.6		
1972-73	2.0	2.5	2.8	2.3	3.6	32.8	39.2		
1973-74	0.4	-0.8	4.9	6.1	5.8	32.1	39.8		
1974-75	-0.9	-2.5	6.6	8.1	9.0	34.8	42.5	52.1	
1975-76	-1.4	-1.7	7.0	7.3	9.2	35.5	43.1	53.8	
1976-77	-1.1	-0.6	5.5	5.1	6.4	35.4	43.5	52.3	
1977-78	-1.3	-1.2	4.3	4.2	3.7	34.3	41.7	49.0	
1978-79	-2.5	-2.4	5.1	4.9	5.2	33.3	40.4	47.1	
1979-80	-1.8	-1.7	4.1	4.0	4.7	33.7	40.9	43.9	
1980-81	-3.0	-1.5	4.9	3.4	5.2	35.8	42.7	46.0	
1981-82	-1.3	2.5	2.3	-1.5	3.3	38.4	46.1	46.2	
1982-83	-1.4	2.9	3.0	-1.3	3.2	38.6	45.8	44.8	
1983-84	-2.0	1.8	3.8	0.1	3.2	38.1	44.7	45.1	
1984-85	-2.1	0.9	3.7	0.7	3.1	38.8	44.6	45.3	
1985-86	-1.2	0.5	2.4	0.7	1.6	38.0	43.5	43.5	
1986-87	-1.4	-1.2	2.1	1.9	0.9	37.7	42.4	41.0	
1987-88	-0.4	-1.7	1.0	2.3	-0.7	37.5	41.4	36.8	73.4
1988-89	1.7	-0.9	-1.3	1.3	-3.0	36.8	41.0	30.5	78.9
1989-90	1.5	-1.4	-0.2	2.6	-1.3	36.1	40.2	27.7	70.7
1990-91	0.3	-1.2	1.0	2.6	-0.1	35.8	39.2	26.2	60.2
1991-92	-2.0	-1.5	3.8	3.4	2.3	34.7	38.8	27.4	52.8
1992-93	-5.7	-3.8	7.6	5.7	5.9	33.5	36.9	32.0	39.9
1993-94	-6.4	-4.2	7.8	5.6	7.1	32.6	36.0	37.3	29.2
1994-95	-4.8	-3.4	6.3	4.9	5.3	33.8	37.1	40.8	28.3
1995-96	-3.4	-2.5	4.7	3.9	4.3	34.5	37.8	42.7	20.9
1996-97	-2.8	-2.3	3.5	3.0	2.9	34.8	37.3	43.6	17.0
1997-98	-0.1	0.0	0.8	0.7	0.2	35.9	38.4	41.6	14.3
1998-99	1.2	1.1	-0.5	-0.3	-0.7	36.3	38.5	39.3	13.4
1999-00	2.3	2.0	-1.8	-1.5	-0.9	36.4	38.9	36.6	16.6
2000-01	2.5	1.9	-2.1	-1.5	-3.8	37.2	39.6	31.7	22.6
2001-02	1.0	0.9	0.1	0.3	0.4	36.6	38.6	30.6	29.4
2002-03	-1.1	-0.7	2.3	1.9	2.4	35.2	37.2	32.0	28.0
2003-04	-1.7	-1.3	3.0	2.7	3.5	35.2	37.4	33.2	28.3
2004-05	-1.6	-1.6	3.3	3.2	3.2	35.9	38.0	35.0	28.8
2005-06	-1.2	-1.0	3.0	2.8	3.2	36.9	39.2	36.4	27.0

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

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

Table B31: Historical series of government expenditure

	£ billion (2005-06 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	180.5	34.4	55.2	235.7	32.8	6.3	10.0	42.8
1971-72	189.4	30.0	51.8	241.1	33.5	5.3	9.2	42.7
1972-73	197.8	28.9	51.7	249.5	33.4	4.9	8.7	42.1
1973-74	216.6	32.4	57.8	274.4	35.3	5.3	9.4	44.7
1974-75	239.8	34.9	61.7	301.5	39.0	5.7	10.0	49.0
1975-76	244.9	34.2	61.2	306.0	40.1	5.6	10.0	50.1
1976-77	251.7	28.1	56.0	307.7	40.1	4.5	8.9	49.0
1977-78	248.2	19.2	47.4	295.5	38.6	3.0	7.4	46.0
1978-79	255.4	16.7	45.5	300.9	38.6	2.5	6.9	45.5
1979-80	261.7	15.6	44.8	306.5	38.5	2.3	6.6	45.1
1980-81	269.5	12.5	42.2	311.7	41.1	1.9	6.4	47.5
1981-82	281.5	6.7	36.2	317.7	42.9	1.0	5.5	48.4
1982-83	287.7	10.5	39.2	327.0	42.9	1.6	5.9	48.8
1983-84	296.7	12.9	41.4	338.1	42.6	1.9	5.9	48.5
1984-85	304.7	11.3	38.5	343.2	42.9	1.6	5.4	48.3
1985-86	305.2	8.8	33.7	339.0	41.3	1.2	4.6	45.9
1986-87	310.1	5.3	30.4	340.5	40.5	0.7	4.0	44.4
1987-88	313.6	4.8	28.4	342.0	38.9	0.6	3.5	42.4
1988-89	306.0	2.9	26.5	332.5	36.5	0.3	3.2	39.7
1989-90	308.0	10.8	34.1	342.1	36.0	1.3	4.0	40.0
1990-91	310.1	11.7	33.0	343.1	36.4	1.4	3.9	40.3
1991-92	328.3	15.3	33.2	361.6	38.7	1.8	3.9	42.6
1992-93	344.4	15.9	33.4	377.8	40.5	1.9	3.9	44.5
1993-94	354.4	12.6	30.0	384.4	40.4	1.4	3.4	43.8
1994-95	365.6	13.0	30.3	395.8	40.0	1.4	3.3	43.3
1995-96	370.1	13.0	29.9	399.9	39.4	1.4	3.2	42.6
1996-97	370.0	6.7	22.2	392.2	38.5	0.7	2.3	40.8
1997-98	368.4	6.3	21.1	389.6	37.0	0.6	2.1	39.2
1998-99	368.8	7.7	21.9	390.6	36.0	0.7	2.1	38.1
1999-00	375.0	5.6	19.9	395.0	35.3	0.5	1.9	37.1
2000-01	393.2	4.4	18.9	412.2	35.8	0.4	1.7	37.5
2001-02	406.4	12.5	27.1	433.5	36.3	1.1	2.4	38.7
2002-03	424.6	14.0	29.2	453.8	37.0	1.2	2.5	39.5
2003-04	446.5	15.9	31.2	477.8	37.8	1.4	2.6	40.4
2004-05	464.3	20.2	36.0	500.3	38.4	1.7	3.0	41.3
2005-06	483.9	22.4	38.9	522.8	39.1	1.8	3.1	42.2

[1] *Net of sales of fixed assets.*

LIST OF ABBREVIATIONS

AEF	Aggregate External Finance
AEI	Average earnings index
AIDS	Acquired Immunodeficiency Syndrome
AMC	Advance Market Commitment
AME	Annually Managed Expenditure
AMS	Asset management Strategy
APD	Air passenger duty
ASP	Alternatively Secured Pensions
BBC	British Broadcasting Corporation
BNFL	British Nuclear Fuels Limited
BP	British Petroleum
BRE	Better Regulation Executive
BRTF	Better Regulation Task Force
CAP	Common Agricultural Policy
CC	Competition Commission
CCAs	Climate Change Agreements
CCL	Climate change levy
CCS	Carbon Capture and Storage
CCT	Company Car Tax
CERF	UN Central Emergency Relief Fund
CEO	Chief Executive Officer
CFC	Controlled Foreign Company
CGNCR	Central government net cash requirement
CNG	Compressed Natural Gas
CPI	Consumer Prices Index
CSR	Comprehensive Spending Review
CTC	Child Tax Credit
CVD	Cardiovascular disease
DCA	Department of Constitutional Affairs
DCLG	Department of Communities and Local Government
DCMS	Department for Culture, Media and Sports
DEFRA	Department for Environment, Food and Rural Affairs
DEL	Departmental Expenditure Limit
DfES	Department for Education and Skills
DfID	Department for International Development
DfT	Department for Transport
DH	Department of Health
DMA	Debt Management Account
DMO	Debt Management Office
DTI	Department of Trade and Industry
DWP	Department for Work and Pensions

ECAs	Enhanced capital allowances
ECFs	Enterprise Capital Funds
ECGD	Export Credits Guarantee Department
ECJ	European Court of Justice
ECOS	Employee car ownership scheme
ECOFIN	Council of European Finance Ministers
EEC	Energy Efficiency Commitment
EFA/FTI	Education for all fast track initiative
EPC	Economic Policy Committee
ERAD	Employment Retention and Advancement Demonstration
ESA	Employment and Support Allowance
EU	European Union
EU ETS	EU Emissions Trading Scheme
EYFR	End Year Fiscal Report
FDI	Foreign Direct Investment
FSA	Financial Services Authority
FTSE	Financial Times Stock Exchange
G7	Group of Seven. A group of seven major industrial nations (comprising: Canada, France, Germany, Italy, Japan, UK and US).
GAVI	Global Alliance for Vaccines & Immunisation
GCSE	General Certificate of Secondary Education
GDP	Gross Domestic Product
GNI	Gross National Income
GOs	Government Offices
GVA	Gross Value Added
HEFCE	Higher Education Funding Council for England
HEIs	Higher Education Institutions
HGVs	Heavy Goods Vehicles
HIPC	Heavily Indebted Poor Countries
HIV	Human Immunodeficiency Virus
HMRC	HM Revenue and Customs
IBAC	International Business Advisory Council
ICT	Information and Communications Technology
IFFIm	International Finance Facility for immunisation
IHT	Inheritance Tax
IMF	International Monetary Fund
IP	Intellectual property
IPCC	Intergovernmental Panel on Climate Change
IQ	IQ capital fund
ISA	Individual Savings Account
ISB	Invest to save budget
IT	Information Technology
IWC	In-work credit
JSA	Jobseeker's Allowance

LAA	Local Area Agreement
LABGI	Local Authority Business Growth Incentive
LASFE	Local Authority Self-Financed Expenditure
LBRO	Local Better Regulation Office
LDA	London Development Agency
LEA	Local Education Authority
LEGI	Local Enterprise Growth Initiative
LESA	Landlords energy Savings Allowance
LFS	Labour Force Survey
LHA	Local Housing Allowance
LPG	Liquefied Petroleum Gas
LTCS	Landfill Tax Credit Scheme
MDGs	Millennium Development Goals
MDRs	Marginal Deduction Rates
MIG	Minimum Income Guarantee
MPC	Monetary Policy Committee
MRC	Medical Research Council
MSC	Managed Service Company
MtC	Million tonnes of carbon
MTIC	Missing Trader Intra-Community
NAO	National Audit Office
NDDP	New Deal for disabled people
NDLP	New Deal for lone parents
NDP	New Deal for partners
NDYP	New Deal for young people
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
NLF	National Loans Fund
NTNIC	National Institute of Health Research
ODI	Office for Disability Issues
ODPM	Office of the Deputy Prime Minister
OECD	Organisation for Economic Cooperation and Development
OFCOM	Office of Communications
OFT	Office of Fair Trading
OGC	Office of Government Commerce
ONS	Office of National Statistics
OPC	Optional planning charge
OPEC	Organisation of Petroleum Exporting Countries
OSCHR	Office for Strategic Coordination of Health Research

PEP	Personal Equity Plan
PFI	Private Finance Initiative
PGS	Planning Gain Supplement
PPPs	Public Private Partnerships
PSA	Public Service Agreement
PSNB	Public sector net borrowing
PSPC	Public Sector Pay Committee
RAE	Research Assessment Exercise
R&D	Research and Development
RC	Research Council
RDA	Regional Development Agency
RPI	Retail Prices Index
RTFO	Renewable Transport Fuel Obligation
SBS	Small Business Service
SDRT	Stamp Duty Reserve Tax
SEEDA	South East England Development Agency
SET	science, engineering, technology
SFLG	Small Firms Loan Guarantee
SMEs	Small and medium-sized enterprises
SNA	System of National Accounts
SSC	Sector skills councils
STEM	Science, technology, engineering and mathematical
TB	Tuberculosis
TESSA	Tax Exempt Special Savings Account
TME	Total Managed Expenditure
UK	United Kingdom
UK-REIT	UK – Real Estate Investment Trusts
UKTI	UK trade and investment
UN	United Nations
UNITAID	UN unit on HIV and AIDS
UNRWA	United Nations Relief and Work Agency
VAT	Value Added Tax
VCR	Video Cassette Recorder
VED	Vehicle Excise Duty
WFI	Work Focussed I nterviews
WFTC	Working Families' Tax Credit
WRAP	Work related activity premium
WTC	Working Tax Credit

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