1 OVERVIEW

The Government's objective is to build a stronger economy and a fairer society, with opportunity and security for all. In an integrated world economy, and at a time of slower than expected global growth and heightened economic uncertainty, the challenge is to harness the opportunities that globalisation brings, while minimising its risks.

The Pre-Budget Report, *Steering a steady course: Delivering stability, enterprise and fairness in an uncertain world*, sets out updated forecasts for the economy and the public finances, reports on how the Government's policies are helping to deliver its long-term goals, and describes the reforms that the Government is considering ahead of Budget 2003 and on which it will be consulting in the months ahead. The Pre-Budget Report:

- **shows that the economy is on course to maintain stability and growth despite renewed uncertainty in the world economy, and that the Government is firmly on track to meet its strict fiscal rules over the economic cycle;**
- **continues to strengthen the drivers of productivity growth, through new measures to build an enterprise society across all areas of Britain and further action to raise levels of skills in the workforce;**
- **takes further steps to extend employment opportunity to disadvantaged groups and deprived local areas, building on the success of the first five years of the New Deal programme;**
- **advances work to promote saving, with a commitment to consult key stakeholders on the detailed implementation of the Child Trust Fund and to set out proposals to help those of working age plan for their retirement; and**
- **describes a range of actions being taken to tackle global poverty and climate change, including through a new International Financing Facility and steps to promote more sustainable waste management.**

INTRODUCTION

1.1 The Government's objective is to build a stronger, more enterprising economy and a fairer society, maintaining stability and ensuring rising living standards for all.

1.2 The increasingly global economy has brought new opportunities for individuals, businesses and countries, but it has also brought new insecurities. Over the past five years, the Government has sought to maximise the benefits of globalisation while minimising its risks. Economic reforms have established a platform of stability and ensured that the UK is well placed to take advantage of opportunities in the global economy. Sustained economic growth has enabled the Government to invest more than ever before in promoting work, reducing poverty and reforming public services, helping to ensure that new opportunities are open to as many people as possible.

1.3 Events around the world over the past two years have highlighted the risks in today's global environment. Slower than expected growth and continued global uncertainty have challenged the economic strength of countries the world over, threatening the prosperity and living standards of many. Last year saw the sharpest slowdown in global growth for three decades. This year, concern over corporate accounting standards and events in the Middle East have brought further uncertainty and volatility to financial markets, the effects of which have reverberated around the world. There is also clear evidence that the international financial system – a source of economic opportunity for the world economy – is being abused by those who seek to plan and perpetrate global acts of terrorism.

1.4 Sound economic fundamentals and decisive macroeconomic policy have improved the resilience of the UK economy to periods of global instability. But challenges and risks remain. The Government is determined to meet these challenges, maintaining economic stability and continuing to meet the fiscal rules. From a platform of stability, and despite continued weakness in the world economy, the Government is committed to taking the further steps needed to advance its long-term goals of:

- raising the sustainable rate of UK productivity growth to deliver rising national prosperity in a global marketplace for business, investment and skills;
- sustaining a higher proportion of people in employment than ever before, seeking to ensure full employment in every UK region;
- eradicating child poverty and tackling pensioner poverty, providing opportunity for all children and delivering security for all in retirement;
- establishing world class public services, with significant extra investment tied to reform and results; and
- tackling global poverty and climate change, helping to achieve the international community's Millennium Development Goals by 2015, and delivering the UK's commitments under the Kyoto Protocol.

MAINTAINING MACROECONOMIC STABILITY

1.5 The Government's long-term economic goal is to maintain stability, ensuring that the fiscal rules are met and that inflation remains low. Economic stability allows businesses, individuals and the Government to plan ahead, improving the quantity and quality of long-term investment in physical and human capital. Chapter 2 describes how the Government is working to achieve its goal and summarises prospects for the UK economy and the public finances, full details of which are set out in Annexes A and B.

The policy framework

1.6 The Government's macroeconomic policy framework is designed to secure lasting economic stability. Underpinned by the principles of transparency, responsibility and accountability, the framework consists of operational independence for the Bank of England to set interest rates to meet the Government's inflation target, and strict fiscal rules to ensure sound public finances over the medium term. Within the fiscal rules, the Government's public spending framework reinforces incentives for long-term planning and delivers a sharper focus on the quality of public service provision and the outcomes it achieves. These policies work together in a coherent and integrated way.

1.7 The framework has successfully maintained stability and growth, and the UK continues to experience the longest period of unbroken economic expansion on record. Despite fragile global conditions, employment has risen to record levels, unemployment is at generational lows, and inflation has been lower and more stable than in the past. Sustained economic growth, and tough decisions on taxation and spending, have brought the public finances to a sustainable position and freed up substantial resources to reform and modernise public services. Fiscal policy has supported monetary policy in limiting the impact of adverse global developments on the UK economy.

Economic prospects

I.8 Last year saw the sharpest slowdown in world growth since 1974, and the first synchronised slowdown in the US, Europe and Asia for almost three decades. Across the major G7 economies, industrial production and investment both fell more sharply than at any time in the last 20 years, while growth in world trade collapsed from 13 per cent to near standstill. The world's three largest economies – the US, Japan and Germany – all experienced periods of recession.

I.9 Evidence of global recovery mounted in the first half of 2002, as world trade strengthened and industrial production began to recover across the G7. But the world economy has since faced a series of new challenges and risks. Concern over corporate accounting standards and events in the Middle East have led to further falls on international equity markets and a rise in oil prices, compounding uncertainty about the strength of global demand and hampering confidence across the industrialised world. As a consequence, the recovery appears to have less momentum than anticipated earlier in the year, and prospects for the world economy seem weaker than at the time of the Budget. GDP in the G7 economies is expected to grow by 1½ per cent in 2002 and by just 2¼ per cent next year, before accelerating to 3 per cent in 2004.

I.10 In an integrated global economy, no country can be fully immune to international developments, and uncertainty in the outlook for global demand has affected UK economic prospects in the short term, deterring companies from expanding investment and increasing production. Strong economic fundamentals and decisive macroeconomic policy have left the UK better placed than in previous world slowdowns to maintain stability. The economy grew faster than any other G7 country last year and is well placed to benefit when the global recovery gathers pace. In the Pre-Budget Report forecast:

- **GDP** is expected to rise by 1.6 per cent in 2002, below the Budget forecast due to renewed uncertainty in the world economy. A strengthening in the pace of global recovery from next year should subsequently allow the economy to achieve a temporary period of above trend growth, GDP rising by 2½ to 3 per cent in 2003 and by 3 to 3½ per cent in 2004 before returning to trend in 2005;
- **growth is expected to become gradually more balanced** over the forecast period as household consumption moderates and business investment picks up in response to a recovery in the world economy, lower uncertainty and improved corporate finances; and
- **RPIX inflation** is expected to remain close to the Government's 2½ per cent target throughout the forecast period.

The public finances

I.11 The current surplus in 2001-02 stood at £7.7 billion, £2.9 billion lower than forecast at the time of the Budget. At £1.2 billion, the outturn for public sector net borrowing was very close to the Budget forecast. **Detailed information on the public finances last year and in 2000-01 is set out in a new *End of year fiscal report*,** published alongside the Pre-Budget Report and further enhancing transparency in fiscal policy.

I.12 The Pre-Budget Report presents new projections for the public finances up to 2007-08. The projections provide an interim forecast update, and are not necessarily the fiscal outcomes that the Government is seeking. They are underpinned by a series of prudent assumptions about economic developments in the medium term, audited by the National Audit Office to ensure that they remain reasonable and cautious.

I.13 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take account of all firm decisions announced in this Pre-Budget Report or since Budget 2002, as set out in Table B4 in Annex B. This includes the addition of a **£1 billion special reserve in 2002-03 to ensure that resources are available to meet overseas and defence needs in the fight against global terrorism**.

1.14 Prolonged uncertainty in the world economy means that receipts – particularly of corporation and income taxes – are now expected to be weaker this year and over the next two years than forecast in Budget 2002. The shortfall in receipts is primarily due to cyclical or otherwise temporary factors, including a further deterioration in financial companies' profits due to weaker financial market activity since the Budget. The use of cautious, audited assumptions, especially for equity prices, further contributes to the decline in receipts, though this is partly offset in the longer term by a prudent assessment of future savings from action to tackle indirect tax fraud and avoidance. Overall, receipts are expected to return to their Budget profile by the end of the forecast period.

1.15 Lower receipts in the short term mean that a current budget deficit of £5.7 billion is now expected this year. The deficit is projected to narrow slightly to £5 billion in 2003-04, before a cyclical recovery in the global economy and an improvement in financial companies' profits restores the current budget to surplus from 2004-05. The projections demonstrate that fiscal policy is supporting monetary policy through the impact of the automatic stabilisers, helping to maintain stability during a period of weaker global demand.

Table 1.1: Meeting the fiscal rules

	Per cent of GDP						
	Outturn[1]	Projections					
	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Golden rule							
Surplus on current budget	0.8	–0.5	–0.4	0.2	0.4	0.6	0.7
Average surplus since 1999-2000	1.7	1.2	0.8	0.7	0.7	0.7	0.7
Cyclically-adjusted surplus on current budget	0.7	0.2	0.3	0.6	0.5	0.6	0.7
Sustainable investment rule							
Public sector net debt	30.4	31.0	32.1	32.4	32.6	32.7	33.0

[1] *The 2001–02 figures were estimates in Budget 2002.*

The fiscal rules

1.16 After allowing for changes to receipts and expenditure resulting from cyclical weakness in the world economy and the use of cautious assumptions, and taking into account the impact of measures described in this Pre-Budget Report, the Government is firmly on track to meet its strict fiscal rules over the economic cycle, including in the cautious case.

1.17 In a period of global weakness and uncertainty, the use of cautious assumptions and the 'stress test' against the cautious case help to ensure that the public finances are sound and sustainable and that the Government is vigilant in the face of potential risks. As shown in Table 1.1, the average surplus on the current budget since the start of the current cycle in 1999-2000 remains positive throughout the forecast period, leaving the Government on track to meet the golden rule. When adjusted for the impact of the economic cycle, the current budget is projected to be in surplus in every year of the projection period. Public sector net debt is projected to rise slightly to 33 per cent of GDP by 2007-08, comfortably meeting the sustainable investment rule, and well below 40 per cent.

Long-term sustainability

1.18 The public finances are also sustainable in the long term. **A new analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report.** Based on reasonable assumptions, the analysis reveals that the UK is well placed to deal with future fiscal challenges, such as those arising from an ageing population, and that current policies impact fairly between generations.

MEETING THE PRODUCTIVITY CHALLENGE

1.19 Raising the UK's sustainable rate of productivity growth is central to the Government's economic strategy. Productivity growth, alongside high and stable levels of employment, is an important driver of long-term economic performance and rising living standards. If the economy is to continue to deliver growing prosperity in a global marketplace for business, investment and skills, it is essential that faster productivity growth is achieved. Chapter 3 describes the steps the Government is taking to address this challenge, narrowing the productivity gap that exists between the UK and other advanced industrial economies.

Action so far

1.20 The Government has taken significant steps to close the productivity gap, targeting historic weakness in five important drivers of productivity performance:

- **improving competition** to encourage firms to innovate and strive for greater efficiency. The Enterprise and Competition Acts increased the powers of the Office of Fair Trading and strengthened the UK's overall competition regime, and investigations have been conducted into competition in specific markets, including banking and the professions;
- **promoting enterprise** by helping businesses to start up, develop and grow. Reforms to the business tax regime, including reduced rates of corporation tax, a generous capital gains tax business assets taper and measures to simplify the VAT regime have increased the support to new and growing businesses. Exemptions from stamp duty and a new Community Investment Tax Credit are helping to encourage enterprise and investment in disadvantaged communities;
- **supporting science and innovation** to deliver efficiency gains from new technologies. Research and development tax credits are rewarding greater innovation by the private sector. Record increases in science spending are supporting improvements in the UK's scientific base to allow it to compete in a global market for research;
- **raising UK skills** through better education and improved workforce training. Substantial resources have been allocated to raise standards in primary and secondary schools, while Employer Training Pilots are testing new measures to improve opportunities for those already in the workforce to acquire new skills; and
- **encouraging investment** to improve the stock of physical capital. Building on a platform of macroeconomic stability, comprehensive reviews into institutional investment and the market for long-term savings have addressed the factors inhibiting sustained investment in the UK, and steps have been taken to improve the flexibility, speed and responsiveness of the planning system. Public sector net investment is projected to have risen almost three-fold over the last five years.

Next steps

1.21 The Pre-Budget Report describes the next steps in the Government's strategy to support the drivers of productivity growth, including:

- **the creation of 2,000 Enterprise Areas** in the most deprived parts of the UK, with extra support to help businesses start up, develop and grow;
- **a review of how business can better draw on the resources available in UK universities and a new DTI review of innovation**, to improve the UK's comparative innovation performance;

- **a new strategy to promote enterprise learning throughout the school and further education systems**, in line with the recommendations of the Davies Review of enterprise in education;
- **a new target to increase the participation of young people post-16 in full-time education and training**, including vocational programmes such as Modern Apprenticeships;
- **a new employer-led taskforce to support the expansion and improvement of Modern Apprenticeships** and other work-based training programmes;
- **£130 million to fund a second year of extended Employer Training Pilots** to continue to test new measures to improve access to training for low-skilled adults in the workforce;
- **extension of the Highly Skilled Migrant Programme**, and changes to the criteria to make the scheme a more effective source of highly skilled labour for the UK economy; and
- further work to establish a modern and competitive business tax system, through **simplified corporation tax rules for employee share schemes and consultation on wider reform of corporation tax.**

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.22 The Government's long-term goal is to ensure a higher proportion of people in work than ever before by 2010. The strength of the economy depends on the number of people in work and how productive they are. For many individuals and their families, employment is also the single most effective means of avoiding poverty, both now and in the future. Chapter 4 describes the steps the Government is taking to extend employment opportunity to all groups in every region of the country.

Action so far

1.23 Macroeconomic stability, a flexible labour market and investment in education are essential for achieving high levels of employment. They also underpin a comprehensive programme of microeconomic reform, including:

- **welfare to work** policies that help the long-term unemployed achieve a successful return to work. The New Deal programmes have helped to reduce long-term unemployment by more than three quarters since 1997 and have sharply reduced youth long-term unemployment, while Employment Zones are allowing jobseekers and their personal advisers to use funds more flexibly to overcome individual barriers to work. UK unemployment, at 5.3 per cent, is now the lowest among the G7 economies for the first time since the 1950s;
- **tailored support for disadvantaged groups and areas** that suffer from particularly low levels of employment. New Deal support has been extended to lone parents, disabled people and partners of the unemployed, helping to reduce the number of workless households, while Action Teams are tackling serious employment problems in disadvantaged areas throughout Britain. The national roll-out of Jobcentre Plus is providing an active, work-focused service to all working age benefit recipients, whether unemployed or economically inactive; and
- **reforms to make work pay** and ensure that individuals are rewarded as they move into and progress within employment. Reforms to the tax and benefit system, underpinned by the National Minimum Wage, the Working Families' (WFTC) and Disabled Person's Tax Credits, and, from April 2003, the Child and Working Tax Credits, are improving work incentives for families with children, people with disabilities and those in low paid work. These reforms guarantee minimum incomes from employment and help to ensure that work pays more than welfare.

Next steps **I.24** The robust performance of the labour market in recent years sets the UK apart from most other industrialised countries, many of which have seen unemployment rates rise significantly as global demand has weakened. The Government is determined to build on this success and is now taking further steps to address the remaining barriers that prevent people from taking up work, including:

- **piloting a programme of intensive support in neighbourhoods with very high concentrations of worklessness**. The pilots will begin from April 2004 in twelve of the most deprived neighbourhoods in the country;
- **extending eligibility for the Job Grant**, and introducing a new higher rate of £250 for households with children, to ease the transition to work;
- **reforming the administration and design of Housing Benefit** to reduce inefficiencies in the current system and ease the transition to work for tenants;
- **piloting new measures to improve employment retention and advancement** among the low paid and those moving off welfare as part of a demonstration project from October 2003;
- **extending Employment Zones to lone parents and people returning to the New Deal** for a second time, and testing the impact of multiple providers in the same areas; and
- **piloting new means of support to help those with health problems and disabilities find work**, including enhanced advice on the return to work and a new return to work credit of £40 a week, from October 2003.

BUILDING A FAIRER SOCIETY

I.25 Economic strength and social justice go hand in hand. Chapter 5 describes how the Government is working to create a fairer and more inclusive society in which everyone has the chance to fulfil their potential and to share in rising national prosperity. Reform of the welfare state is central to the Government's strategy for achieving its long-term goals of eradicating child poverty and tackling pensioner poverty, extending opportunity to all children and ensuring security for all in old age. The Government is also taking steps to reward and encourage saving, establish a modern and fair tax system, and promote international efforts to reduce global poverty.

Action so far **I.26** The Government has introduced a number of important reforms to achieve its objectives, including:

- **support for families with children** to tackle child poverty. Financial help through the tax and benefit system has been increased, with record rises in Child Benefit, enhanced maternity and paternity provision, the introduction of the WFTC and the Children's Tax Credit and, from April 2003, the launch of the new Child Tax Credit. Sure Start and the Children's Fund are improving the provision of local services for children across the country, especially in deprived areas;
- **support for pensioners** to tackle poverty and ensure that all pensioners are able to share in rising national prosperity. The Minimum Income Guarantee is already improving living standards for the poorest pensioners, while the Pension Credit will ensure that those on low and modest incomes are

rewarded for their savings from 2003. The basic state pension has been increased by more than inflation in each of the last two years; it will rise by $2^1/_2$ per cent in 2003-04 and by at least $2^1/_2$ per cent a year from 2004-05. As a result of policies introduced since 1997, the Government will be spending an additional £6 billion in real terms on pensioners this financial year; and

- **steps to support and encourage saving**. Stakeholder pensions are delivering the benefits of pension saving to previously excluded groups, and Individual Savings Accounts are extending tax-advantaged saving further than ever before. Saving Gateway pilots are currently testing a new approach of Government-funded matched contributions to help people on low incomes develop a regular saving habit and make informed saving choices.

Next steps

1.27 Building on this programme of reform, the Government is now taking further steps to promote social progress and establish a modern and fair tax system, including:

- **publishing shortly next steps in the Government's strategy to help parents balance their work and family lives**;
- **consulting key stakeholders on the detailed implementation of the Child Trust Fund** to strengthen the saving habit and spread the benefits of asset ownership;
- **taking forward the recommendations of the Sandler review** to improve competition and efficiency in the market for long-term savings;
- **publishing on 17 December a Green Paper on pensions** setting out proposals to help those of working age plan more effectively for their retirement;
- **consulting, alongside the pensions Green Paper, on radical proposals to simplify the taxation of pensions** to increase choice and flexibility for all;
- **investing in the Social Fund** to improve its ability to help those on low incomes manage their finances;
- **working to deliver a global new deal to tackle international poverty**, by promoting a new $50 billion International Financing Facility and improvements in aid effectiveness;
- **taking further steps to encourage charitable giving**, including by extending the Government supplement on payroll donations until 2004;
- **abolishing Royalty payments made by North Sea oil companies** to encourage long-term investment by the industry;
- **launching a new strategy to protect VAT revenues and taking further steps to tackle tax avoidance** to ensure that everyone pays their fair share of tax; and
- **consulting further on the shape of a modernised stamp duty regime** for land and buildings to be introduced late next year.

DELIVERING HIGH QUALITY PUBLIC SERVICES

I.28 The Government's long-term goal is to deliver world class public services that provide opportunity and security for all. Strong and efficient public services are central to the Government's strategy for tackling poverty and social exclusion, removing the barriers that prevent people from realising their full potential. They also lay the foundations for a prosperous, high productivity economy. High and stable levels of growth and employment provide the platform from which the Government is working to improve Britain's public services, through sustained investment matched by ambitious plans for reform and stretching targets for results.

Action so far

I.29 Chapter 6 describes the steps the Government has already taken to deliver lasting improvements in public service delivery, including:

- **a new framework for managing public spending** that strengthens incentives for departments to plan for the long term, and ensures that resources are targeted on priority areas, supported by reform and linked clearly to improved outcomes for public services;
- **significant extra resources** for public services. Building on the increases delivered in the last Parliament, the 2002 Spending Review planned an additional £63 billion of departmental spending by 2005-06 compared with this financial year – an average annual increase in public services spending of over 5 per cent in real terms. To address the legacy of under-investment in public services, public sector net investment, projected to be almost three times higher this year than in 1997-98, is planned to rise further to 2 per cent of GDP in 2005-06; and
- **targeting resources to deliver improvements in priority services**. Economic stability has led to significant savings in social security and debt interest payments, and allowed more resources to be devoted to frontline public services. Over 75 per cent of the additional resources allocated in the 2002 Spending Review have been directed to the Government's priorities of education, health, transport, housing and the fight against crime.

Next steps

I.30 The Government is as determined to secure value for money as it is to secure money for priority services. In each area of public service delivery, resources allocated in the 2002 Spending Review are tied to reform and results. The Pre-Budget Report describes how the Government is working to deliver reform, based on:

- **independent auditing and inspection** to ensure that departments and agencies are held accountable for performance against targets, including through a new independent Commission for Healthcare Audit and Inspection, a Comprehensive Performance Assessment in local government and the new Police Standards Unit;
- **maximum local flexibility and discretion to innovate**, to ensure that local service providers can respond to local conditions and consumer demands, with new freedoms for high performing local authorities, Regional Development Agencies, further education colleges and hospitals; and
- **increased transparency** about what is being achieved, with regular web-based reporting of departments' progress against all new Public Service Agreement targets from next April.

PROTECTING THE ENVIRONMENT

1.31 Sustainable development aims to ensure a better quality of life for everyone - today and for generations to come. Economic growth and social progress must be balanced with action to protect and improve the environment. Climate change, poor air quality and environmental degradation in urban and rural areas diminish the quality of life for every citizen. The Government is therefore using a range of economic instruments to address the challenge of sustainable development, tackling local environmental threats and controlling and reducing emissions of the gases responsible for global warming.

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

- **tackle climate change and improve air quality**, ensuring that the UK meets its international commitments under the Kyoto Protocol. The climate change levy is encouraging business to use energy more efficiently, while the world's first economy-wide emissions trading scheme is helping companies to reduce their emissions at the lowest possible cost. Tax incentives and reforms have been introduced to promote the take-up of cleaner fuels and vehicles and to encourage investment in environmentally-friendly fuels and technologies;
- **regenerate Britain's towns and cities** so that they can attract investment and foster strong local communities. A significant package of fiscal measures has been introduced to support sustainable regeneration of urban areas, including targeted VAT reliefs, tax incentives for cleaning up contaminated land, extra funding for improving local public spaces and stamp duty exemptions to promote the economic, social and physical development of deprived areas; and
- **protect Britain's countryside and natural resources**, to ensure they are sustainable economically, socially and environmentally. The aggregates levy and sustainability fund are helping to tackle the environmental costs of quarrying, while a voluntary package of measures has been introduced to limit the environmental damage caused by pesticide use. Funding has been increased to support improvements in rural enterprise and productivity and in the provision of rural services.

Next steps **1.33** The Pre-Budget Report describes the further steps the Government is taking to protect and improve the environment, including:

- **publishing details of its strategy for using economic instruments** to tackle environmental problems;
- **further action to improve waste management**, by:
  - consulting on a revenue neutral proposal to **increase the landfill tax escalator** to £3 per tonne in 2005-06 and to increase the rate of tax by at least £3 per tonne in future years, on the way to a medium- to long-term rate of £35 per tonne; and
  - **reforming the Landfill Tax Credit Scheme** to ensure that funds more effectively promote sustainable waste management, while continuing to support local community environmental projects.
- **consulting on a new proposal to allow local authorities to retain increases in business rates revenue** to spend on their own priorities;
- **a new tax incentive to encourage donations towards the running costs of Urban Regeneration Companies**;

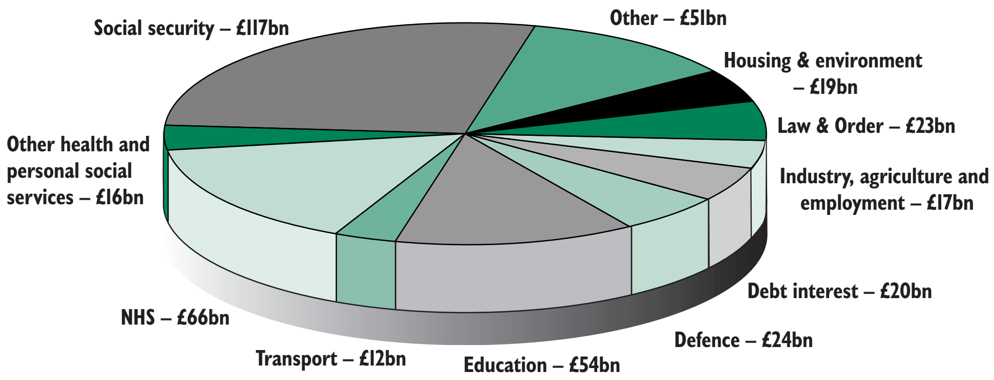
- **further steps to promote cleaner fuels**, including through a new low rate of duty on bioethanol;
- **the next steps towards introducing a lorry road-user charge** to ensure that all lorry operators contribute to the cost of using UK roads, regardless of nationality;
- discussing with stakeholders the role of **economic instruments in encouraging the aviation industry to take greater account of its environmental impact**; and
- **further consultation on the use of economic instruments** to promote household energy efficiency and to address the environmental impacts of agriculture.

GOVERNMENT SPENDING AND REVENUE

1.34 Chart 1.1 presents public expenditure by main function. Total public spending (Total Managed Expenditure – TME) is expected to be around £420 billion in the current financial year, 2002-03. TME is divided into Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME). DEL spending is set out in Table B15, though a number of DELs, particularly those of the devolved administrations, contribute to spending on more than one of the functions in Chart 1.1. AME components are shown in Table B17 and some of these, especially spending financed locally by local authorities, also cover spending on several different functions.

Chart 1.1: Government spending by function

Total managed expenditure: £420 billion

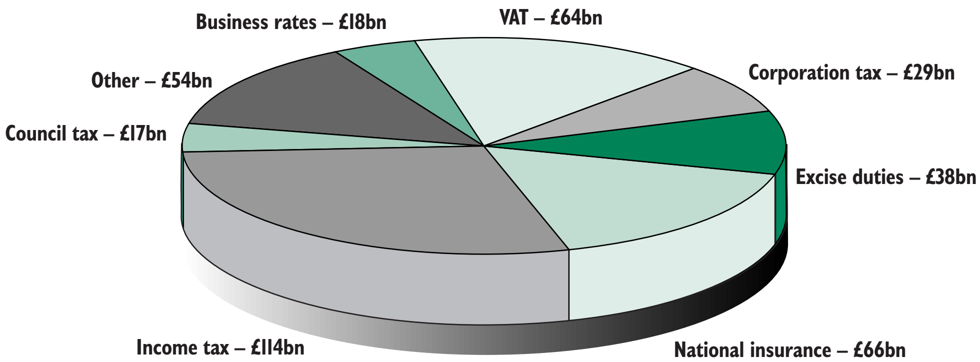


Source: HM Treasury, 2002–03 figures. Other expenditure includes spending on central administration; culture, media and sport; international cooperation and development; public service pensions; plus spending yet to be allocated and some accounting adjustments.

1.35 Chart 1.2 shows the different sources of government revenue. Public sector current receipts are expected to be around £400 billion in 2002-03. Table B12 provides a more detailed breakdown of receipts consistent with this chart.

Chart 1.2: Government receipts

Total receipts: £400 billion



Source: HM Treasury, 2002–03 figures. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts – for example, interest and dividends.

2 Maintaining macroeconomic stability

The global economic recovery has gathered less momentum than forecast in Budget 2002. Slower growth in the US and continental Europe, concern over corporate accounting standards and developments in the Middle East have led to further falls on world equity markets and a rise in oil prices, compounding existing uncertainties over global economic prospects. Nonetheless, the economic stability delivered by the Government's macroeconomic framework has left the UK well placed to deal with the impact of global events:

- **the monetary policy framework is delivering low and stable inflation, while allowing the Bank of England's Monetary Policy Committee to respond to risks to the symmetrical inflation target; and**
- **the fiscal rules are delivering sound public finances so that the Government can let the automatic stabilisers operate freely, while meeting the rules over the economic cycle.**

International conditions continue to be a major influence on the UK economy and heightened global uncertainty presents risks to the forecast. UK GDP is forecast to grow by 1.6 per cent this year, below the Budget 2002 forecast, and by between 2½ to 3 per cent next year.

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

- **the average current budget since the start of the present cycle in 1999-2000 is comfortably in surplus, ensuring the Government is on track to meet the golden rule, using cautious assumptions and in the cautious case;**
- **this is confirmed by the cyclically-adjusted current budget, which allows for the impact of the economic cycle and is in surplus in every year throughout the projection period; and**
- **public sector net debt is projected to be low and stable throughout the next five years, comfortably meeting the sustainable investment rule and, at 31 to 33 per cent of GDP, the lowest in the G7.**

In a period of global economic weakness and uncertainty, the use of cautious assumptions and the 'stress test' against the cautious case help to ensure that the public finances are sound and sustainable and that the Government is vigilant in the face of potential risks. In the short term, the automatic stabilisers are operating freely, as a cyclical shortfall in receipts this year and over the next two years helps to support monetary policy in maintaining economic stability while the economy is below trend. In the medium term, the public finances return towards the Budget 2002 profile as the economy returns to trend. In the long term, a new assessment published alongside this Pre-Budget Report shows that the UK is well placed to deal with future fiscal challenges, such as those arising from an ageing population, and that current policies impact fairly between generations.

THE MACROECONOMIC FRAMEWORK

2.1 Following a pronounced slowdown in 2001, growth in the world economy showed signs of strengthening earlier in the year. But the world economy has since faced a series of new challenges and risks. Concern over corporate accounting standards and other financial malpractices, and events in the Middle East, have led to further falls on international equity markets and a rise in oil prices, compounding uncertainty about the strength of global demand and hampering confidence and business investment across the industrialised world. In an integrated global economy, no country can remain fully immune to international developments. The role of the macroeconomic framework is to limit the impact of adverse developments on the economy so that the UK can maintain high and stable levels of growth and employment.

2.2 The macroeconomic framework is designed to secure and maintain long-term economic stability. Large fluctuations in output, employment and inflation create uncertainty for businesses, consumers and the public sector, and can hold back the economy's long-term growth potential. Stability helps businesses, individuals and the Government plan 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 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 two strict rules that guarantee sound public finances over the medium term. The fiscal rules are the foundation of the Government's public spending framework, which ensures long-term planning while putting in place incentives to increase the quality of public services and deliver specified outcomes. These coordinated policies work together in a coherent and integrated way.

Monetary policy framework

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

- clear and precise objectives. The primary objective of monetary policy is to deliver price stability. The Government's single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's target of $2^1/_2$ per cent for the 12-month increase in the Retail Prices Index excluding mortgage interest payments (RPIX), which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings, and the 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 clear 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 this meets the MPC's remit.

2.5 These arrangements have removed the prospect of short-term political influence over 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 five key principles of fiscal management set out in the *Code for fiscal stability*[2] – transparency, stability, responsibility, fairness and efficiency. The Code, enshrined in legislation through the 1998 Finance Act, describes how these principles relate to the formulation and implementation of policy and requires the Government to state both its objectives and the fiscal rules through which policy is operated. The Government's fiscal policy objectives are:

[1] *Reforming Britain's economic and financial policy*, HM Treasury, 2002.
[2] *The code for fiscal stability*, HM Treasury, November 1998.

- 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 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 promote economic stability by ensuring sound public finances, while allowing flexibility in two key respects. First, the rules are set over the economic cycle, allowing the fiscal balances to vary between years in line with the cyclical position of the economy. This allows the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand. Second, the interaction of the two rules promotes capital investment while ensuring sustainable public finances over 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 for capital spending. The sustainable investment rule ensures that borrowing for investment is conducted in a responsible way.

2.9 The fiscal framework also recognises that projections of the current budget and net debt are subject to uncertainty. The average absolute difference between the year-ahead forecast of public sector net borrowing and the outturn has been around one per cent of GDP over the last ten years. Projections of the public finances are therefore based on deliberately prudent assumptions for key economic variables, including the trend rate of growth, the level of unemployment and equity prices. These assumptions are audited by the Comptroller and Auditor General under a three-year rolling review to ensure that they remain reasonable and cautious. This approach minimises the need for unexpected changes in the direction of taxation or spending.

End of year fiscal report

2.10 **In order to enhance its reporting of fiscal developments, a new *End of year fiscal report* is published for the first time alongside this Pre-Budget Report.** The Report provides detailed retrospective information on the public finances in 2000-01 and 2001-02, including their performance against the fiscal rules and against published forecasts and plans. The *End of year fiscal report* further enhances the Government's commitment to transparency in fiscal policy and brings the UK fully into line with international best practice. It supplements the historical and provisional outturn data published in Annex B of the Pre-Budget Report and in the Financial Statement and Budget Report in accordance with the *Code for fiscal stability*. It shows that the Government was firmly on track to meet its fiscal rules in 2000–01 and 2001–02 with strong surpluses on the current budget in both years and low and stable levels of public sector net debt.

Public spending framework

2.11 Sound public finances that are sustainable over the cycle are a prerequisite for sustainable investment in public services. The fiscal rules underpin the Government's public spending framework and have important consequences for the structure of the budgeting regime. The main elements of the framework are:

- firm and fixed three-year Departmental Expenditure Limits (DEL) to help departments to plan and manage resources with greater certainty over the medium term;

- Annually Managed Expenditure (AME) which includes those elements of spending that cannot reasonably be subjected to firm multi-year limits. DEL and AME sum to Total Managed Expenditure (TME);
- separate resource (current) and capital budgets, consistent with the distinction in the fiscal rules. Departments are required to manage these budgets separately, so helping to remove the bias against investment that was present in the previous planning regime;
- full end-year flexibility (EYF), which allows departments to carry forward underspends from one year to the next; and
- Public Service Agreements (PSAs) that commit departments to challenging outcome-focused targets and set out the public service improvements that increased spending will deliver.

2.12 The 2002 Spending Review established departmental spending plans and PSA targets for the three years to 2005-06, consistent with the firm overall limits for public spending set in Budget 2002. Chapter 6 provides further information on the 2002 Spending Review and on the Government's strategy for reforming public services.

Box 2.1: Macroeconomic frameworks in the new global economy

An increasingly integrated global economy offers substantial economic benefits, while also posing new challenges for macroeconomic policy. An analysis of the implications of globalisation for macroeconomic policy-making, *Macroeconomic frameworks in the new global economy*, is published alongside this Pre-Budget Report.

Increased access to global capital brings both new opportunities and greater international competition for investment capital, as investors are able to move their money from one country to another rapidly in response to economic news. As a result, policy credibility has become more important than in the past, and is more quickly rewarded by international capital markets. Conversely, weaker macroeconomic frameworks which lack credibility are now more quickly and severely punished. Credible macroeconomic frameworks that deliver stability are therefore essential to promote stability, and attract and retain domestic and foreign capital.

As economies become more open and integrated, potential sources of economic shocks are likely to widen and shocks themselves will be transmitted more rapidly. Macroeconomic policy frameworks must ensure that economies are sufficiently robust to cope with such shocks, while also allowing flexibility to respond in the most appropriate manner when shocks do occur.

Fixed rules, applied whatever the state of the economy or the nature of the shock, are unlikely to work in the modern global economy. Yet entirely discretionary approaches are equally inadequate, since the temptation for policymakers to respond to short-term pressures and to depart from long-term objectives can be too powerful.

A balanced approach lies in 'constrained discretion' – frameworks that constrain macroeconomic policy to meet clear long-term goals, but which allow policy to respond flexibly in the short term to a variety of shocks without damaging credibility. Frameworks based on constrained discretion need to be underpinned by clear and sound long-term policy objectives, pre-commitment through strong institutional arrangements and procedural rules, openness and transparency, and clear accountability. Countries which have a high degree of transparency and build up a track record of credibility over a long period of time will have greater freedom to implement discretionary responses to shocks, without undermining that credibility and putting stability at risk. The challenge for all countries is to manage the shocks that globalisation can bring, and to capture its benefits by enhancing credibility.

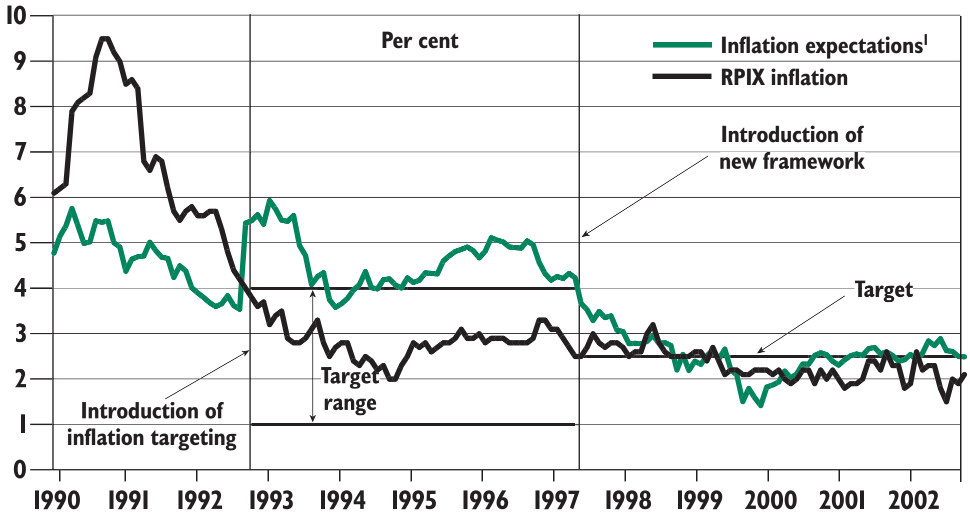
THE PERFORMANCE OF THE FRAMEWORK

2.13 The Government's framework for monetary and fiscal policy and for public spending forms an integrated strategy for maintaining high and stable levels of growth and employment, and for minimising the adverse impact of external events.

Monetary strategy

2.14 The monetary policy framework has enhanced the credibility and transparency of economic policy-making and continues to deliver positive results. Since the framework was introduced, RPIX inflation has fluctuated in the narrow range of 1.5 to 3.2 per cent and has averaged 2.3 per cent, close to the Government's target and within the range outside of which an open letter would be triggered. Long-term inflation expectations, as measured by survey and financial markets data, show that inflation is expected to remain close to the Government's inflation target, having fallen from over four per cent in 1997.

Chart 2.1: Inflation performance and expectations



[1] *Ten-year ahead market inflation expectations.*

2.15 The framework has dealt successfully with unforeseen shocks. The MPC responded promptly and decisively to the global slowdown during 2001 and the events of 11 September by cutting interest rates seven times, and by a total of two percentage points, from six to four per cent. This decisive policy response helped to keep output close to its potential level throughout the year, while ensuring that inflation continued to remain close to target.

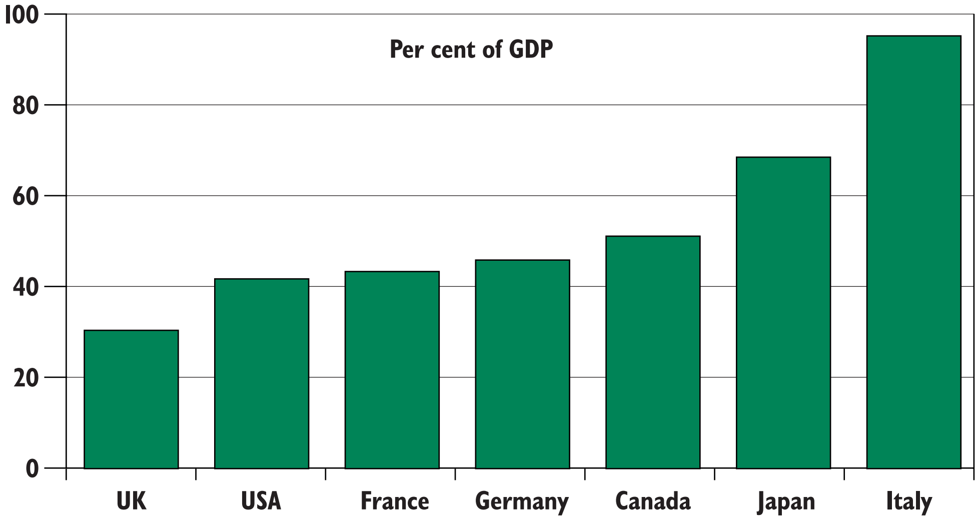
2.16 Since November 2001 the MPC has held official short-term interest rates at four per cent, as buoyant growth in domestic consumption and rising house prices have helped counteract the effect of slower growth in the world economy, weak investment growth and turbulence in foreign exchange and equity markets. Long-term interest rates are around their lowest levels for over 35 years, helping to restrict the size of debt interest payments and freeing up valuable resources for investment in public services. Market expectations reflect investor confidence that the monetary framework will continue to deliver inflation close to target.

Fiscal strategy

2.17 The public finances have been restored to a position of sustainability. As a result of tough decisions on taxation and spending, and with the benefits of greater economic stability, fiscal policy was tightened in structural terms by over 4 percentage points of GDP between 1996-97 and 2000-01, supporting monetary policy during a period when the economy was generally above trend.

2.18 These actions, including the use of the £22.5 billion proceeds from the auction of spectrum licences, have allowed the Government to repay more than £50 billion of debt since 1996-97. Public sector net debt has been reduced from 44 per cent of GDP in 1996-97 to under 31 per cent of GDP – lower than that in any other G7 economy. Low and stable debt levels, combined with accumulated current budget surpluses over the course of the economic cycle, have allowed the automatic stabilisers to operate fully, helping to limit the impact of the more recent global slowdown on the UK economy.

Chart 2.2: OECD projections of general government net financial liabilities for G7 countries, 2002



Source: OECD Economic Outlook June 2002.

2002 Spending Review

2.19 Significant investment in the reform and modernisation of public services has been delivered within this framework. The 2002 Spending Review[3] established departmental spending plans for the three years to 2005-06, and for the five years to 2007-08 for UK spending on the NHS, consistent with the firm overall 'envelope' set in Budget 2002 and within the Government's strict fiscal rules.

2.20 Total managed expenditure (TME) is set to rise by 4.3 per cent a year, on average, in real terms, over the Spending Review period. Within this, the Government has been able to devote additional resources to priority public services. Social security payments, tax credits and debt interest payments will account for just 23 per cent of the additional public spending planned over the next three years, compared with 57 per cent between 1991-92 and 1996-97. Debt interest payments have fallen by £7 billion since 1996-97, and are expected to have fallen by almost 4 per cent a year, on average, over the period 1996-97 to 2005-06, compared with an average annual increase of more than 6 per cent between 1991-92 and 1996-97. To address the legacy of under-investment in public services, public sector net investment, already planned to be almost three times higher this year than in 1997-98, is projected to rise still further to $2^1/_4$ per cent of GDP in 2007-08. Further details are set out in Chapter 6.

[3] *Opportunity and security for all: investing in an enterprising, fairer Britain*, HM Treasury, July 2002.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.21 During the first half of 2002, a recovery in world trade and industrial production provided clear evidence that a global economic recovery was underway. However, the immediate outlook for the world economy has weakened in more recent months as corporate accounting scandals, further falls on world equity markets, developments in the Middle East and rising oil prices have compounded existing uncertainty over world economic prospects. Consequently, the global economic recovery currently appears to have less momentum than was anticipated earlier in the year.

Table 2.1: Summary of world forecast

	Percentage changes on a year earlier				
	Outturn	Forecast			
	2001	2002	2003	2004	2005
Major 7 countries[1]					
Real GDP	½	1½	2¼	3	2¾
Consumer price inflation[2]	1½	1¾	1¼	1½	1½
World trade in goods and services	½	2	5½	8¾	7½
UK export markets[3]	1	1½	5	8	6½

[1] *G7: US, Japan, Germany, France, UK, Italy and Canada.*
[2] *Final quarter of each period. For UK, RPIX.*
[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

2.22 In an integrated global economy, no country can remain immune to these developments, and the emergence of new challenges and risks has further affected already fragile business confidence across the industrialised world. As a result, and mirroring developments in most other major economies, the corporate sector in the UK has reduced investment spending, and the strengthening in activity has been weaker than forecast in Budget 2002.

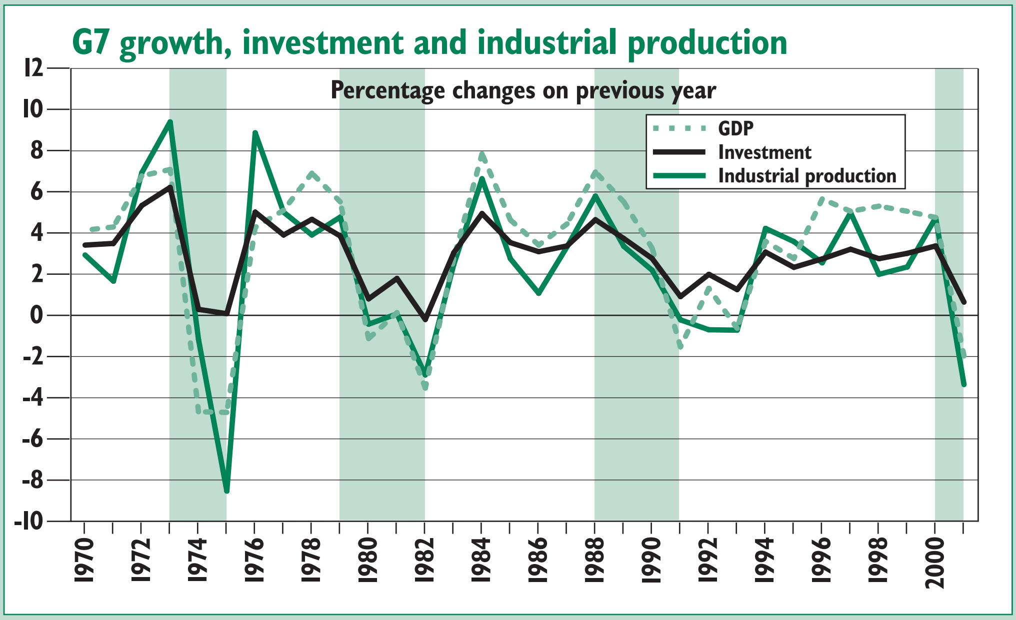
2.23 Nonetheless, UK GDP growth has strengthened since the beginning of this year, following the marked slowdown in the world economy in 2001. The Government's reforms to the macroeconomic framework are ensuring that the UK faces challenges in the global economy from a position of underlying strength, with low inflation and sound public finances. Historically low interest rates, a robust labour market, further gains in house prices and strong consumer confidence, have underpinned solid growth in household consumption and allowed the UK to maintain stability despite an uncertain global recovery. UK GDP rose by 0.8 per cent in the third quarter of 2002, to stand 1.8 per cent up on a year earlier.

Economic prospects

2.24 Table 2.2 summarises the outlook for UK growth and inflation. GDP growth for 2002 as a whole is now expected to be 1.6 per cent, below the Budget forecast. However, sound fundamentals mean that the UK economy is well placed to respond positively when the world economic recovery gathers momentum.

Box 2.2: Global economic slowdowns

During 2001 growth slowed significantly and simultaneously in the US, Europe and Asia for the first time for almost thirty years, and the world's three largest economies – the US, Germany and Japan – were all in recession.



A striking feature of the slowdown was that it was accompanied by falling investment and industrial production in nearly all of the major advanced economies. Industrial production in the G7 economies fell by 3.3 per cent in 2001 while whole-economy investment fell by two per cent. Both contracted more sharply than at any other time in the past 20 years.

World trade growth slipped from 12 per cent in 2000 to a near standstill in 2001 as a result of the synchronised slowdown in economic growth and the collapse in demand for highly traded investment goods. World trade picked up in the first half of 2002 and is expected to grow by two per cent over the year.

The global outlook in 2002 has been affected by fresh uncertainties that have prompted further falls in stock markets around the world and increases in oil prices. Like any other economy, the UK is not immune to these events. While on previous occasions, particularly in the mid-1970s, early 1980s and early 1990s, the UK has suffered more than its competitors from global turbulence and experienced more severe slowdowns, on this occasion the stability delivered by this Government's macroeconomic framework has allowed the UK economy to remain in a strong position.

While a number of major economies saw falls in output last year, the UK continued to grow, and at the fastest rate of all G7 economies. This year, amid new uncertainties and risks, the economy continues to experience the longest unbroken economic expansion on record. The resilience of the labour market also sets the UK apart from most other industrialised countries, many of which have seen unemployment rates rise significantly since the slowdown began in 2001. UK unemployment, at 5.3 per cent, is currently the lowest among the G7 economies for the first time since the 1950s.

2.25 The effects of continuing global uncertainty and equity price falls are expected to restrain UK GDP growth at slightly below-trend rates through to the middle of next year. Thereafter, GDP is expected to see a period of above-trend growth as recovery in the world economy becomes more firmly established and gathers pace, allowing slack in the UK economy to be taken up. Growth is forecast to rise to between $2^1/_2$ to 3 per cent next year and to reach 3 to $3^1/_2$ per cent in 2004, before returning to trend by the end of 2005.

Table 2.2: Summary of UK forecast

	Outturn	Forecast			
	2001	2002	2003	2004	2005
GDP growth (per cent)	2	$1^1/_2$	$2^1/_2$ to 3	3 to $3^1/_2$	$2^3/_4$ to $3^1/_4$
RPIX inflation (per cent, Q4)	2	$2^1/_2$	$2^1/_4$	$2^1/_2$	$2^1/_2$

2.26 Private investment, which has been particularly affected by uncertainties surrounding the global environment this year, is expected to pick up during 2003 as strengthening global demand, reduced uncertainty and improvements in corporate finances increase confidence and encourage the business sector to pursue more expansive investment strategies. Government investment is also forecast to expand further in 2003, as significant increases in resources are directed to priority public services, in accordance with the Government's plans and within the fiscal rules. A gathering in the pace of external demand growth from the middle of next year should also provide a renewed impetus to exports, with export growth expected to be above its long-run average in both 2004 and 2005. Higher demand for investment goods and rising external demand should help the manufacturing sector to build on the stabilisation in output seen through this year.

2.27 Growth in household consumption is forecast to be more moderate than in recent years as the delayed effects of stock market falls and weaker income growth take hold and the appetite for further increases in debt recedes. With stronger growth in investment and export demand, but weaker growth in private consumption, GDP growth is expected to become more balanced over the forecast period.

2.28 After moving back to target at the end of this year, RPIX inflation is expected to fall slightly below the Government's $2^1/_2$ per cent target next year with downward pressure from slack in the economy. It is forecast to return to target by 2004 as the effects of a pick-up in import prices and the economy accelerating back to trend work through.

Forecast risks

2.29 Heightened global uncertainty is reflected in upside and downside risks to the UK forecast. On the upside, the accommodating stance of fiscal and monetary policy in the US or a diminution of tensions in the Middle East could give rise to a stronger than anticipated recovery in global demand. Similarly, the Government's reforms to boost productivity have the potential to improve the trend rate of growth of the UK economy over the medium term.

2.30 Global downside risks include those of continued volatility in equity prices, a delayed recovery in business investment, renewed rises in oil prices, and the prospect of current account imbalances unwinding in a disorderly way. Domestic downside risks include the possibility of a sharp correction in house prices in the event of further steep growth, and the emergence of inflationary pressures in the labour market. Both monetary and fiscal policies must remain vigilant to these risks. Low and stable inflation improves the ability of the MPC to respond to risks to the symmetrical inflation target, while the Government will continue to base projections of the public finances on cautious assumptions, including for equity prices and trend growth, and to 'stress test' projections against the cautious case. This helps to ensure that the public finances remain sound, that fiscal policy can support monetary policy over the economic cycle and that the Government remains on track to meet its tough fiscal rules, while remaining vigilant in the face of potential risks.

Box 2.3: 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 the economic case for joining is clear and unambiguous.

The Government has set out five economic tests which must be met before any decision to join can be made. A comprehensive and rigorous assessment of the five tests will be made within two years of the start of this Parliament. On the basis of the assessment, the Government will decide whether the five tests have been met. If a decision to recommend joining is taken by the Government, it will be put to a vote in Parliament and then to a referendum of the British people.

The preliminary analysis supporting the five tests assessment – technical work needed to enable the assessment to be completed within two years of the start of the Parliament – is well underway. A number of supporting studies encompassing the preliminary and technical work will be published alongside the assessment.

The Government is also committed to ensuring that preparations are made so that the British people would be in a position to exercise genuine choice in a referendum, should the economic tests be met. The Government's Outline National Changeover Plan describes how the UK can be ready for a smooth and cost-effective changeover should Government, Parliament and the people decide to join the single currency. The Treasury has monitored the changeover in the Euro-area to gather examples of best practice. This work has been published in the Government's *Sixth report on Euro preparations*, which also contains an update on preparations for a possible UK changeover.

The Government continues to help small and medium-sized enterprises (SMEs) consider the impact of the euro on the way they do business and is committed to ensuring that UK business has access to the information it needs to take advantage of opportunities in the Euro-area.

The economic cycle

2.31 Since Budget 2000, the Government's provisional judgment has been that the economy completed a full, albeit short cycle between the first half of 1997 and mid-1999. The current economic cycle therefore began in mid-1999, with output moving slightly above trend in 2000 and the first half of 2001.

2.32 As more data becomes available there is still some doubt as to whether the economy was on trend or just close to trend in mid-1999, so the judgement that the present cycle started in mid-1999 rather than in the first half of 1997 remains provisional. Paragraph 2.51 shows that this judgement does not affect the fact that the Government remains firmly on track to meet its fiscal rules over the economic cycle. The average current budget since 1997-98 and since 1999-2000 remains comfortably in surplus in every year of the projection period.

Caution and the public finance projections

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

2.34 For this Pre-Budget Report, the Comptroller and Auditor General has audited the assumptions relating to oil prices, anti-tobacco smuggling measures and VAT that underpin the public finances projections. All three were deemed to be reasonable and to incorporate caution.[4]

2.35 The Government is launching a comprehensive new strategy for tackling VAT fraud, avoidance and non-compliance, details of which are set out in Chapter 5 and in *Protecting indirect tax revenues*, published alongside the Pre-Budget Report. Consistent with previous cautious practice, the update to the relevant assumption which takes account of the direct and preventive impacts of this strategy, but not of the deterrent effects, has been audited by the Comptroller and Auditor General.

RECENT FISCAL TRENDS AND OUTLOOK

2.36 The public finance projections in the Pre-Budget Report have a different status to 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 fiscal effects of firm decisions announced since Budget 2002 and in this Pre-Budget Report have been incorporated into the fiscal projections in accordance with the requirements of the *Code for fiscal stability*.

2.37 Since Budget 2002, the immediate outlook for the world economy has weakened as concern over corporate accounting standards and events in the Middle East have led to further falls on world equity markets and a rise in oil prices, compounding uncertainty over world economic prospects. Even under cautious assumptions, disciplined management of the public finances means that the Government can allow the automatic stabilisers to operate in full during this period, while remaining on track to meet the fiscal rules over the cycle, including in the cautious case. Full details of changes in taxation and expenditure since the Budget are set out in Annex B.

[4] *Audit of Assumptions for the 2002 Pre-Budget Report*, National Audit Office, November 2002.

Table 2.3: Fiscal balances compared with Budget 2002

	Outturn	Projections				
	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Surplus on current budget (£ billion)						
Budget 2002	**10.6**	**3.2**	**7**	**9**	**7**	**9**
Effect of forecasting changes	–3.0	–7.9	–12	–7	–3	–1
of which: effect of automatic stabilisers	*–0.6*	*–5.8*	*–9*	*–5*	*–1*	*0*
effect of other non-discretionary factors	*–2.4*	*–2.1*	*–4*	*–2*	*–2*	*–1*
Effect of policy decisions since Budget 2002	—	–1.0	1	0	1	1
PBR 2002	**7.7**	**–5.7**	**–5**	**3**	**5**	**8**
Net borrowing (£ billion)						
Budget 2002	**1.3**	**11.2**	**13**	**13**	**17**	**18**
Effect of forecasting changes	–0.2	7.8	12	6	2	1
of which: effect of automatic stabilisers	*0.6*	*5.8*	*9*	*5*	*1*	*0*
effect of other non-discretionary factors	*–0.8*	*2.0*	*4*	*2*	*1*	*1*
Effect of policy decisions since Budget 2002	—	1.0	–1	0	–1	–1
PBR 2002	**1.2**	**20.1**	**24**	**19**	**19**	**19**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2002[1]	1.0	0.5	0.6	0.7	0.6	0.7
PBR 2002	**0.7**	**0.2**	**0.3**	**0.6**	**0.5**	**0.6**
Cyclically-adjusted public sector net borrowing (per cent of GDP)						
Budget 2002[1]	0.2	0.9	1.2	1.2	1.4	1.4
PBR 2002	**0.2**	**1.2**	**1.5**	**1.3**	**1.5**	**1.5**
Net debt (per cent of GDP)						
Budget 2002[1]	30.4	30.2	30.4	30.4	30.7	31.0
PBR 2002	**30.4**	**31.0**	**32.1**	**32.4**	**32.6**	**32.7**

Note: Figures may not sum due to rounding.
[1] The 2001-02 figures were estimates in Budget 2002.

2.38 Table 2.3 compares the medium-term projections for the current budget, net debt and net borrowing with those produced in Budget 2002. The impact of the automatic stabilisers, other non-discretionary factors and policy decisions since Budget 2002 are described later in this section.

2.39 The current budget surplus in 2001-02 stood at £7.7 billion, almost £3 billion lower than the estimate published in Budget 2002. At £1.2 billion, the outturn for public sector net borrowing in 2001-02 was very close to the Budget estimate.

2.40 Looking forward, the projections for the current budget and net borrowing are temporarily weaker than projected at the time of the Budget, largely reflecting the cyclical impact of the automatic stabilisers on receipts. A deficit on the current budget of £5.7 billion is now expected for 2002-03, while public sector net borrowing is expected to be £20.1 billion. In the medium term, the projections return towards the Budget profile as the economy returns to trend.

2.41 Table 2.3 also sets out estimates of the underlying structural position of the fiscal balances, adjusted for the estimated impact of the economic cycle. On this basis, the projections for the current budget and for net borrowing remain close to the Budget 2002 profile. A cyclically-adjusted surplus on the current budget of 0.2 per cent of GDP is expected in 2002-03, while net borrowing is expected to be equivalent to 1.2 per cent of GDP. In structural terms, the current budget is in surplus in each year of the projection period.

2.42 Table 2.4 sets out the impact on the current budget of changes since Budget 2002 attributable to the operation of the automatic stabilisers, other non-discretionary factors and policy decisions since Budget 2002. The impact of the different factors on public sector net borrowing is very similar, as the projections for public sector net investment are little changed.

Table 2.4: Factors behind changes to the current budget since Budget 2002

£ billion			Projections		
	2002-03	2003-04	2004-05	2005-06	2006-07
Automatic stabilisers	–5.8	–9	–5	–1	0
Other non-discretionary factors	–2.1	–4	–2	–2	–1
Policy decisions since Budget 2002	–1.0	1	0	1	1
Total change	**–8.9**	**–12**	**–6**	**–2**	**–1**

Note: Figures may not sum due to rounding. A positive number reflects a higher current surplus.

2.43 The table shows that the automatic stabilisers account for £5.8 billion of the change in the current budget in 2002-03, and £9 billion in 2003-04. The change in the automatic stabilisers declines over the forecast period as the economy returns to trend. These estimates of the changes in the size of the automatic stabilisers are based on the average impact of changes in the output gap on the public finances over previous cycles.[5] They reflect both the direct impact of changes in GDP and its components, and other factors that are determinants of tax receipts, including changes in asset prices, to the extent that they have been related to changes in the output gap in the past.

Changes in receipts

2.44 The changes to the projections of the current budget mostly reflect updated projections of receipts which are expected to be weaker this year and over the next two years. Table 2.5 decomposes the changes to the projections of receipts into NAO-audited assumptions, financial company profits and other economic and forecasting effects. Each of these contributes – to differing extents – both to the change in the automatic stabilisers and to other non-discretionary factors. Table 2.5 shows that the difference in receipts is larger in 2003-04 than in 2002-03, reflecting the delayed impact of weaker growth and further falls in equity prices during this year. The factors are explained in more detail in Annex B. They include:

- the impact of the NAO-audited assumptions, particularly on equity prices which are 25 per cent lower throughout the forecast period than assumed in Budget 2002, affecting capital taxes, stamp duty on equities and corporation tax. The audited assumption requires equity prices to rise from existing levels in line with money GDP, reducing receipts by £3½ to £4 billion in every year from 2003-04 relative to the Budget 2002 projections. Applying this cautious assumption will tend to affect the non-discretionary factors shown in Table 2.4 throughout the forecast;
- revisions to the tobacco and VAT assumptions, that partly offset the impact of lower equity prices, and impact as non-discretionary factors. The revisions have been audited by the NAO to ensure they remain reasonable and cautious;
- financial company profits, which have continued to be affected by the current downturn in international capital markets and global economic uncertainty, but are expected to return to trend in the medium term, and therefore have only a temporary impact on the forecast; and

[5] *Fiscal policy, public finances and the cycle*, HM Treasury, 1999.

- other economic and forecasting effects, which are weaker than in the Budget this year and next as the economy remains below trend, but become positive in the medium term, partly as a result of changes to the composition of GDP. This is explained in more detail on a tax-by-tax basis in Annex B.

Table 2.5: Changes in current receipts since Budget 2002

£ billion		Projections			
	2002–03	2003–04	2004–05	2005–06	2006–07
Effect on receipts of changes in:					
Assumptions audited by the NAO	**0**	**–3½**	**–3**	**–2½**	**–1½**
of which: Equity prices	*–1*	*–3½*	*–4*	*–4*	*–4*
Revised tobacco and VAT assumptions	*0*	*½*	*1½*	*2*	*2*
Financial company profits	**–5**	**–5**	**–3½**	**–1½**	**–1**
Other economic and forecasting effects[1]	**–2½**	**–3½**	**½**	**2**	**2½**
Total before policy changes	**–8**	**–12**	**–6**	**–2**	**0**
Policy decisions since Budget 2002 affecting receipts	½	½	½	½	1
Total change	**–7½**	**–11½**	**–5½**	**–1½**	**½**

Note: Figures may not sum due to rounding.
[1] *Excluding assumptions audited by the NAO.*

2.45 Heightened global uncertainties present risks to the projections for the public finances, underlining the need for vigilance and for caution in projecting the fiscal balances. By basing its projections on cautious assumptions, independently audited by the NAO, and by 'stress-testing' these projections against the cautious case, the Government is ensuring that the public finances remain sound, that fiscal policy can support monetary policy over the economic cycle and that the fiscal rules continue to be met.

Changes in spending

2.46 Projections for DEL up to the end of 2005-06 are based on the 2002 Spending Review allocations, adjusted to take account of changes to certain public sector pension schemes and some other classification changes between DEL and AME which have no impact on overall public spending. Projections for expenditure on AME programmes are higher than those made at the time of the 2002 Spending Review, largely due to an increased forecast of payments made under the coal health compensation scheme and projected investment in London Underground to be delivered through the Public-Private Partnership. These are partly offset by lower projections for social security spending, reflecting a downward revision to the inflation forecast since Budget 2002. In line with the convention adopted in previous Pre-Budget Reports, changes to the forecast for AME programmes have been offset in the AME margin.

Discretionary policy changes

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

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

Box 2.4: Public finances in the EU and the US

The global economic slowdown has had a significant impact on fiscal positions across the industrialised world.

The table below shows that budget deficits in the EU and the US this year and next year are now expected to be greater than anticipated earlier in the year. In 2002, the OECD estimates that this is mostly explained by increases in cyclically-adjusted net borrowing. In 2003, the impact of the automatic stabilisers also explains part of the increases, except in Germany.

Revisions to forecasts for general government net borrowing

	General government net borrowing (per cent of GDP) 2002		2003	
	June 2002	November 2002	June 2002	November 2002
Germany	2.8	3.7	2.1	3.3
France	2.0	2.7	1.8	2.9
Italy	1.4	2.3	1.3	2.1
Euro area	1.5	2.2	1.2	2.1
United States	1.0	3.1	0.7	3.0
	Cyclically-adjusted general government net borrowing (per cent of GDP) 2002		**2003**	
	June 2002	**November 2002**	**June 2002**	**November 2002**
Germany	1.5	2.7	1.1	2.3
France	1.8	2.5	1.8	2.6
Italy	0.4	1.6	0.5	1.2
Euro area	0.7	1.6	0.7	1.4
United States	0.7	2.7	0.5	2.5

Source: OECD.

The Pre-Budget Report forecast for UK general government net borrowing (the Treaty deficit) is set out in Table 2.6. While general government net borrowing is forecast to be about one percentage point higher in 2002-03 and 2003-04 compared with the Budget 2002 forecast, in cyclically-adjusted terms the increase is 0.3 percentage points in both years. The developments have to be seen in the context of the overall sustainability of the public finances. Table 2.6 also sets out the forecast for UK general government gross debt (Treaty debt), which is one of the lowest in the EU.

2.48 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all firm decisions announced in this Pre-Budget Report or since Budget 2002, including the abolition of North Sea Royalty payments and further measures to tackle tax avoidance and establish a modern and fair tax system. To ensure that resources are available to meet the UK's defence and overseas needs in the fight against global terrorism, this Pre-Budget Report also makes available an additional provision of £1 billion this year to be held in a special reserve. The fiscal impact of these and other measures is set out in Table B4, which shows that policy measures announced since Budget 2002 cost the Exchequer £1 billion in 2002-03, but yield £0.6, £0.4 and £0.5 billion in the following three years. The projections do not take account of measures proposed in this Pre-Budget Report for consultation prior to Budget 2003, including increases in the standard rate of landfill tax, or other proposals where final decisions have yet to be taken. Decisions on such measures will be taken in the Budget, and along with revised forecasts for the economy and the public finances, will impact on the final Budget forecast.

Fiscal position and medium-term prospects

2.49 Table 2.6 presents a summary of the key fiscal aggregates under the five headings of fairness and prudence, sustainability, economic impact, financing and European commitments. It illustrates the Government's performance against its fiscal rules, and shows that the Government remains on track to meet its strict fiscal rules over the economic cycle.

Table 2.6: Summary of public sector finances

	Per cent of GDP						
	Outturn[1]	Projections					
	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Fairness and prudence							
Surplus on current budget	0.8	–0.5	–0.4	0.2	0.4	0.6	0.7
Average surplus since 1999-00	1.7	1.2	0.8	0.7	0.7	0.7	0.7
Cyclically-adjusted surplus on current budget	0.7	0.2	0.3	0.6	0.5	0.6	0.7
Long-term sustainability							
Public sector net debt	30.4	31.0	32.1	32.4	32.6	32.7	33.0
Core debt	30.3	30.3	30.6	30.6	30.8	31.0	31.3
Public sector net worth[2]	26.5	26.7	22.2	20.6	19.5	19.0	17.9
Primary balance	1.7	–0.3	–0.6	0.0	0.0	0.1	0.0
Economic impact							
Public sector net investment	0.9	1.4	1.8	1.9	2.0	2.1	2.2
Public sector net borrowing (PSNB)	0.1	1.9	2.2	1.6	1.6	1.5	1.5
Cyclically-adjusted PSNB	0.2	1.2	1.5	1.3	1.5	1.5	1.5
Financing							
Central government net cash requirement	0.3	1.8	2.8	1.9	1.7	1.9	1.6
European commitments							
Treaty deficit[3]	0.2	1.8	2.2	1.7	1.6	1.6	1.6
Cyclically-adjusted Treaty deficit[3]	0.2	1.1	1.4	1.3	1.5	1.6	1.6
Treaty debt ratio[4]	38.2	37.9	38.8	38.9	38.9	39.1	39.2
Memo: Output gap	–0.3	–1.3	–1.0	–0.3	0.0	0.0	0.0

[1] *The 2001–02 figures were estimates in Budget 2002.*
[2] *At end-December; GDP centred on end-December.*
[3] *General government net borrowing on a Maastricht basis.*
[4] *General government gross debt.*

Golden rule

2.50 The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and is therefore an important indicator of inter-generational fairness. Lower receipts in the short term mean that a current budget deficit of 0.5 per cent of GDP is now expected this year. The deficit is projected to narrow slightly to 0.4 per cent of GDP in 2003-04, before the current budget is restored to surplus from 2004-05, as the economy and financial company profits return towards trend. Strong surpluses on the current budget are projected by the end of the period.

2.51 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the impact of the automatic stabilisers. Progress against the rule is measured by the average surplus on the current budget since the cycle began. The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is comfortably positive throughout the forecast period by at least 0.7 per cent of GDP. On this basis, the Government is firmly on track to meet the golden rule. This is confirmed by the surpluses on the current budget in cyclically-adjusted terms in every year of the projection period. Were the current economic cycle thought to have begun in 1997-98 rather than in 1999-2000, the average currrent budget since the start of the cycle would also be in surplus in each year of the projection period.

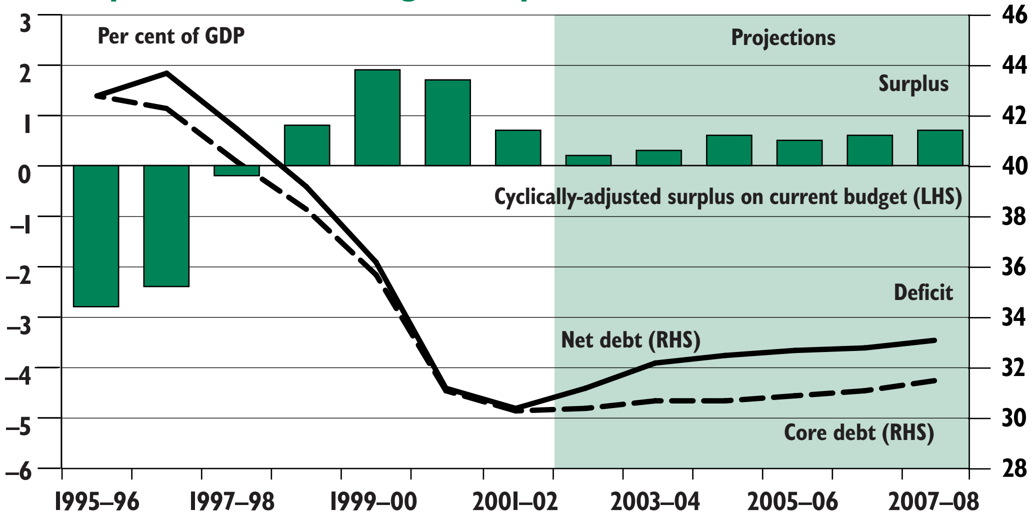
Sustainable investment rule

2.52 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector debt at a low and sustainable level – other things being equal, net debt should be held below 40 per cent of GDP.

2.53 The Pre-Budget Report projections show that, despite continued weakness in the world economy, net debt is expected to remain low and stable, rising slightly from 31 per cent to stabilise around 33 per cent of GDP over the forecast period, comfortably meeting the sustainable investment rule by remaining well below 40 per cent. As a result of sound public finances and greater economic stability, the Government can therefore deliver the significant investment in public services announced in the 2002 Spending Review, while continuing to maintain a buffer against unexpected economic events and wider global instability. Having fallen by £7 billion since 1996-97 to their lowest level as a per cent of GDP since the First World War, debt interest payments are also expected to remain low, ensuring that resources can be directed toward improving front-line public services.

2.54 Chart 2.3 shows the projected net debt ratio and cyclically-adjusted current surplus. It demonstrates that the Government comfortably met the golden rule and the sustainable investment rule over the economic cycle which began in the first half of 1997 and is thought to have come to an end in mid-1999, and that the Government remains on track to meet these firm fiscal rules over the present economic cycle.

Chart 2.3: Meeting the fiscal rules – cyclically-adjusted surplus on current budget and public sector net debt



2.55 Chart 2.3 also illustrates the Pre-Budget Report projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt is estimated in accordance with the methodology published alongside Budget 2002.[6] Economic stability has meant that levels of core debt have been very similar to total net debt over recent years, and a similar relationship is expected over the forecast period. Core debt is projected to rise slowly to just over 31 per cent of GDP as the Government borrows modestly to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the key principle of inter-generational fairness with underpins the fiscal framework.

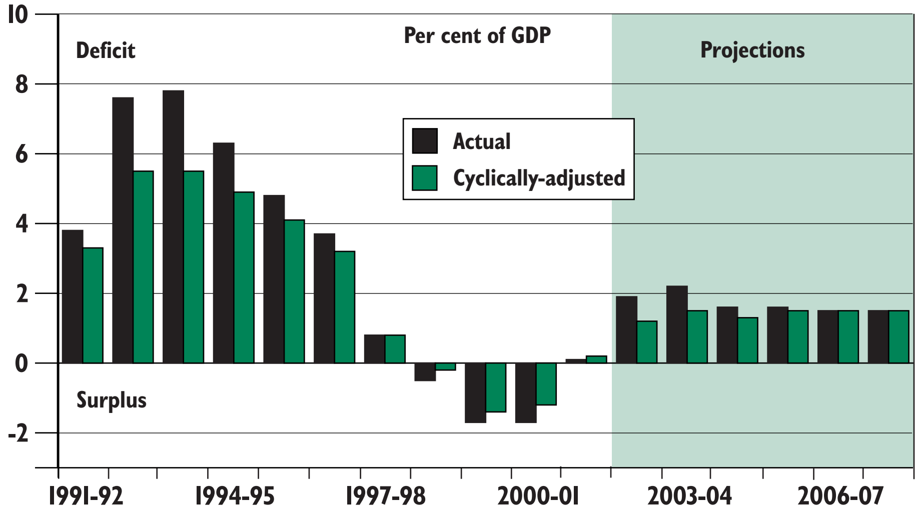
[6] *Core debt – an approach to monitoring the sustainable investment rule*, HM Treasury, April 2002.

2.56 A further measure of the sustainability of the fiscal position is net worth, the difference between the total assets and liabilities of the Government. A modest decline is expected over the projection period. At present net worth is not used as a key indicator, mainly because of the difficulties involved in measuring government assets and liabilities accurately.

Economic impact

2.57 While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.4 sets out the interim projections for actual and cyclically-adjusted net borrowing.

Chart 2.4: Public sector net borrowing – actual and cyclically-adjusted



2.58 Modest levels of borrowing over the forecast period reflect sustained capital investment in public services. In addition to the operation of the automatic stabilisers this year and next year, rising public spending, including investment, will support monetary policy in maintaining economic stability as the economy remains below trend. Higher investment spending is sustainable and fully consistent with the fiscal rules since net debt remains at a stable and prudent level over the forecast period.

Financing

2.59 As a result of the new projections for the fiscal balances, the forecast for the central government net cash requirement for 2002-03 has been revised from £13.5 billion to £18.7 billion, an increase of £5.2 billion. Accordingly, it has been decided to meet the increase financing requirement by:

- increasing gilt sales by £3.8 billion to £26.2 billion; and
- increasing the run down of the Debt Management Office's net cash position by £1.2 billion, to £6.6 billion.

2.60 Full details and a revised financing table can be found in Annex B.

European commitments

2.61 The Pre-Budget Report projections comfortably meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (three per cent of GDP) throughout the projection period. The projections are consistent with the Government's prudent interpretation of the Stability and Growth Pact, which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty). Based on cautious assumptions and consistent with the Government's fiscal rules, the cyclically-adjusted Treaty deficit is projected to remain at or below 1.6 per cent of GDP throughout the projection period. General government gross debt, the Treaty measure, remains consistently well below the 60 per cent reference value, ensuring the public finances are sustainable.

Box 2.5: The Stability and Growth Pact

The Stability and Growth Pact was finalised at the European Council in June 1997 to ensure that EU member states maintain sound and sustainable government finances through the medium-term budgetary objective of "close to balance or in surplus".

Fiscal sustainability is a pre-condition for macroeconomic stability, and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy coordination as set out in the EU Treaty. Building on the Code of Conduct, agreed by member states in June 2001, the Government supports a prudent interpretation of the Stability and Growth Pact which takes into account the following factors:

- **the economic cycle – allowing automatic stabilisers to operate fully and symmetrically over the cycle will ensure that fiscal policy supports monetary policy in smoothing economic fluctuations. It is therefore important to focus on cyclically-adjusted fiscal balances when assessing public finances and subsequent policy decisions;**
- **sustainability – low debt levels enhance the sustainability of the public finances, allow more room for the operation of the automatic stabilisers, and provide a sound basis for investment in public services and reforms to encourage productivity, employment and fairness. In considering the sustainability of public finances, it is necessary to examine the budgetary impact of an ageing population and, where possible, generational accounts. The *Long-term public finance report*, published alongside this Pre-Budget Report, presents such an assessment; and**
- **public investment – against a background of sound public finances and economic stability, public investment contributes to the provision of high quality public services and can help to raise the overall productive potential of the economy. The 2002 Spending Review set new plans to increase public sector net investment in the UK to 2 per cent of GDP by 2005-06 – a five-fold increase compared to 1997–98 – while meeting the fiscal rules and maintaining low levels of debt.**

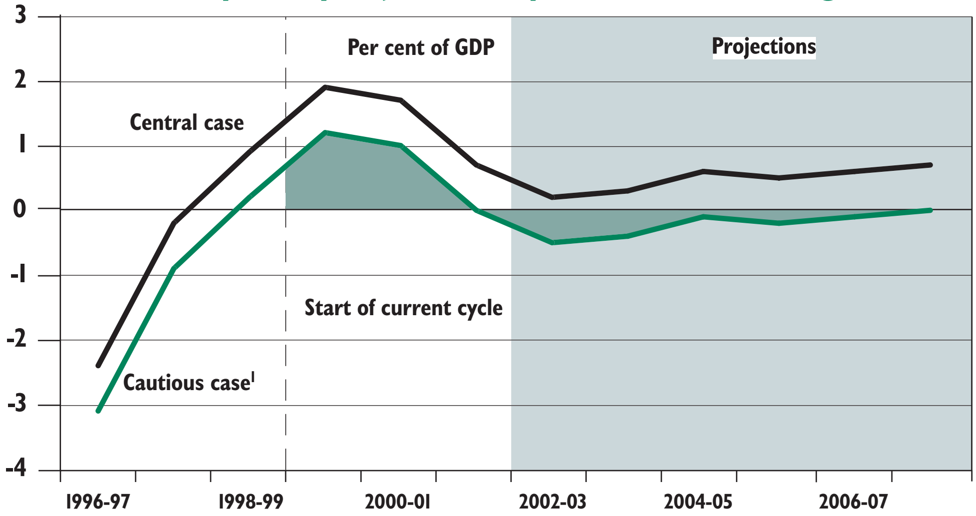
A prudent interpretation of the Pact will lock in longer-term fiscal discipline and sustainability, enhancing credibility, while allowing the automatic stabilisers to smooth fluctuations in output, and enabling appropriate increases in investment in public services.

Dealing with uncertainty

2.62 Fiscal balances represent the difference between two large aggregates, and forecasts of them are inevitably subject to wide margins of error. The use of cautious assumptions audited by the NAO builds an allowance into the public finance projections to guard against unexpected events. To accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term, the Government bases its public finance projections on a trend growth assumption that is $^1/_4$ percentage point lower than its neutral view.

2.63 A second important source of potential error results from misjudging the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. This margin for error is particularly important given continued global uncertainties and risks to the forecast. Chart 2.5 illustrates the Pre-Budget Report projection for this cautious case.

Chart 2.5: Cyclically-adjusted surplus on current budget



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

2.64 The chart shows that the cyclically-adjusted current budget in the cautious case was in strong surplus in 1999-2000, the provisional start of the current economic cycle, and in 2000-01. It is projected to move into moderate deficit before returning to balance towards the end of the forecast period. The average cyclically-adjusted current budget since the start of the present cycle is also in surplus in the cautious case, meeting the 'stress test' of the golden rule. The Government is therefore on track to meet the golden rule over the economic cycle, including in the cautious case.

LONG-TERM FISCAL SUSTAINABILITY

2.65 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.*

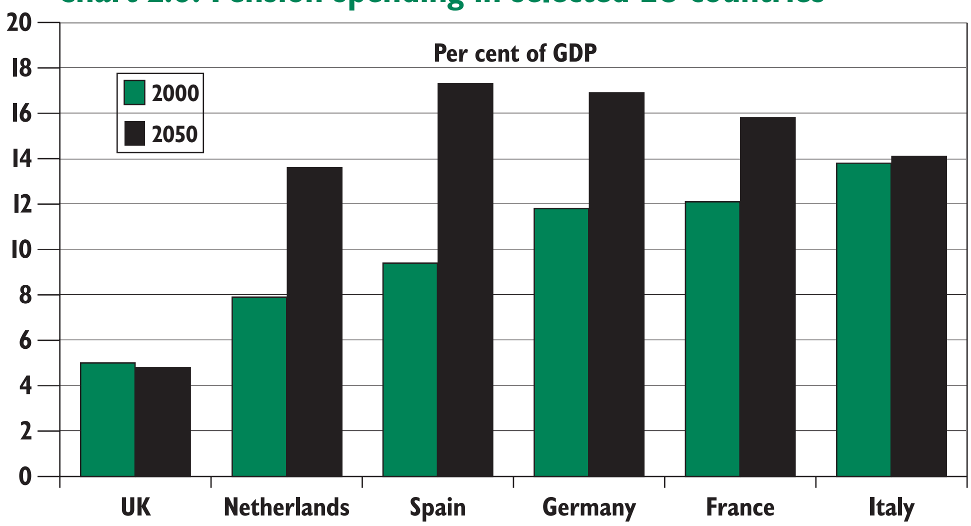
2.66 **A new analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report**[7]. The report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances. It updates the illustrative long-term fiscal projections set out in Budget 2002[8] and confirms the findings of the Budget projections.

[7] *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, November 2002.
[8] *Illustrative long-term fiscal projections*, Annex A of the Economic and Fiscal Strategy Report, Budget 2002.

2.67 Based on reasonable assumptions, the report shows that the public finances are sustainable in the longer term, and that current policies impact fairly between generations. Given the projected profiles for tax revenues and transfers, current consumption can grow slightly faster than GDP growth in the long term while still meeting the golden rule. Public sector net investment can grow close to the economy's growth rate over the 30-year projection period without jeopardising the sustainable investment rule, and the net debt to GDP ratio is projected to remain below 40 per cent.

2.68 The report also shows that the changing demographic structure of the UK's population is expected to have only a limited impact on the public finances over the coming decades. This is in contrast with many other developed countries, in which spending pressures arising from an ageing population are much greater. Chart 2.6 illustrates that, on the assumption of unchanged policies, UK public spending on pensions is projected to remain fairly constant as a proportion of GDP, in contrast to the substantial increases expected in many other EU countries.

Chart 2.6: Pension spending in selected EU countries



Note: UK figures are taken from Chart 6.5 of the Long-term public finances report *and are for 2001-02 and 2051-52 respectively.*
Sources: Table 3.5, EPC Working Group on Ageing (2001) and HM Treasury.

2.69 The report presents a series of additional indicators, including generational accounts, fiscal gaps and projections of spending on education, pensions, health and long-term care – together, about half of all public spending. These indicators confirm the overall result that that UK fiscal position is sustainable in the long term and that the UK is in a strong position relative to many other developed countries. They also demonstrate that there is a high degree of inter-generational fairness, particularly when account is taken of announced increases in public investment which will benefit both current and future generations.

3 MEETING THE PRODUCTIVITY CHALLENGE

Productivity is a key determinant of economic performance and living standards. The Government's long-term goal is that Britain will achieve a faster rate of productivity growth than its main competitors, closing the productivity gap.

The Enterprise Act gives full independence to the UK competition authorities and a new proactive role for the Office of Fair Trading to keep markets under review, strengthening the competition regime and seeking to bring down barriers to enterprise. The Pre-Budget Report sets out the further steps the Government is now taking to support the drivers of productivity growth, including:

- **the creation of 2,000 Enterprise Areas** in the most deprived parts of the UK, with extra support to help businesses start up, develop and grow;
- **a review of how business can better draw on the resources available in UK universities and a new DTI review of innovation**, to improve the UK's comparative innovation perfomance;
- **a new strategy to promote enterprise learning throughout the school and further education systems**, in line with the recommendations of the Davies Review of enterprise in education;
- **a new target to increase the participation of young people post-16 in full-time education and training**, including vocational programmes such as Modern Apprenticeships;
- **a new employer-led taskforce to support the expansion and improvement of Modern Apprenticeships** and other work-based training programmes;
- **£130 million to fund a second year of extended Employer Training Pilots** to continue to test new measures to improve access to training for low-skilled adults in the workforce;
- **extension of the Highly Skilled Migrant Programme**, and changes to the criteria to make the scheme a more effective source of highly skilled labour for the UK economy; and
- further work to establish a modern and competitive business tax system, through **simplified corporation tax rules for employee share schemes and further consultation on wider reform of corporation tax.**

THE PRODUCTIVITY CHALLENGE

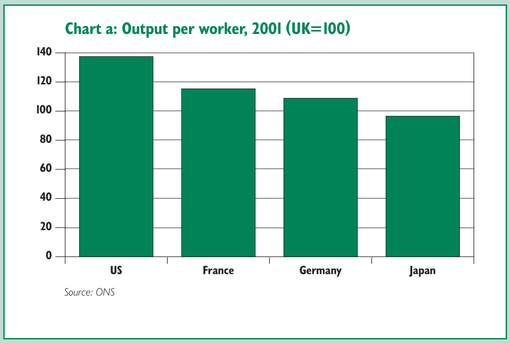
3.1 Productivity growth, alongside high and stable levels of employment, is an important determinant of long-term economic performance and rising living standards. Increasing the sustainable rate of UK productivity growth is central to the Government's economic strategy.

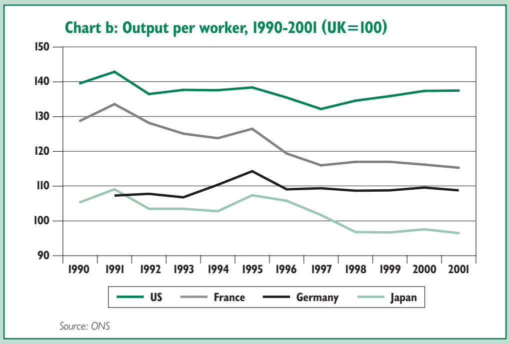
3.2 The UK has historically experienced low rates of productivity growth by international standards. Macroeconomic instability and microeconomic failures have inhibited competition, enterprise and innovation, and discouraged firms and individuals from long-term investment in human and capital resources. If the economy is to continue to deliver growing prosperity in a global marketplace for business, investment and skills, it is essential that faster productivity growth is achieved.

Box 3.1: The productivity challenge

Productivity is a measure of how effectively the economy uses resources to generate economic outputs. The Government's central measure of productivity is output per worker, a measure that is both relatively straightforward to quantify and is directly related to the Government's objective of raising the economy's trend rate of growth.

Chart (a) shows that, on this measure, US productivity is around 38 per cent higher than that in the UK, while productivity in France and Germany is 15 and 9 per cent higher respectively. Measured in terms of output per hour, the US and France both register 29 per cent higher productivity than the UK, while the gap with Germany is 27 per cent.





International comparisons of productivity should be made over the long term. Chart (b) shows that over the last ten years the gap relative to France has narrowed significantly, while that with the Japanese economy has closed altogether. However, this pattern is not repeated in comparisons with the US or German economies. Indeed, the productivity gap with the US has widened in recent years.

The Government's approach

3.3 The Government is pursuing a wide-ranging strategy to tackle the barriers to productivity growth and close the productivity gap. Macroeconomic stability is helping businesses, individuals and the Government plan effectively for the long term, improving the quantity and quality of investment in physical and human capital. Microeconomic reform aims to remove barriers that prevent markets from functioning efficiently, allowing firms and workers to maximise their productive potential. The Government's programme of microeconomic reform targets historic weaknesses in five key drivers of productivity performance:

- strengthening the **competition** regime, to encourage firms to innovate and minimise costs, and to deliver better quality goods and services to customers;
- promoting **enterprise**, to help new and established businesses start up, develop and grow;
- supporting **science and innovation**, to utilise the potential of new technologies and to develop more efficient ways of working;
- improving **skills**, through better education for young people and greater training opportunities for those already in the workforce; and
- encouraging **investment** to improve the stock of physical capital in all sectors and industries.

Long-term challenges

3.4 This agenda presents some major long-term challenges that the Government will continue to address going forward:

- a critical productivity issue for the UK is to raise the performance of the weakest regions[1]. The productivity gap between the richest and poorest regions in the UK is large - over 30 per cent in 1999 - and has been remarkably persistent, with evidence suggesting that existing patterns of regional activity emerged during the 1920s;
- while policy is seeking to strengthen the enterprise culture across all UK regions, the proportion of the workforce involved in new businesses is almost twice as high in the US as it is in the UK. The long-term challenge is to raise new business creation throughout Britain and to provide opportunities for those in all regions to participate in enterprise;
- innovation is at the heart of productivity growth and social gain, and yet business expenditure on research and development (R&D) in the UK is lower than in other competitor countries, while investment in universities' capital infrastructure has historically failed to keep pace with research spending. Successful implementation of the Government's science strategy[2] is key to realising the UK's innovation potential;
- the flow of skills into the workforce has seen improvements as the performance of the school system has got better. However, the effect on the stock of adult skills is slow. A third of the workforce do not have level 2 skills (equivalent to five good GCSEs) and seven million adults lack basic literacy or numeracy. New ways of working with trade unions and employers, which go with the grain of their business needs, are required to address this;
- high quality infrastructure is a prerequisite for a developed economy that supports a competitive business environment and a productive workforce. UK workers commute furthest and face the most congestion in the EU, and there is a strong economic case for additional airport capacity to meet growing demand. There are also serious imbalances between the supply and demand of housing across the UK, with the lowest rate of house building since 1929;
- strong management performance in business is a key determinant of productivity[3]. The CBI-TUC Best Practice working group stated that although there are many examples of successful UK companies that have inspiring leaders and very able managers, evidence suggests strongly that in relation to leadership and management too many UK companies fall short of world class performance; and
- the UK must continue to learn from experience elsewhere. For instance, some US business sectors have experienced dramatic productivity gains in recent years driven by dynamic processes of competition and innovation[4]. It is important to learn from these experiences and to ensure that the lessons for the UK business environment are clearly understood.

[1] *Productivity in the UK: 3 - the regional dimension*, HM Treasury and the Department of Trade and Industry, November 2001.

[2] *Investing in innovation: a strategy for science, engineering and technology,* Department of Trade and Industry, HM Treasury and the Department for Education and Skills, July 2002.

[3] *Reviving UK manufacturing,* McKinsey & Company, October 2002; *Leadership: the challenge for all*, Institute of Management, December 2001; *Catching up with Uncle Sam,* EEF, December 2001; *Lessons from Uncle Sam*, EEF, March 2001.

[4] *US productivity growth 1995-2000,* McKinsey Global Institute, October 2001. For example, the retail and wholesale sectors together contributed more than half of the 1.33 percentage point acceleration in US productivity in the period 1995-99 compared with 1987-95.

Public sector productivity

3.5 As well as creating the right environment for improved productivity in the private sector, the Government is also striving for greater efficiency in the public sector. Increased public service productivity lays the foundations for a more productive economy. Improved education, health and transport infrastructure can help to raise private sector performance by producing a healthier, better skilled and more mobile labour force. Chapter 6 describes the Government's approach to reforming public service delivery in detail.

CBI-TUC productivity campaign

3.6 Improving the UK's productivity performance requires action by employers, employees and the Government. The CBI-TUC Productivity Group has an important role in monitoring progress against a range of productivity drivers and identifying the practical steps that all groups can take to raise productivity. Measures in this Pre-Budget Report build on the CBI and TUC recommendations for joint action to address basic and intermediate skills shortages in the UK and to strengthen the UK's innovation performance.

Productivity across the regions

3.7 The Government is committed to ensuring that the benefits of improved productivity are spread throughout the country, and has established a new Public Service Agreement target to reduce the persistent gap in growth rates between the regions over the long term, while delivering sustainable improvements in the economic performance of all English regions.

3.8 Measures to raise productivity should often be focused at the regional or sub-regional level[5]. The Regional Development Agencies (RDAs) act as strategic leaders of economic development and regeneration in the regions, and are central to the Government's productivity strategy. A new, more flexible system of RDA funding was introduced in April 2002 to improve their ability to respond to regional productivity challenges. The 2002 Spending Review increased overall RDA funding to £2 billion by 2005-06, and gave the Agencies new responsibilities for regional tourism promotion and transport and consultative roles for housing and planning.

3.9 From April 2003, **two pilot schemes will be launched giving RDAs in selected regions a wider role in driving forward economic development**. The schemes will last initially for two years and involve:

- improvements to the delivery, effectiveness and coordination of business support management at the regional level, including through RDA-led management and coordination of Business Link Operators; and
- RDA co-management, with the Learning and Skills Council, of funding for post-19 training. These pilots will bring together the different sources of funding for post-19 skills at the regional level, delivering a more effective match of skills demand and supply, and allowing a closer alignment of regional skills funding with Frameworks for Regional Employment and Skills Action.

3.10 The Government has invited RDAs in the East and West Midlands to develop proposals for the business support pilots, and those in the North East, East and South East to develop the skills pilots. The Government has also invited the Northwest Development Agency to develop arrangements for the piloting of both business support services and co-management of post-19 skills funding in this region, to exploit the synergies between the two areas of activity.

3.11 To benefit from the regional perspective that RDAs can add to the development of central government policy, the Treasury has asked the Agencies to provide advice on policy relating to enterprise, innovation, regulatory reform and skills, in preparation for Budget 2003.

[5] *Productivity in the UK: 3 - the regional dimension*, HM Treasury and the Department of Trade and Industry, November 2001.

3.12 Just as it seeks to raise domestic productivity, so the Government is also working to promote economic reform and productivity growth in Europe.

European economic reform

3.13 In March 2002, the Barcelona Council gave renewed impetus to an ambitious agenda of reform, approving new commitments to liberalise non-domestic energy markets, complete the single market in financial services, boost levels of R&D and reduce regulatory burdens on business. Economic reform in Europe holds the potential to strengthen the drivers of UK productivity and the Government is committed to promoting change, building on the progress made in Barcelona. The Government's White Paper on economic reform[6] describes the next steps in this process, including:

- further reform of labour markets to meet EU employment targets and establish employment opportunity for all;
- less and better-targeted state aid;
- continued improvement of the EU's competition regime;
- work to deliver a genuine single market in services, including financial services, as well as in manufacturing; and
- the full opening up of gas, electricity and telecoms markets.

3.14 The Government will report on developments since the White Paper in a progress report early in the new year.

COMPETITION

3.15 Competition is among the key drivers of productivity performance. Open and competitive markets encourage firms to innovate and strive for greater efficiency. They also provide incentives for firms to reduce costs and prices and to enhance quality and choice in the goods and services they deliver, ensuring that consumers receive the best possible deal.

The competition regime

3.16 The Government has taken important steps to strengthen the UK competition regime. The Enterprise Act grants full independence to the UK competition authorities and gives the Office of Fair Trading (OFT) a clear proactive role to keep markets under review. It improves the mergers regime, introduces a new regime for market investigations and allows for criminal sanctions to be imposed on those engaging in hard core cartels. The new provisions will come into effect in spring 2003 and have been matched with substantial increases in resources for the competition authorities. Together, the changes will increase the competitive intensity of the UK economy and bring down barriers to enterprise and innovation.

Consumers

3.17 Active consumers are central to the competitive process and are an important driver of productivity at the firm level. Just as a vigorous competition regime is the best way to ensure that consumers receive a good deal, so an empowered, active consumer population is the best way to ensure that poorly performing firms improve or leave the marketplace, and that the best firms are rewarded.

[6] *Realising Europe's potential: economic reform in Europe*, HM Treasury, February 2002.

3.18 The Government wants to see empowered consumers at the heart of the competition regime, and is committed to ensuring they have the skills and information needed to perform an effective role. A new national telephone consumer help-line, *Consumer Direct*, is being developed with £30 million of Government funding, and there is ongoing work to enhance the public information and education resources provided by the Trading Standards Departments, the OFT and various consumer bodies. **The Government is also carrying out a major consumer study to assess the current state of the UK and other regimes**, and to lay the foundations for future policy development.

Promoting competition in specific markets

3.19 The OFT has already successfully promoted competition in a number of markets. Last year, an OFT court action against the practice of setting minimum prices for branded medicines led major retailers to reduce prices on leading brands by between 25 and 50 per cent. The OFT's first completed market investigation into extended warranties for electrical goods found that competition was not working effectively and that consumers lacked adequate information. The Competition Commission will now consider remedies and report on this matter in summer 2003. The OFT is also investigating consumer IT services and estate agencies and, in response to super-complaints brought by consumers' associations, has launched new investigations into doorstep selling and the market for private dentistry.

The professions

3.20 Following the OFT's report into competition in the professions, the Lord Chancellor's Department (LCD) began consulting in July 2002 on matters falling to the Government, including conveyancing and probate, the multi-disciplinary environment for solicitors, legal professional privilege and the Queen's Counsel system. The LCD will report on the consultation in the spring. The Government is also reviewing the framework for regulating legal services with the aim of ensuring that the regulatory regime supports a dynamic and competitive market with appropriate levels of consumer protection.

Small business banking

3.21 Since the Competition Commission's report into the small- and medium-sized enterprise (SME) banking market, the eight largest banks have agreed to a number of steps designed to increase transparency and make it easier for small businesses to switch their accounts. As these measures will take time to improve competition in the market, the Competition Commission has also recommended that the four largest banks offer all their SME customers in England and Wales the option of receiving interest on their current accounts or an account free of money transmission charges. The banks have agreed to implement this by 1 January 2003.

Payment systems

3.22 **The OFT have decided to conduct an empirical study into recent payment system developments, starting early in 2003**. The Government is closely monitoring developments and will introduce legislation to give the OFT new powers to promote effective competition in payment systems as soon as parliamentary time allows. In the meantime, the Government welcomes moves by payment system participants to address the competition issues identified by the Cruickshank report, *Competition in UK Banking*, and urges the industry to continue with these reforms.

New cars

3.23 A major pro-competition reform of the new cars market was achieved in July, with the announcement of a new European Commission cars block exemption. The new rules will take effect from October 2003 and allow dealers to market their services freely across the EU and to sell multiple brands of car through their showrooms. Internet retailers will also find it easier to cooperate with dealers and individuals who wish to import cars, and the after-sales market will be opened to greater competition.

The European trademark regime

3.24 The Government is committed to reforming the European trademark regime to give business greater freedom to source goods from low price markets. By allowing brand owners to prevent the import of products marketed outside the European Economic Area, the current regime confers market power upon brand owners, preventing parallel importers from providing a competitive constraint on their pricing behaviour.

The water industry

3.25 The Government proposes to extend competition for non-household consumers using large quantities of water. These proposals form the basis of a new framework to be implemented through the forthcoming Water Bill.

Energy

3.26 Liberalisation of energy markets has delivered lower prices for consumers. Electricity and gas prices fell by 15 per cent between 1997 and 2001, saving consumers around £3 billion. Increased competition has also reduced the need for regulation, and price controls were removed from domestic gas and electricity supply in April 2002. The Government's Energy Policy White Paper will be published early next year, and will set out the next steps for secure and sustainable energy over the long term, building on the benefits of competitive and liberalised energy markets.

3.27 The Government's existing credit facility for British Energy of £650 million will expire on 29 November 2002. The Secretary of State for Trade and Industry will therefore make an announcement about the outcome of the Government's discussions with the company shortly. The Government expects the loan facility to be managed within the planned totals for Departmental Expenditure Limits and the financial implications of any restructuring to be consistent with the forecast of the public finances and performance against the fiscal rules published in this Pre-Budget Report.

Regulatory reform

3.28 Whereas effective and well-focused regulation can help to correct market failures, promote fairness and ensure public safety, unnecessary or poorly enforced regulation can restrict competition, stifle innovation and deter investment. The Government is therefore committed to regulatory reform in the UK and EU.

Competition and regulation

3.29 The Government has empowered the competition authorities to challenge anti-competitive regulations, increase their scrutiny of new and existing regulation and to be as rigorous in assessing the impact of the public sector's commercial activities on competition as they are for the private sector. The OFT is already investigating pharmacies and taxis - markets in which the operation of entry licensing regimes may be restricting competition to the detriment of consumers. The pharmacies report will be published within the next few months and will be the first under the new competition and regulation arrangements. The Government will publish a full response within 90 days of receiving each report from the OFT and, if changes are agreed, will monitor progress every six months. Since October 2001, the OFT has scrutinised and provided competition advice to the Government on more than 100 proposed regulations.

Public sector procurement

3.30 The Government wants to see dynamic competitive markets operating throughout the economy. Strong competition encourages firms to bear down on costs and improve their efficiency, thereby enhancing their competitiveness at home and abroad. In markets where the Government is a major procurer of goods and services, its own actions may greatly influence how the market operates and therefore impact on competition and on the long-term value for money it can secure. So for procurement, ensuring value for money and encouraging strong competition go hand in hand.

3.31 The Government has welcomed the Competition Commission's recent recommendations to improve competition in procurement and has asked **the Office of Government Commerce (OGC) to consider what further steps can be taken to increase competition and encourage better long-term capacity planning in markets where the Government possesses significant purchasing power**. This could include improving advance information for potential suppliers about forthcoming opportunities. The Government has also asked the OGC to build on their recent work to enable SMEs to compete for government contracts and deliver value for money. The OGC will take forward these points in consultation with a working group comprising the Department of Trade and Industry (DTI), the Small Business Service and the Treasury. The OGC will report to the Government in the summer.

Exposing regulations to scrutiny

3.32 To strengthen further existing regulatory procedures, the Cabinet Office will issue revised guidance on Regulatory Impact Assessments later in the year, ensuring that the costs, benefits and risks of proposed regulations are fully considered. This approach is beginning to be applied in Europe, where the European Commission's Action Plan for simplifying and improving the regulatory environment is now being implemented. The Government's Regulatory Reform Action Plan, published in February, sets out 268 deregulatory proposals for reform to be delivered over the next three years. One quarter of these proposals have now been completed.

Liability insurance

3.33 Premiums for Employers' Liability Compulsory Insurance (ELCI) have increased substantially in recent months, affecting many businesses, and especially SMEs in high-risk sectors. Following a request from the Government, the Association of British Insurers (ABI) and trade associations are working to ensure that affordable cover is available. The Government has engaged with a wide range of stakeholders including the CBI, TUC and ABI to discuss the long-term issues affecting ELCI. **The Department for Work and Pensions will now undertake a formal review of the operation of ELCI**. Full details of this review will be announced shortly.

ENTERPRISE

3.34 Enterprise is essential for productivity growth. New and successful businesses increase competitive pressure and facilitate the introduction of new ideas and technologies. There is, however, clear scope to raise levels of enterprise. The proportion of the workforce involved in entrepreneurial activity in the US is nearly twice as high as that in the UK, and business start-up rates in the UK's least enterprising communities are ten times lower than in the best-performing areas.

3.35 The Government's strategy for promoting enterprise is described in *Enterprise Britain: a modern approach to meeting the enterprise challenge*, published alongside this Pre-Budget Report. In addition, the Small Business Service will publish shortly a framework for government policy towards small business, which will also set out its refocused and enhanced role. The Government is committed to:

- building an enterprise society in which people from all backgrounds consider and act upon enterprise opportunities;
- providing extra support to tackle barriers to small business growth in skills, finance and innovation;
- creating a fertile business environment through a modern and competitive business tax system; and
- removing the obstacles to, and raising levels of, enterprise and investment in the UK's most disadvantaged areas.

Creating an enterprise society

3.36 Strengthening the links between education and business is essential to encourage entrepreneurial activity among young people, to transform attitudes and to create an enterprise society.

Davies review of enterprise and education

3.37 In February 2002, Sir Howard Davies, Chairman of the Financial Services Authority (FSA), reported to the Chancellor and the Secretaries of State for Trade and Industry and Education and Skills on the steps needed to promote a better understanding of business, the economy and enterprise throughout the school and further education systems.

3.38 The Government shares and accepts the review's recommendations and its assessment that efforts to build a deeper and wider entrepreneurial culture must begin in schools, and **will ensure that by 2005-06 every secondary school can offer five days' enterprise activity to pupils**, discussing with OFSTED the best way of assessing performance in this area. **The Government will provide £60 million in 2005-06 for this and, in preparation, intends to test a number of approaches through pilot schemes**, allocating £5 million in 2003-04 and £10 million in 2004-05. This investment will be supported by a number of measures, including new guidance for teachers on enterprise learning, along with new teaching materials, and a new national benchmark of enterprise capability among young people.

Supporting small business

Corporation tax and business rates

3.39 To support new and growing businesses, Budget 2002 introduced reforms to reduce the corporation tax bills of over 90 per cent of all taxpaying companies in the UK. In April 2002, the corporation tax starting rate was reduced from 10 per cent to zero and the small companies' rate from 20 to 19 per cent. As a result of these changes around 150,000 small companies no longer pay any corporation tax. The Government is now legislating to reduce business rates for more than half of all small businesses by up to £700 per year.

Simplifying VAT for small businesses

3.40 The Government has also taken steps to allow small and newly-registered businesses to reduce their VAT administration burden, improve their cash flow and manage their entry into the VAT system. Budget 2002 announced the Government's intention to extend eligibility for the optional flat-rate scheme to businesses with a taxable turnover of up to £150,000 from April 2003, and to ensure that more businesses are offered advice and support before they face penalties. A targeted information campaign to raise awareness of the benefits of the VAT flat-rate scheme among eligible businesses is being launched. The Government will also seek views on whether the scheme could be further extended or improved to enhance the benefits to the small business sector.

Improving service delivery

3.41 New entrepreneurs need clear information on the services available to them, what is required of them and where they can access help and advice. The cross-cutting Review of Government Services for Small Business[7] found that some businesses have difficulty accessing basic information on government services and requirements. The Government is committed to addressing this problem through:

- understanding small firms' needs and treating them as customers;
- making it easy for small firms to find advice and support;
- ensuring that information provided to small firms is concise and appropriate to the audience;

[7] Available on the SBS website.

- enforcing rules in a proportionate way, recognising that prevention is better than prosecution;
- better coordinated delivery of related services; and
- actively considering alternatives to regulation.

The role of the Small Business Service

3.42 The Government is also enhancing the role of the Small Business Service (SBS). The SBS has a key role in improving the business environment and removing barriers to enterprise, particularly among disadvantaged groups. The cross-cutting Review identified that a wide range of public sector institutions come into contact with small business, spending some £2.5 billion a year on services for the sector[8], but that they do not always fully recognise the benefits and particular needs of small business. In its enhanced role, the SBS will be the centre of expertise on small business in government, championing their needs and working with the range of government service providers to raise standards.

Advice and communication

3.43 The SBS and others across government intend to take further steps to improve the quality of their interactions with small business by:

- **publishing next spring a new start-up pack**, bringing together information on all government requirements and support for those setting up in business;
- **launching a series of Personal Enterprise Shows** to encourage start-ups and publicise the services and support available for business;
- **making it easier for small business to understand and comply with government regulations through the development of a single web portal**, designed around customer needs, by summer 2003;
- **completing the national manufacturing advisory service networks**, providing free and subsidised advice for all manufacturing businesses; and
- helping central and local government enforcement agencies to follow the agreed priorities of good practice set out in the Enforcement Concordat and to take action to ensure that companies being regulated are aware of these principles.

3.44 The Inland Revenue's *Starting Up In Business* initiative also offers a range of guidance and support to new businesses, and has encouraged start-ups to view the Inland Revenue as a source of advice and assistance. An evaluation of the initiative is published alongside this Pre-Budget Report.

Small business university

3.45 The Government welcomes a proposal from high street banks to provide leadership support for prospective and existing businesses by creating a virtual university for small businesses with ready access to information, advice, support and mentoring through the internet and more specialist training courses.

Improving access to finance

3.46 The Government is also committed to improving access to finance for small business. While macroeconomic stability means that the vast majority of businesses are able to access the finance they need, small businesses with high growth potential still have difficulty raising risk capital, particularly sums of less than £1 million. The Government is therefore taking action to address the funding gap and improve access to finance for new and growing businesses, by:

- launching Regional Venture Capital Funds in every English region, with investment of £270 million. Seven of the nine funds are now running and three have already made their first investments. The remaining two are due to be launched by the end of the financial year;

[8] Excluding agricultural support payments.

- **improving the administration and take-up of the Small Firms Loan Guarantee Scheme**. From April 2003 eligibility for the scheme will be extended to firms in the retail and catering sectors - sectors which make an important contribution to enterprise activity within disadvantaged communities and some ethnic minority groups; and
- providing tailored educational programmes through investment readiness demonstration projects, to help small businesses and intermediaries understand and access different finance options.

Small business accounting

3.47 In July 2000, the Secretary of State for Trade and Industry announced an increase in the turnover threshold for statutory audit of company accounts from £350,000 to £1 million. This allowed a further 150,000 companies to be released from the obligation to undertake an audit. As set out in the July 2002 White Paper, *Modernising company law*, DTI ministers will shortly announce a programme of research to assess the impact of this increase before making decisions on further increases, inviting key stakeholders and other interested parties to contribute their views and experiences. In the light of conclusions drawn from the assessment, **the Government will consult by summer 2003 on whether the audit exemption threshold should be increased or maintained at the current level**.

A modern and competitive business tax system

3.48 To provide stability for business, allow the UK to compete effectively in global markets and ensure that the rewards to successful enterprise are commensurate with the risks that business owners must bear, the Government has introduced significant reforms to the business tax regime, including:

- a reduction in the main rate of corporation tax to 30 per cent;
- a generous capital gains tax (CGT) taper for business assets to encourage investment and entrepreneurial activity, and render the UK regime among the most favourable to enterprise in the world;
- an exemption from corporation tax for gains and losses on most substantial shareholdings in trading companies to ensure that business decisions are driven by commercial rather than tax factors; and
- a new regime for providing tax relief for the costs of intellectual property, goodwill and other intangible assets, to encourage business to take advantage of opportunities in the knowledge-based economy.

Corporation tax

3.49 To maintain and build upon the UK's position as an internationally competitive location for business, and to make further progress in removing tax distortions to business decision-making, the Government has recently consulted on further reform of the corporation tax system. The consultation addressed the tax treatment of capital assets not covered by earlier reforms, rationalisation of the schedular system and the scope for greater alignment between the tax treatment of trading and investment companies. Over 150 written responses have been received and **the Government intends to consult further on the corporation tax regime once these have been analysed in detail**.

3.50 In the meantime, to enable and encourage companies to offer equity remuneration schemes to their employees, **the Government is simplifying the corporation tax rules for employee share schemes**. The new rules provide a statutory corporation tax deduction for the cost of providing shares for employee share schemes, removing existing complexity and duplication in the tax treatment of these schemes. The timing of the deduction will be aligned with the point at which the employee is taxable on the share award and will apply to accounting periods starting from 1 January 2003.

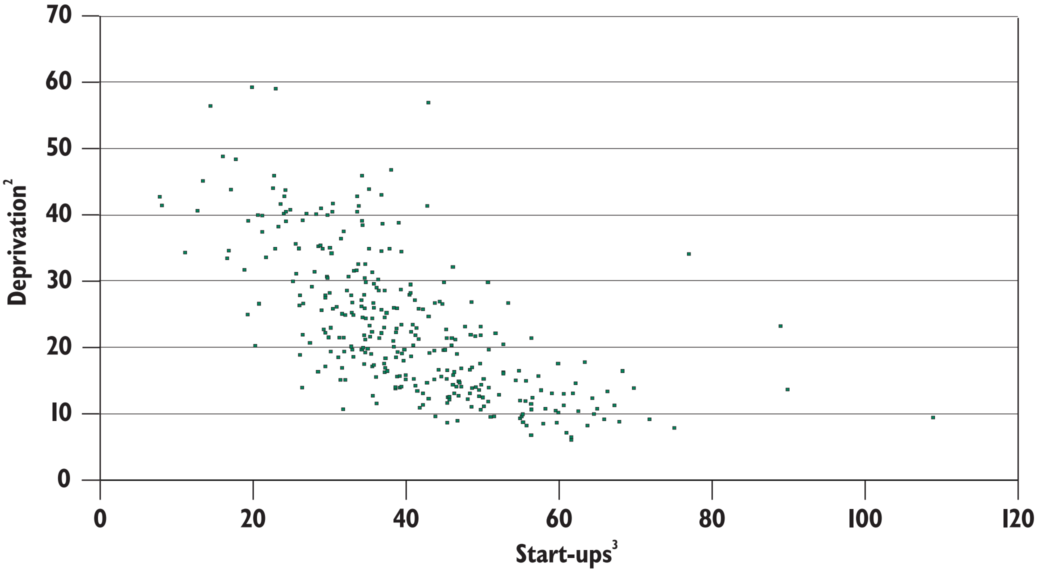
Reducing compliance burdens

3.51 Budget 2002 introduced a series of measures to simplify the tax system and reduce compliance burdens on businesses and investors, including reform of the rules governing withholding tax at source and simplification of the CGT regime. To reduce further compliance burdens on business, **the Government will now consult on options for reform of the Construction Industry Scheme and will continue to consult on simplified VAT rules for imports**. As part of its strategy for encouraging VAT compliance, set out in Chapter 5, the Government will also increase the advice and support it offers to help businesses manage their VAT affairs correctly.

Promoting enterprise in disadvantaged areas

3.52 Levels of enterprise vary dramatically across the UK, with far lower levels of business start-up activity in deprived areas compared with elsewhere. In these areas, enterprise plays a critical role in helping to deliver sustainable neighbourhood renewal. Long-term change in these neighbourhoods depends not only on delivering improvements in public services and to the physical environment, but also on revitalising economic activity, driving up educational standards and building a sound economic base.

Chart 3.1: Business start-ups and deprivation in English local authorities[1]



[1] *Number of VAT registrations per 10,000 adult population during 2001. Source: Small Business Service.*
[2] *Average of ward scores on the Index of Multiple Deprivation. Source: Office of the Deputy Prime Minister.*
[3] *Excluding London boroughs.*

Enterprise Areas

3.53 Local Strategic Partnerships (LSPs) are responsible for coordinating and driving forward neighbourhood renewal on the ground, consistent with the regional economic strategies of the RDAs. The Government is committed to working with LSPs to improve the delivery of key public services in deprived areas and to tackle barriers to enterprise. To this end, **the Government has designated 2,000 Enterprise Areas in which measures to boost enterprise are now being concentrated**. These areas cover the most deprived communities in the UK, which already qualify for stamp duty exemptions. The full range of measures in these areas is set out in *Enterprise Britain*, published alongside this Pre-Budget Report.

3.54 In England, the Government is providing extra support to help businesses in these areas across the full range of their activities. This support is underpinned by a target fot the DTI to promote enterprise in disadvantaged communities, narrowing the gap in business start-up rates between the most deprived and the most affluent wards in the country. However, many elements of business support and enterprise policy are areas of devolved responsibility and the devolved administrations will pursue their own policies, including to increase the supply of equity finance to small businesses in their countries.

3.55 In addition to this support, **the Government will consult on a proposal to allow local authorities to retain some or all of the increases in business rates revenue as a result of economic growth in their area**. Such a scheme would provide incentives for local authorities to encourage enterprise and growth throughout the country, including in the 2,000 Enterprise Areas. Chapter 7 provides further details of this proposal.

Starting and growing a business

3.56 To reduce the costs to business of investing in deprived areas, the Government has exempted from stamp duty all property transactions up to £150,000 in the 2,000 Enterprise Areas and **will exempt all commercial property transactions in these areas from stamp duty**, irrespective of value. The Government is now actively seeking EU state aids clearance for this measure. As described in Chapter 7, **the Government will also introduce a new tax incentive to encourage donations toward the running costs of Urban Regeneration Companies** that support regeneration strategies in urban areas, including some of the 2,000 Enterprise Areas.

3.57 Business incubators nurture start-ups and early stage SMEs, and have been shown to enhance the chances of their survival and growth. In addition to providing loans for business incubator projects, **the Business Incubation Fund will now offer grants to cover the costs of feasibility studies to increase the number of quality incubator proposals, with extra funding for deprived areas**. In the most deprived wards in England, including the Enterprise Areas, grants of up to £30,000 covering 70 per cent of the cost of a feasibility study will be available. In other areas, up to £20,000 will be available to cover 50 per cent of the cost of the study.

3.58 The Government is also taking steps to reduce red tape for growing businesses and **intends to give local authorities new powers to create Business Planning Zones (BPZs)** in which there will be no requirement to apply for planning permission where predetermined criteria are met. The Government wishes to encourage the widespread adoption of BPZs, and will expect local authorities, RDAs and Regional Planning Bodies to give active consideration to the potential for BPZs in their region. Where they do not, the Government will have powers to direct local authorities to establish BPZs. BPZs may be attractive to local authorities as a means of stimulating economic activity in Enterprise Areas. The rules for BPZs will ensure that development is of high quality and low environmental impact. The Government is also considering an intermediate package of planning flexibilities for Enterprise Areas where a BPZ is not felt to be appropriate.

3.59 To support small businesses in deprived areas, and to encourage entrepreneurial activity among women and ethnic minorities, the 2002 Spending Review allocated a further £50 million to the Phoenix Fund. This is in addition to the £96 million already invested in the Fund, which supports organisations that promote enterprise in disadvantaged communities. The Government is also supporting the Inner City 100 index which provides entrepreneurial role models for those living in deprived urban areas.

Trading and employing

3.60 Small businesses in deprived areas benefit from a wide range of support, including rates relief, payroll incentives and the flat-rate VAT scheme. In recognition of the higher barriers to enterprise in deprived areas, **the SBS will include in its new start-up pack information tailored to the needs of firms in Enterprise Areas. The Inland Revenue will also provide firms in these areas with a special package of targeted support**, including help and advice on payroll requirements and extra assistance from Business Support Teams. Over the next few months, **HM Customs and Excise will work with the SBS and others to examine how their support services for businesses, in particular with regard to VAT, can be enhanced and targeted more effectively in disadvantaged areas**.

Box 3.2: Encouraging development in Enterprise Areas

As it may not be appropriate to establish the full flexibility of BPZs in all Enterprise Areas, the Government is considering the feasibility of a number of additional measures for these areas, including:

- modifying the planning application and building regulations fees regimes to make special arrangements for developers in Enterprise Areas to take account of the effect that fees, even for minor development such as changes of use, can have on expansion;
- better targeting, from 2004-05 onwards, of the Government's new resources for planning authorities to ensure that developers in Enterprise Areas get an improved service;
- using the Best Value regime to ensure that developers in Enterprise Areas get an improved service;
- requiring local planning authorities to draw up Action Area Plans for development within Enterprise Areas as part of the Local Development Framework. This would ensure that developers have a clear understanding of planning requirements; and
- encouraging local authorities to introduce Local Development Orders to relax planning control in Enterprise Areas, as part of their Action Area Plans.

The Government will also consult, as part of its review of Planning Policy Guidance Note 4 (Commercial and Industrial Development and Small Firms), on whether a 'sequential approach' for business development in favour of Enterprise Areas should be introduced.

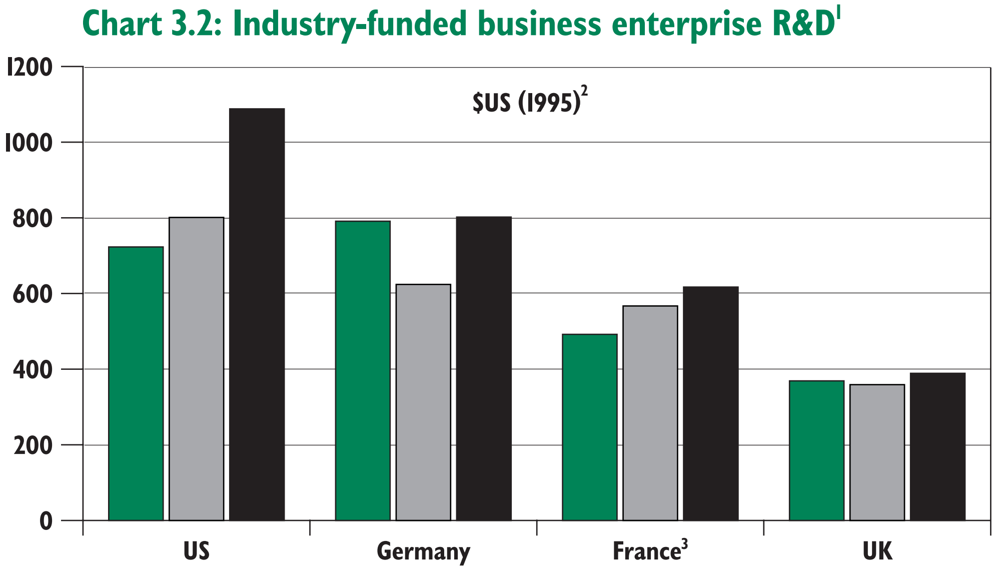
Investing

3.61 To promote private investment in enterprises in disadvantaged communities, the Government has legislated to implement the Community Investment Tax Credit (CITC) and has published a draft prospectus for organisations wishing to gain accreditation. State aids approval has now been obtained and the SBS will allocate the first round of tax credits under the CITC by the end of 2002-03.

3.62 In May 2002, the Chancellor launched the Bridges Community Development Venture Fund to boost the provision of risk finance for firms operating in disadvantaged areas in England. The £40 million Fund is a matched funding partnership between government and the venture capital industry. The Government and private sector investors have both committed £20 million and the Fund is now actively seeking investment opportunities in deprived areas.

SCIENCE AND INNOVATION

3.63 Innovation is a key catalyst for productivity growth. New ideas, products, services and technologies can open up markets and opportunities for firms, generating significant productivity gains and helping to deliver a better deal for consumers. The strength of the science base, the level of business investment in R&D and other aspects of innovation, and the degree of knowledge transfer from universities to business are key elements of market-driven innovation. By international standards, levels of innovation in the UK have historically been low.



Source: OECD
[1] Real expenditure per worker
[2] US dollars, at 1995 prices and purchasing power parities.
[3] 1999 data used for France.

Supporting science and research

3.64 The UK science base needs to compete in a global market for science and research. The Government is committed to supporting the science base to ensure that the UK retains its tradition of scientific excellence and has a good supply of new ideas and skilled people. Details of the Government's strategy for supporting UK science were set out in *Investing in Innovation*, published in July. The strategy builds on the recommendations of Sir Gareth Roberts' review of the supply of scientists and engineers[9], and on the conclusions of the Government's cross-cutting Review of Science and Research in the UK. It focuses on:

- investing in the UK's science base, upgrading capital infrastructure and increasing research funding;
- moving the funding of university research onto a financially sustainable footing;
- improving the supply of people with science and engineering skills, and increasing the attractiveness of science and engineering careers in both business and universities; and
- encouraging the translation of research into business innovation, through the new Higher Education Innovation Fund (HEIF) and the R&D tax credits for small and larger companies.

3.65 To support implementation of this strategy, the 2002 Spending Review announced the largest sustained increase in the science budget for more than a decade. Overall science spending will increase by around £1.25 billion by 2005-06 compared with 2002-03.

[9] *SET for success: the supply of people with science and mathematics skills*, April 2002.

UK science base

3.66 These resources will help to fund a comprehensive new approach to boosting the UK science base, including:

- increasing the funds earmarked for capital investment and improved infrastructure in higher education to £500 million a year by 2004-05;
- establishing principles for the relative roles of government, business and charities in funding science and engineering research;
- increasing by £244 million a year by 2005-06 government funding for university research departments through the Higher Education Funding Council for England;
- adding £300 million a year to Research Council funding by 2005-06, with an additional £120 million to enhance the contribution of this funding stream to universities' research infrastructure;
- providing extra funds for schools to improve their laboratories and attract more science teachers;
- establishing a National Centre for Excellence in Science Teaching, co-funded with the Wellcome Trust, to provide continuing professional development for science teachers, as well as programmes to bring university science students into schools to support science teaching; and
- improving the career paths for academic scientists, including better training for PhD and post-doctoral researchers, improved pay, an increase in minimum PhD stipends for Research Council students, increased pay flexibility in high-demand subjects and funds to improve teaching laboratories.

Business-university collaboration

3.67 Strong business innovators naturally draw on the knowledge and skills in UK universities to further their own growth, and some UK universities are playing an increasing role as the knowledge hub of their regional economy, as the major US universities do. As the Government increases public investment in the UK's science and engineering research base, there is a major opportunity for business in the UK to reap far greater benefits from universities' research and teaching outputs. However, to be effective in boosting UK innovation, increased supply of technological knowledge and skills must be matched by stronger demand and capabilities from within business in the UK to draw on and exploit this resource produced by universities. There needs to be better dialogue and interaction between the two sectors, with a stronger pull from business and more responsive supply from universities.

3.68 To identify how this might best occur and to draw on the widest possible international practice, **the Government is commissioning an independent review into how, over the coming decade, business can better draw on universities to the mutual advantage of both sectors**. The aim is to enable business-university interaction in the UK to provide a greater contribution to UK productivity growth and innovation performance.

3.69 The review will consult widely with businesses, universities and national and regional administrations in the UK and overseas. The aim of the review will be to identify the benefits to business of greater interaction with higher education, how this can be promoted and how any barriers holding back business demand for universities' knowledge and skills outputs can be addressed. The review will examine a range of important issues, including:

- the national, regional and local economic impacts of business-university interactions, including how RDAs and Sector Skills Councils can best support such interactions;
- lessons to be learned from business-university interaction across a range of countries and from best practice in the UK;
- how business employers can better communicate to a responsive university sector their skills requirements and can improve the attractiveness of career paths to graduates and postgraduates, especially in technology; and
- the effectiveness of measures, such as the R&D tax credits, on business demand for research and skills.

3.70 The review will report by summer 2003, to inform decisions on funding for business support, university research and knowledge transfer over the coming decade. It will build on the Higher Education Strategy which the Department for Education and Skills (DfES) is launching in January 2003, and will feed into the work of the DTI Innovation Review.

DTI Innovation Review

3.71 Building on the Government's science strategy and the growing level of resources for DTI innovation programmes, **the Government is launching a wide-ranging review of business innovation and its contribution to UK productivity growth**. The review, led by the Science and Innovation Minister working across Government with the DTI, the Office of Science and Technology, the Treasury and other stakeholders, will set out a clear strategy for improving the UK's comparative innovation performance. The review will report by summer 2003.

Knowledge transfer

3.72 Improved knowledge transfer is a key element of the Government's strategy for supporting science and research, and is starting to deliver stronger business-university collaboration. Funding for the HEIF will rise to £90 million by 2005-06, and the Fund will form the basis of a third permanent funding stream for universities, in addition to teaching and research. The HEIF will work with the RDAs to encourage links between universities and business, support universities in transferring knowledge into business and the community, and fund spin-out companies and the development of commercial enterprises to support knowledge transfer. The Government has also increased funding for other DTI knowledge transfer activities to £300 million by 2005-06.

Research and development tax credits

3.73 To encourage commercial R&D in the UK, the Government has introduced two new tax credits for small and large companies. A series of national roadshows has promoted take-up of the credits and the Inland Revenue is now preparing guidance for companies on how to utilise them. In its first year, the Government invested £80 million in R&D through the small companies' tax credit and take-up has continued to rise. The Government hopes that larger companies will follow suit, and **will continue to collaborate with business in developing guidance for the credits and considering options for changes to improve their operation**.

Scientific Research Organisations

3.74 **The Government also intends to consult on options to modernise the tax exemption for Scientific Research Organisations (SROs)**. SROs are privately funded, not-for-profit organisations that promote technology transfer and innovation within industry. The Government believes that there may be a case for improving the existing tax rules to allow SROs to undertake a wider range of R&D activity beyond scientific research while remaining within the conditions for exemption from tax.

Box 3.3: Commercialisation of science and technology research

Technology transfer between the public and private sectors operates through many channels, including collaborative research, training, licensing of intellectual property and the creation of spin-off companies. To enhance public sector support for the creation of spin-off companies, the Government has funded the creation of 15 University Challenge Seed Capital Funds, along with the Wellcome Trust and the Gatsby Foundation. These provide a total of £65 million of initial investment capital to which 31 universities and 7 Research Council institutes have access. The programme has been recently expanded, with 19 Seed Funds now involving 57 institutions across England. The Proof-of-Concept Fund in Scotland and the Wales Spinout Programme operate to achieve similar goals.

This investment is now starting to bear fruit. By its third year of operation, the University Challenge programme had helped to finance the creation of 150 spin-off companies. Initial investment of £30 million by the Funds has attracted an additional £40 million from private sector sources. The best performing universities are now establishing a strong record in commercialising research through company formation, leading to growing portfolios of equity holdings in technology companies. Universities hold some £180 million of equity in spin-off companies, the total market value of which is now around £3 billion[1].

[1] *Annual UNICO-NUBS Survey on University Commercialisation Activities, financial year 2001.*

Broadband

3.75 The Government's goal is that the UK should have the most extensive and competitive broadband market in the G7 by 2005, with significantly increased connections to schools, libraries, further education colleges and universities. Take-up of broadband in the UK is growing substantially, the number of broadband subscribers having trebled since the beginning of the year. One million households and businesses are now connected and prices for consumers are as cheap or cheaper than those in the US, Germany and France.

3.76 The continuing broadband challenge is primarily one for the industry, the role of government being to set the right framework for the market, above all by promoting competition and providing appropriate regulation to tackle significant market power. Government also has important, but tightly defined, roles as a purchaser for public services and as a source of assistance to help firms and other users make the most of new technology. The Government is investing in networking public services, with connectivity for schools, the National Health Service and the criminal justice system. A new UK broadband taskforce will focus on promoting broadband availability and take-up, and will support effective public sector broadband procurement.

Managing the radio spectrum

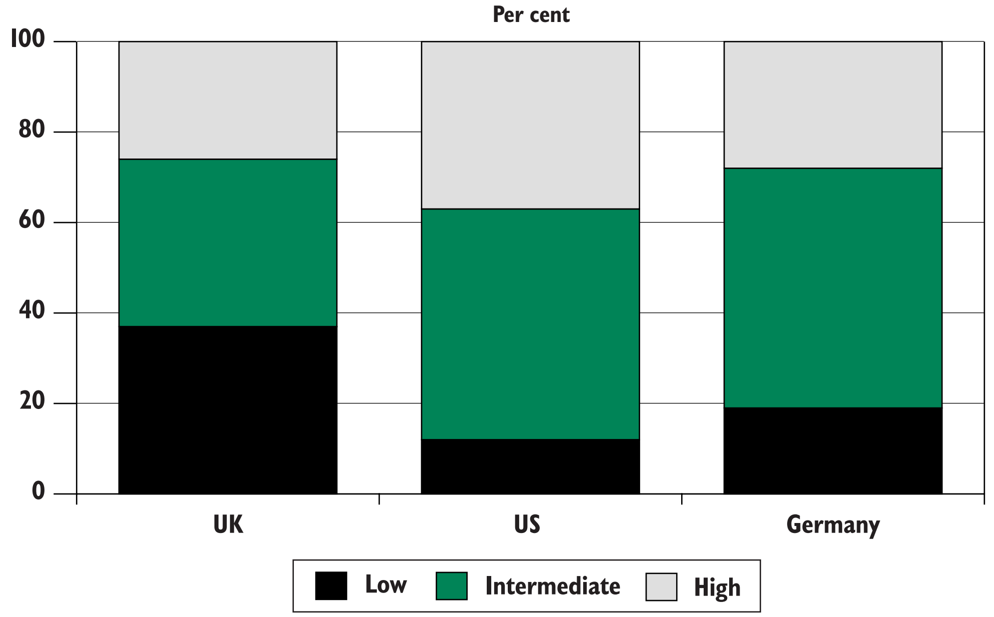
3.77 Radio spectrum is a valuable national asset of growing economic importance. However, new technologies and services are increasing the demands on this finite resource. The Government has taken steps in recent years to improve the management regime, increasing its responsiveness to market developments and establishing incentives for innovation and efficient spectrum use. The Communications Bill will build on this work, bringing responsibility for spectrum management within the remit of the Office of Communications (Ofcom) and introducing secondary trading of spectrum licences.

3.78 The Government published its response to Professor Martin Cave's independent review of spectrum management on 15 October. The review recommended that all spectrum users should face incentives to promote efficiency and innovation by being exposed to the value of the asset under their control, and that this could be achieved through greater use of market-based mechanisms such as auctions, trading and pricing. The Government welcomes the conclusions of the review and is committed to implementing its recommendations. It agrees with the review that in some cases – for example, where spectrum is needed to provide essential public services – applying the full range of market-based mechanisms may not be practical or desirable. In such instances, the Government believes that pricing and charging can ensure that public sector users face similar incentives for efficiency and innovation as comparable users in the private sector.

SKILLS

3.79 The quantity and quality of skilled labour available in an economy are important determinants of economic performance and productivity growth. A highly skilled workforce allows firms to update working practices and products at the rate demanded by rapidly changing markets, making the economy more flexible and productive in the long term. International evidence suggests that the UK suffers from significant skills shortages, especially at the lower-intermediate level. To raise UK skill levels and increase productivity, the Government is therefore seeking to improve both the skills of young people entering the workforce and the opportunities available to those already in the workforce to acquire new skills.

Chart 3.3: Employees by skill level



Source: OECD, 2001.

Note: International comparisons of workforce skills are complicated by the difficulty in establishing equivalencies between countries with widely different education systems. The data used here is drawn from OECD (2001) which, unlike previous studies, compares both work-related and academic-based qualifications across countries. The study shows the UK with a greater human capital deficit compared with the US than the data cited in 'Productivity in the UK: Enterprise and the Productivity Challenge', HM Treasury, June 2001. More detailed discussion of this issue may be found in 'Developing Workforce Skills: Piloting a New Approach', published alongside Budget 2002.

Developing the skills of young people

Primary and secondary education

3.80 The Government is determined to raise standards across the education system. Between 1997 and 2002, the proportion of 11 year-olds reaching expected levels in reading and maths rose by 12 per cent and 11 per cent respectively. The proportion of 16 year-olds achieving five A*-C grades at GCSE also rose, from 45 per cent in 1997 to 51 per cent in 2002.

3.81 To maintain progress, the Government has set demanding new targets, including minimum attainment targets for schools, to ensure that the education system meets the needs of all. The minimum attainment targets mean that up to 5,000 primary schools and over 1,000 secondary schools – mainly located in the most challenging localities, and especially in urban areas – will need to improve their performance significantly over the next five years. Planned reforms to the funding of Local Education Authorities will help to support increased local reforms in these schools. The new Leadership Incentive Grant will also enable secondary schools in challenging areas undertake a wide range of measures to develop excellent leadership.

Post-16 participation

3.82 The skills and qualifications acquired by a young person through post-16 academic or vocational education are vital if they are to enter skilled employment. While reform in secondary education has led to a marked increase in attainment at GCSE level, the Government recognises that more work must be done to increase participation and attainment beyond the age of 16 towards the levels seen in competitor countries. In 2000, 86 per cent of 18 year-olds in Germany were enrolled in full-time or part-time education, compared with 56 per cent in the UK. The Government is concerned about the high number of 16 year-olds that do not currently continue in full-time education or training, but instead go directly into low-skilled, often part-time, employment without training, or that are not in education, employment or training at all – it is estimated that this is the case for 14 per cent of 16 year-olds in the UK.

3.83 **The Government is therefore setting an ambitious new target to increase post-16 participation in education and training that, by 2010, 90 per cent of young people will have participated in a full-time programme fitting them for entry into higher education or skilled employment by the age of 22**. This will increase the proportion of young people expected to participate in such programmes from the current rate of around 80 per cent. Achievement of the target will require a significant reduction in the number of 16 year-olds not currently in full-time education or work-based training, and more support for those that need to progress further with their learning to reach the threshold for skilled employment. This target reinforces the Government's commitment to delivering quality vocational programmes, such as Modern Apprenticeships, and does not change the Government's continued commitment to ensure that, by 2010, participation in higher education increases toward 50 per cent of those aged between 18 and 30, as set out in the 2002 Spending Review.

Modern Apprenticeships and work-based learning

3.84 To widen the vocational choices available to young people, and increase participation in work-based learning, the Government has reformed, strengthened and expanded the Modern Apprenticeships (MA) scheme by establishing:

- a target for 2004 that 28 per cent of young people should enter an apprenticeship by the age of 22;
- an entitlement, from 2004, to an apprenticeship place for all 16 and 17 year-olds with five or more GCSEs at A*-G, including maths and English;
- a national framework to ensure world class standards, with a network of high quality Apprenticeship Agents to help more employers, including SMEs, deliver apprenticeships; and
- a major three-year marketing campaign to promote apprenticeships to young people and increase take-up.

3.85 While recent measures have done much to improve the MA system, and reforms in secondary and further education are raising standards and participation in work-focused learning, more work is needed to ensure that standards are consistently high, that more young people are able to participate and complete their courses, and that more employers become involved in training young people.

3.86 Employer involvement in MAs is critical to ensuring that the new post-16 participation target is met, and that MAs continue to meet the needs of UK firms while providing young people with high quality training opportunities in a work environment. **The Government is therefore launching a National Modern Apprenticeship Taskforce to champion the MA scheme and report on key policy issues**. The taskforce will be led by Sir Roy Gardner, CEO of Centrica, and will include individuals from across business and the education and training sector. It will report to the Chancellor, the Secretary of State for Education and Skills and to the Chairman of the Learning and Skills Council (LSC) on a range of important policy issues, building on the work of Sir John Cassels and his committee. These issues will include the involvement of SMEs in MAs, the MA framework, particular problems faced by some sectors in recruiting and training young people, and measures to support improved completion rates. The taskforce will be supported by its own secretariat.

Higher education

3.87 Higher education is central to the development of a highly skilled workforce. The Government's aim is that, by 2010, 50 per cent of young people will have the chance to participate in higher education. To achieve its target, the Government is seeking to widen access to higher education and to improve the current funding system to ensure that universities are better able to sustain teaching and research excellence. The 2002 Spending Review provided additional resources to support improvements in the UK's international research competitiveness. Increased funding per student and targeted pay incentives will allow institutions to improve teaching and to recruit and retain key staff. However, questions remain about the longer term funding requirements of higher education, the appropriate balance between Government and private contributions to tuition costs, and the financial arrangements for students. The Government will publish its Higher Education Strategy document in January 2003.

Improving workforce skills

3.88 Improving the skills of young people will help to lay the foundations for long-term improvements in the UK skills base. To deliver faster improvements, the Government is taking steps to improve training opportunities for those already in the workforce. New policies are starting to have an impact. The Skills for Life Programme has already supported nearly 250,000 adults to improve their basic skills, while the University for Industry, which offers flexible and convenient learning opportunities to meet adult training needs, has reached over 500,000 learners through *learndirect*.

3.89 Although progress is being made in developing adult skills, workforce training is inhibited by a range of market failures. Businesses may be unable to gain the full returns to investment in employer training, and many individuals face financial barriers or are poorly informed about the value of training. Evidence suggests that these market failures affect low-skilled workers and those who work for small firms most of all.

3.90 As set out in Budget 2001, the Government believes that, although voluntary approaches have secured increased participation in workplace training, they have not been sufficient given the scale of the problem. Addressing this problem is a priority and will require a step-change on the part of employers, individuals and government. The Government is therefore seeking to develop policy which helps employers and individuals to meet their responsibilities in this area.

Box 3.4: Employer Training Pilots

To test new measures to improve access to training, the 2001 Pre-Budget Report announced the launch of Employer Training Pilots from September 2002. Further details were published alongside Budget 2002[1]. The pilots are now operating in six local LSC areas. Firms that offer their low-skilled staff paid time off to train are being provided with subsidies (of up to 150 per cent of wage costs for small firms) to cover the costs involved in releasing staff to train, free training courses up to NVQ level 2 (including basic skills) and information and guidance on training.

The Employer Training Pilots are operating in Birmingham and Solihull, Derbyshire, Essex, Greater Manchester, Tyne and Wear, and Wiltshire and Swindon. Early evidence suggests that the model being tested in the pilots is proving successful in engaging low-skilled individuals in training, and employers have responded positively to the pilots. At the end of October, only two months into the pilots, nearly 500 employers had signed up to participate and almost 900 employees with low levels of qualifications and skills had committed to undertaking basic skills or NVQ level 2 training. Over 40 per cent of individuals signed up to the pilots so far work in firms employing fewer than 50 people.

[1]*Developing workforce skills: piloting a new approach*, HM Treasury and the Department for Education and Skills, April 2002.

Increasing the demand for training

3.91 To gather further evidence on these methods of supporting training for low-skilled adults, **the Government is now providing £130 million in England to enable the Employer Training Pilots to be extended for a second year**, including resources from the Windfall Tax Margin as set out in Table 4.1. This will enable the Government to further explore the impact of existing pilots on the demand for training and allow the testing of a wider range of policy packages in different areas, with the pilots extended to around a quarter of the 47 local LSC areas.

3.92 Employer Training Pilots are an important strand of wider Government work to improve workforce skills. The Cabinet Office Strategy Unit recently published its second report on workforce development and increasing the demand for training among employers and individuals. In addition, the DfES will publish a Skills Strategy in June next year, describing in detail the Government's plans to address UK skills shortages.

Improving the supply of training

3.93 The performance of the further education sector is critical to the success of work to increase training and skills in the workforce. The 2002 Spending Review significantly increased the resources devoted to further education, with an additional £1.2 billion to be invested over the next three years. To match this increase in resources, the Government is introducing a series of reforms, including:

- a three-year budget and full 100 per cent end-year flexibility for the LSC, cascaded in full to local LSCs and in turn to providers, allowing them to plan on a longer-term basis;
- a new approach to funding which rewards colleges that deliver on their targets and provides clear incentives for all college staff to improve services;
- greater specialisation with more distinct provision for 16 to 19 year-olds, and more Centres of Vocational Excellence to meet employers' skills needs;
- raising the number of fully-qualified teachers, managers and leaders in the sector, ensuring better rewards for high performing staff and a major programme of teacher training; and
- pilots to improve the coordination of skills budgets and activities between local LSCs and RDAs at the regional level, as described earlier in this chapter.

3.94 The Government is also reviewing the funding of adult learning to ensure that training providers have the incentives and capacity to respond to the needs of local employers. The review will examine how the entire post-19 learning budget could be more effectively deployed to:

- increase incentives for employers to engage in training;
- make institutions responsive to the needs of individuals and employers, in particular through building their capacity to work with businesses and organisations;
- widen participation in learning among low-skilled people; and
- enable the RDAs to play a full and effective role in developing and implementing regional skills strategies.

Management

3.95 Strong management performance is a central determinant of productivity performance. In its report to the Government in May, the Council for Excellence in Management and Leadership (CEML) concluded that the UK faces pervasive management problems. The CEML report made 30 recommendations, including that the evidence base on management and leadership should be improved. As a result, the DTI and the Economic and Social Research Council have asked Professor Michael Porter of Harvard Business School to oversee a short research project as part of a broader study into UK competitiveness. Professor Porter will report in January 2003.

Migration

3.96 Migration has always been a source of skills and labour in Britain, and over time has helped to improve productivity, raise economic growth and cover shortages in domestic skills. The Government has taken a number of steps to help employers facing skills shortages in the UK recruit from overseas. The work permit system has been reformed so that permits now last for up to five years and are processed more quickly – 95 per cent of complete applications are now dealt with in less than 24 hours. Steps are also being taken to ensure that employers – especially small businesses – and individuals have access to appropriate information on UK migration routes, improving the effectiveness of the system.

3.97 The Government is now taking further steps to improve the service offered to SMEs by the work permit system. To ensure that SMEs can benefit fully from the system, **the Government is creating a new Small Business Unit in Work Permits UK to enable SMEs to access information about work permits and use the system more effectively to meet their skills needs**.

3.98 To provide a further source of skills for the UK economy a pilot Highly Skilled Migrant Programme was launched in January 2002, allowing highly skilled individuals to enter the UK to seek and take work. Applicants to the scheme may demonstrate their eligibility by educational qualifications, work experience, achievements in their field or past income. Since its introduction, the scheme has helped many highly skilled individuals enter the UK to live and work, making a valuable contribution to the economy. In view of its success, **the Highly Skilled Migrant Programme will be extended**. To improve its effectiveness still further, the criteria for awarding points in certain categories will be revised from 28 January 2003. In particular, the past earnings category will be updated to better reflect income differences between countries.

3.99 The Government recognises that those with very high skills are not the only people who contribute to the economy. Migrants with lower or intermediate skills may also complement the skills of the domestic population and help to raise productivity. Last month, the Home Secretary announced new sectoral migration schemes to help address skills shortages in specific sectors, such as the hospitality and food processing sectors. In the light of experience with these schemes, the Government will consider the case for further policy development in this area, working with other sectors where employers are facing labour shortages.

Box 3.5: The economic effects of migration

Migration affects a wide range of Government objectives and has a positive impact on growth and productivity, the public finances and on meeting labour and skills shortages in the public and private sectors. It can also have localised impacts on public services and community cohesion, which Government policy must recognise and manage.

Migration affects aggregate economic growth through its contribution to growth in the working-age population. It also affects growth in other ways. For example, evidence on the wages of the foreign-born population suggests that, overall, migrants are productive members of the workforce[1]. Through spillover effects, and as a potential source of innovation and entrepreneurship, migrants may also have a positive impact on the productivity of domestic workers and may therefore help to improve per capita income growth.

Labour at all skill levels can help to fill vacancies and avoid bottlenecks, increasing efficiency and productivity. Linked to this, evidence suggests that migrants' success in the labour market is not at the expense of the domestic population. Research in the UK finds little indication of a negative impact on domestic employment and suggests that immigration may, if anything, have a positive impact on domestic wages[2].

Research by the Home Office has also found that migrants made a net positive fiscal contribution of £2.5 billion in 1999-2000, paying more in taxes than they received in benefits[3]. The full extent of the fiscal contribution made by migrants is difficult to calculate accurately, and depends on migrants' ages, economic activity, wages, skills and how long they stay in the country. However, the Home Office study states that £2.5 billion may, if anything, underestimate the contribution that migrants make.

[1] LFS data suggest that foreign-born weekly wages are around 19 per cent higher than the wages of people born in the UK (figures refer to an average over the period June 2001 to May 2002).

[2] *Secure borders, safe haven: integration with diversity in modern Britain*, CM 5387, Home Office, February 2002.

[3] *The migrant population in the UK: fiscal effects*, Gott and Johnston, RDS Occasional Paper No. 77, Home Office, 2002.

INVESTMENT

3.100 Productivity growth relies on investment in physical capital to augment the productivity of labour. In the past, the capital stock of firms and the stock of public infrastructure in the UK has fallen well below those of competitor countries. These shortfalls help to explain the UK's relatively poor labour productivity performance, and reflect years of low investment in both the public and private sectors.

Planning

3.101 An effective planning system is vital for successful and speedy development. The Government's proposals for reform of the planning system were set out by the Deputy Prime Minister in July 2002. The proposals include clearer and shorter central government guidance, statutory regional spatial strategies and more flexible local development plans. As described earlier in this chapter, **the Government also proposes to establish Business Planning Zones to facilitate business development in local areas**.

3.102 The 2002 Spending Review allocated an extra £175 million by 2005-06 to secure a step change in the effectiveness of the planning system. A new Planning Delivery Grant will be introduced to incentivise improved performance by local planning authorities. The Grant will reward authorities in proportion to the extent of their performance improvement. Next year there will be additional funding from the Grant for regional planning bodies to strengthen the quality of regional planning, and for planning authorities in London and the South East to support delivery of existing housing targets. The Deputy Prime Minister will shortly set out full details of the new grant.

3.103 The Government has set Best Value targets for 2002-03 for local planning authorities for handling planning applications, with separate targets for major applications, minor applications and other types of application. The Government has stated that it will be ready to intervene in cases of poor performance if there is no evidence of improvement, and has set standards for the poorest performing authorities. Last year 15 authorities were subject to standards and intensive monitoring because of poor performance, and the majority of these authorities have since improved significantly. This year 78 authorities are being monitored, with a particular focus on performance in dealing with major planning applications. The Office of the Deputy Prime Minister (ODPM) will publish a Service Delivery Agreement by the end of the year, setting out stretching targets for the period from 2003 to 2006.

3.104 The Government is also committed to speeding up the process for consideration of major infrastructure projects that make a significant contribution to economic growth, and is considering how public inquiries into such projects can be made more efficient. Legislation will be brought forward to ensure inquiries can deal with issues concurrently rather than sequentially to save time. The Government will also examine whether these process improvements can be applied to other types of infrastructure inquiry.

Housing

3.105 In recent years, serious imbalances between supply and demand have emerged in regional housing markets. In the North and Midlands nearly a million homes are afflicted by low demand and abandonment, while in other areas demand is not being met, with house building now at its lowest level since the 1920s and insufficient to meet the growth in household numbers. The Government has set a challenging new target to achieve a better balance between housing availability and demand in all regions.

3.106 In his July statement on housing and planning, the Deputy Prime Minister acknowledged the scale of the challenge and emphasised the Government's commitment to achieve a step-change in housing supply, including by accelerating existing proposals to deliver significant growth in the South East. The Government is also committed to ensuring, through intervention if necessary, that local authorities in areas of high demand deliver the housing numbers set out in Regional Planning Guidance. These measures are being supported by substantial new investment. By 2005-06, investment in housing will have risen by £1.1 billion to £5.9 billion from this year's level, supporting a substantial increase in new provision of affordable housing. It will also allow nine pathfinder projects in areas of low housing demand to implement market renewal strategies, benefiting over 400,000 blighted properties and providing a boost to the economic regeneration of these areas.

3.107 Reforming the way decisions on housing are taken is integral to successful delivery of the Government's objectives. The Deputy Prime Minister has therefore announced that **new regional bodies will be established, bringing housing investment within a single regional pot and ensuring better coordination with planning, transport and regional economic growth strategies**. Joined-up regional decision-making is essential to ensure that the supply of housing does not become an unnecessary constraint to regional economic development, and that growth is delivered in a sustainable way. These new regional bodies will provide the right conditions for delivery and facilitate the smooth transition of responsibilities and funding to Elected Regional Assemblies when these are established. The first steps towards this will be taken in 2003-04 when shadow structures, including RDA and English Partnerships representation, will be formed and arrangements agreed to facilitate joint working on Regional Housing and Spatial Strategies and associated regional investment plans.

3.108 A key role of the planning system is to enable the provision of new homes in the right place and at the right time. This is important to ensure that everyone has the opportunity of a decent home and to maintain the momentum of economic growth, which should not be frustrated by a lack of homes for those wishing to take up new employment opportunities. The Government therefore expects regional planning bodies and local planning authorities to provide sufficient housing opportunities to meet the likely housing requirements of their areas. In doing so, they should provide a choice of sites which are both suitable and available for housebuilding. Local authorities must be realistic in their expectations of when sites will be ready for development. This will be a key element of the scrutiny of local plans by Government Offices. In revising its planning guidance on commercial development and industry, the Government will make clear that redundant commercial buildings and land currently allocated for employment should be considered for housing or mixed use development, unless a convincing case for retention of commercial use can be made.

Investing in transport

3.109 Good transport links have an important role in promoting investment. They connect businesses and individuals to wider markets, and can open up new opportunities for employment, production and distribution. The Government's Ten-Year Plan for Transport sets out plans for public and private spending in excess of £180 billion to create a modern transport network across the UK. The Secretary of State for Transport will report shortly on progress toward delivering the ambitious objectives of the Plan. The Department for Transport (DfT) is also conducting a review of the Ten-Year Plan to reassess the way ahead, and roll forward the Plan into the next decade. The DfT and ODPM will work together to explore whether the process for taking the results of transport studies through the planning system can be streamlined so that, for example, the same issues are not consulted on twice.

3.110 The Deputy Prime Minister's July statement announced reforms to improve the operation of the compulsory purchase system and the levels of compensation for those directly affected in this way by development, including transport infrastructue. The ODPM will continue work with other departments, including the DfT, on the compensation code, including compensation for indirect effects. A final report from the Law Commission on these issues is expected during 2003.

Airports

3.111 Air travel offers significant economic benefits to the UK. Many thousands of jobs depend on the industry, and businesses rely on air links to provide access to markets and to bring in investment. Despite these benefits and continued growth in demand for air travel, UK airport capacity is fast falling behind that of other European competitors and many of the UK's largest airports are already reaching full capacity. These capacity constraints particularly affect airlines' ability to sustain 'hub' operations that allow a wide range of destinations to be served with high frequency. The Government is consulting on how best to maximise the benefits of growth in aviation, while striking the right balance between the social, economic and environmental impact of any airport development. These issues will be addressed in the Government's Air Transport White Paper, to be published next year.

Public enterprises

3.112 As well as providing efficient public services, the performance of public enterprises has an important role to play in raising productivity in the UK. The challenge for government is to better fulfil its role as shareholder of these businesses. To achieve this **the Government has decided to create a Shareholder Executive located in the Cabinet Office**, bringing together departmental and external expertise including secondees, that will both advise and work with government departments. It will help them to distinguish and set out their long-term commercial and policy objectives for businesses, scrutinise and assess departmental capability and processes to fulfil their role as shareholder, and develop and monitor action plans to enable departments to implement change to structurally improve their ability as shareholder.

The Myners review of institutional investment

3.113 The Myners review of institutional investment in the UK was published in March 2001. The Government confirmed last year that it would take forward all the recommendations of the review, including that for Codes of Investment Principles to encourage diversity in investment approaches. The Government will conduct an assessment of the effectiveness of these principles in delivering change, beginning in March 2003. Details of this review will be announced later this year.

3.114 Following the recommendations of the Myners review, the Government has consulted on three areas of proposed legislation:

- shareholder activism. The Institutional Shareholders' Committee has produced a new statement of principles that sets out strengthened responsibilities of institutional shareholders and agents, and outlines best practice on the part of institutional investors to promote their members' interests through more active engagement as shareholders. The Government welcomes this approach and the proposal to review the impact of the principles after two years. At that point the Government will review whether the non-legislative approach has been successful in delivering behavioural change;

- independent custodians. The review proposed increasing pension fund members' security by requiring funds to have an independent custodian. However, in the light of consultation, the Government has concluded that the existing regulatory requirements in this area are satisfactory and that further legislation would not be appropriate; and

- pension scheme trustees. Pension funds' investment decisions are of vital importance to the future security of their members and to the health of the wider economy, and the Government is committed to legislating to require trustees to have appropriate expertise. The forthcoming Pensions Green Paper, described in Chapter 5, will provide further detail on this issue.

The Sandler review of retail savings

3.115 In June 2001, the Government appointed Ron Sandler, former CEO of Lloyd's of London, to conduct a review of the medium- and long-term savings industry, building on some of the recommendations of the Myners review. The review, which reported in July, examined the markets for medium – and long-term retail savings in the UK, identifying the competitive forces and incentives that drive the industries concerned and analysing the potential policy responses. Chapter 5 describes the review in detail.

Accountancy and audit

3.116 Corporate crises in the US have highlighted the vital importance of strong frameworks for corporate governance, financial reporting and audit regulation in underpinning strong and efficient national and international capital markets. The Government has acted quickly to ensure that the UK's own arrangements are thoroughly reviewed and further strengthened where necessary. The objective is to rebuild investor confidence while acting proportionately. These issues have global implications and should not be considered merely in a domestic context. The Government has therefore encouraged the search for global solutions that will not hinder the growing and beneficial integration of international capital markets, working through the Financial Stability Forum and the EU.

3.117 In the UK, a number of core issues are being addressed by the Company Law Review. In addition, the Treasury and the DTI have established a Coordinating Group on Audit and Accounting Issues (CGAA) to review the UK accounting and auditing regime. An interim report by the CGAA contained a number of recommendations which the Government supports, and the DTI is now reviewing the regulatory arrangements for the accounting and audit professions. The CGAA also proposed that the Government should consider whether competition in the market for large company audit and accountancy is currently too constrained. Following an examination of the competition issues, the OFT decided not to refer the market to the Competition Commission or to launch its own investigation at this stage, but to keep the market under review. Work to develop the Combined Code guidance for audit committees, commissioned by the CGAA, is taking place alongside Derek Higgs' Review of the role and effectiveness of non-executive directors, and the FSA is currently consulting on the role and practices of financial analysts.

Box 3.6: The Higgs Review of the role and effectiveness of non-executive directors

Effective non-executive directors play a central role in raising corporate performance. From the point of view of increasing productivity and competitiveness, a progressive strengthening of the role of non-executive director is strongly desirable. In April 2002, the Chancellor and the Secretary of State for Trade and Industry appointed Derek Higgs to lead a short independent Review into the role and effectiveness of non-executive directors.

Over 260 responses have been received to the Review's consultation document. The overwhelming majority converge on the view that the existing corporate governance framework in the UK, though fundamentally sound in its essentials, would benefit from progressive strengthening. The 'comply-or-explain' approach of the Combined Code is widely supported. A number of core themes emerged from the consultation:

- **a need for greater clarity in defining the role of the non-executive director in the context of the Board as a whole;**
- **the important position of the Chairman of the Board, widely regarded as essential to facilitate effective individual director and overall Board performance, and the nature of the relationship between Chairmen and companies and their executives;**
- **the importance of independence, and the existence of a number of competing definitions of "independence" which is seen to be confusing;**
- **the need for a nominations and appointments process which is open, fair and rigorous to promote meritocracy;**
- **the fact that the current population of non-executive directors does not necessarily include all talented individuals with the right mix of skills, knowledge and attributes who could make a strong contribution;**
- **widespread recognition that relationships between shareholders and non-executive directors could be improved; and**
- **the potential value of appraising the mix of skills, knowledge and expertise needed on a Board, including more formal evaluation of individual and Board performance.**

The majority of submissions are available publicly on the DTI's website.

In addition to the consultation process, more than 700 directors have been surveyed or interviewed in the course of the Review's work. The Review will also include a detailed review of the current population of non-executive directors and the composition of Boards in UK listed companies.

Derek Higgs will report to the Government in January next year.

4 INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

The Government's long-term goal is to ensure a higher proportion of people in work than ever before by 2010.

Five years ago the Government launched its Welfare to Work programme to tackle long-term unemployment. Since then, the New Deal has delivered large reductions in long-term unemployment, especially among young people, and help has been extended to support those areas and groups that suffer from the greatest labour market disadvantage. Reforms to the tax and benefit system and the National Minimum Wage have improved work incentives, particularly for those on low incomes.

Nevertheless, major challenges remain to reduce persistent economic inactivity and repeated periods of worklessness, and to raise levels of employment in the most deprived local areas and among people from ethnic minorities. Building on the progress already made, the Government is taking further steps to extend employment opportunity to all groups in all areas of Britain, by:

- **piloting a programme of intensive support in neighbourhoods with very high concentrations of worklessness.** The pilots will begin from April 2004 in twelve of the most deprived neighbourhoods in the country;
- **extending eligibility for the Job Grant**, and introducing a new higher rate of £250 for households with children, to ease the transition to work;
- **reforming the administration and design of Housing Benefit** to reduce inefficiencies in the current system and ease the transition to work for tenants;
- **piloting new measures to improve employment retention and advancement** among the low paid and those moving off welfare as part of a demonstration project from October 2003;
- **extending Employment Zones to lone parents and people returning to the New Deal** for a second time, and **testing the impact of multiple providers in the same areas**; and
- **piloting new means of support to help those with health problems and disabilities find work**, including enhanced advice on the return to work and a new return to work credit of £40 a week, from October 2003.

INTRODUCTION

4.1 Five years ago, the Government set out its aim of extending employment opportunity to all in a changing labour market. The Government's long-term goal is to ensure a higher proportion of people in work than ever before by 2010.

4.2 At the time, the labour market was characterised by a number of severe problems, many of which had developed over long periods. Despite five years of economic recovery, aggregate levels of unemployment were still high, especially compared with those seen before the 1980s. Over two million people were unemployed on the International Labour Organisation (ILO) definition, while long-term unemployment remained high by historical standards.

4.3 The previous 20 years had also seen a growing concentration of worklessness among certain individuals, households and communities. By the mid 1990s, more than one in six households had no one in work, while in the most deprived communities as many as half of the working age population were out of work.

4.4 These problems had multiple causes. Long-term trends had led to a decline in the demand for unskilled labour throughout the developed world. In the UK, the job prospects for those without skills declined dramatically. Alongside these economic changes were important social and demographic trends, including growing female employment and changing household composition.

4.5 Policy mistakes also contributed. Macroeconomic instability during the 1980s and early 1990s was deeply damaging to the labour market, with large falls in employment during recessions. The UK was often hardest hit by global slowdowns, with unemployment rising more sharply than in other countries. The numbers who were unemployed and on benefit peaked at around 3 million in both 1986 and 1992.

4.6 Offered too little help, many unemployed people drifted into economic inactivity, often on disability-related benefits, and never returned to work, even as the economy recovered. Rather than being a solution to these problems, the welfare system had become part of the problem itself. For an increasing number of people, it offered no help to find work or develop skills, and no recognition that for some families work simply did not pay.

Delivering employment opportunity for all

4.7 Since 1997, the Government has implemented a comprehensive programme of reform to improve the performance of the labour market and advance its long-term goal. The Government's strategy involves:

- maintaining macroeconomic stability and a flexible labour market, avoiding the cycle of boom and bust that leaves people detached from the labour market, and ensuring the right conditions for employers to create jobs;
- investing in education, to tackle one of the most important long-term causes of worklessness, lack of skills;
- Welfare to Work policies that help the unemployed, particularly the long-term unemployed, achieve a successful return to work;
- extending help and support to areas and groups suffering from the greatest employment disadvantage, tackling wider worklessness to extend employment opportunity to all individuals in all parts of Britain; and
- improving work incentives, to ensure that individuals are rewarded as they move into, and progress within, employment.

4.8 This chapter describes the strategy that the Government has followed over the past five years, evaluates progress to date and sets out how the Government intends to build on the results it has achieved to address the remaining barriers that prevent people from entering and progressing in work.

TACKLING UNEMPLOYMENT

4.9 A dynamic and flexible labour market is key to achieving and sustaining low levels of unemployment. The UK labour market is dynamic: around 1½ million people either move into employment or change jobs each quarter. Reforms introduced by the Government have ensured that the labour market remains dynamic and flexible and can adapt quickly to changes in global and domestic demand.

4.10 Though worklessness is a short-term experience for most unemployed people, those who do not return to work rapidly are at risk of prolonged disadvantage. Long-term unemployment[1] peaked at more than 800,000 in 1986, and long-term youth unemployment[2] at over 500,000. Five years ago, despite relatively strong economic growth, ILO unemployment still stood at 7.2 per cent; more than 400,000 people were long-term unemployed, and long-term youth unemployment stood at more than 175,000.

4.11 Those who experience long-term unemployment encounter ever greater difficulties finding work than those who have been unemployed for short periods. They are also more likely to move on to other benefits. Long-term youth unemployment is particularly damaging since early spells of unemployment can have a detrimental effect on future employment prospects. The initial focus of the Government's Welfare to Work strategy was, therefore, to tackle long-term unemployment, by equipping people with the skills and opportunities they need to find and remain in work, and ensuring they do not become detached from the labour market while out of work.

Tackling long-term unemployment

New Deal

4.12 The New Deal was launched in 1998 to end long-term youth unemployment. The New Deal for young people (NDYP) provides a range of support for 18 to 24 year old jobseekers, including regular contact with personal advisers, help with job search activities and assistance in addressing basic skills gaps. For those who do not move into work from the initial Gateway period, there is a range of further options providing full-time intensive activity and a follow through period to capitalise on employability gains. These rights are balanced with responsibilities – the New Deal ends the option for young people of remaining indefinitely on Jobseeker's Allowance.

4.13 The Government met its target of helping 250,000 young people move from welfare to work through the New Deal almost two years ahead of time in September 2000. The development of the New Deal for those aged 25 and over (ND25+) seeks to build on this success by providing assistance on a similar basis to older long-term unemployed people. NDYP and ND25+ have made substantial contributions to the reductions in long-term unemployment and long-term youth unemployment achieved over the past five years.

Over 50s

4.14 To improve the labour market position of older people, the New Deal for the over 50s (ND50+) was also introduced throughout the country in 2000. ND50+ offers a package of personal advice, help with job search, and in-work training and support tailored to the needs of older workers. ND50+ has assisted more than 75,000 people into jobs since that time, helping the employment rate of those aged between 50 and state retirement age rise to 68 per cent.

---

[1] Long-term unemployment is defined as those aged between 25 and state pension age who have been unemployed for more than 18 months.

[2] Long-term youth unemployment is defined as people aged between 18 and 24 who have been unemployed for more than 6 months.

Employment Zones

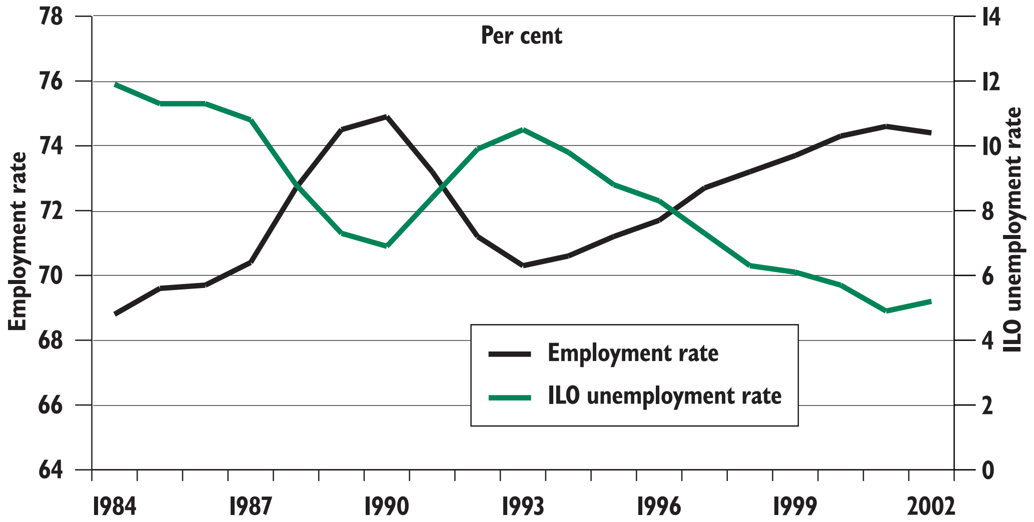
4.15 In addition to the New Deal, Employment Zones are testing a new and innovative approach to helping long-term unemployed people aged 25 and over back into work, in partnership with private and voluntary sector organisations. Introduced in April 2000, Employment Zones differ from ND25+ in that jobseekers and their personal advisers are able to make more flexible use of available funds to overcome individual barriers to work. Employment Zones are currently being tested in 15 areas of England, Scotland and Wales, including in some of the most disadvantaged communities.

Reducing unemployment

4.16 The Government's strategy to help the unemployed into work has delivered structural improvements in the labour market. The resilience of the UK labour market in recent years has set the UK economy apart from most other industrialised countries, many of which have seen the rate of unemployment rise significantly over the past year or so.

4.17 At 5.3 per cent, UK unemployment is now the lowest among the G7 economies for the first time since the 1950s. Claimant count unemployment has fallen by more than 700,000 over the past five years to levels last seen a generation ago, and has remained below one million since the start of 2001 – the first time this has happened since 1975. Spending on social security benefits for the unemployed is now £5 billion lower than it would have been had unemployment remained at 1996-97 levels. Employment is at record highs, having risen by 1.3 million since spring 1997.

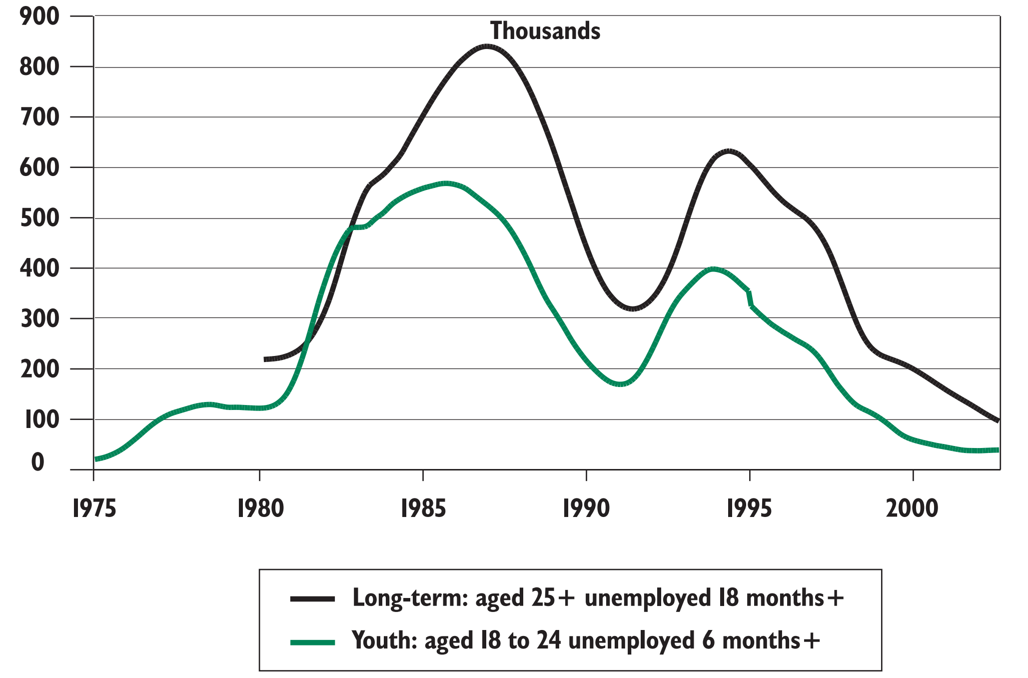
Chart 4.1: UK employment and ILO unemployment rates



4.18 The Government's strategy has helped to reduce long-term unemployment to levels last seen a generation ago. Over the past five years, long-term unemployment has fallen by over 300,000 – more than three quarters – and long-term youth unemployment has also fallen sharply. More than 375,000 long-term unemployed 18 to 24 year olds have found jobs through NDYP, while ND25+ has helped over 110,000 older long-term unemployed people back into work.

4.19 Independent research confirms the positive impact of the New Deal. In 2000, the National Institute of Economic and Social Research (NIESR)[3] found that, without NDYP, the level of long-term youth unemployment would have been twice as high. A study by the National Centre for Social Research[4] also concluded that NDYP has had a significant impact on the employability of young people.

Chart 4.2: Long-term unemployment, youth and aged 25+



Next steps

4.20 Despite the success of these New Deal programmes, significant challenges remain. More than 1.5 million people are still unemployed on the ILO definition and too many people continue to suffer repeated spells of unemployment and are therefore at risk of becoming long-term unemployed.

4.21 To address these challenges, the Government is now taking steps to extend the support offered under the New Deal and is considering how best to tailor future support. As announced in Budget 2002, **a more intensive approach to the Gateway period of ND25+ is planned in Dundee, London, Manchester and Swansea from April 2003**. This will provide mandatory, personalised help and support to address the needs of those aged 25 and over who have been out of work for 18 out of the last 21 months.

4.22 **The Government also intends to pilot mandatory schemes to extend eligibility for ND25+ to jobseekers who have been unemployed for a total of 18 months over the previous three years, rather than 18 of the previous 21 months.** These pilots are planned to begin in April 2003 and will focus support on jobseekers who have experienced repeated spells of unemployment. If the pilots prove successful, the Government will look to extend greater rights and responsibilities to those with histories of repeat unemployment who may not currently be eligible for the New Deal.

[3] *The New Deal for young people: implications for employment and the public finances*, National Institute of Economic and Social Research, December 2000.

[4] *New Deal for young people: national follow-through*, National Centre for Social Research, April 2000.

4.23 Early evidence on the use of Employment Zones (EZs) is encouraging and the Government intends to extend the help they provide more widely and to encourage innovation among providers. As announced in the 2002 Spending Review, **the Employment Zone approach will now be extended to people who would otherwise return to the New Deal for a second time in existing Employment Zone areas from October 2003**. In addition, the Government intends to **develop the Employment Zone model further by testing the effect of introducing multiple providers in the the largest EZ areas from April 2004**. Multiple providers will each be allocated a random cross-section of clients with similar characteristics so that performance can be compared on a like-for-like basis. **Employment Zones will also be extended to lone parents in existing EZ areas from October 2003**.

Funding for Welfare to Work

4.24 The Welfare to Work programme has been funded by the one-off Windfall Tax on the excess profits of the privatised utilities. In 1997 the Government expected to spend over £3 billion of the £5.2 billion Windfall Tax on the New Deal for young people. In the event, as Table 4.1 shows, the success of programmes to tackle long-term youth unemployment means that only £1.5 billion of the Windfall Tax will be needed for this programme. These savings have allowed the Government to extend its Welfare to Work strategy to address problems of wider worklessness and to improve skills.

4.25 The majority of the Welfare to Work programme is delivered by the Department for Work and Pensions (DWP) and the associated resources are generally now included within its Departmental Expenditure Limit (DEL). The 2002 Spending Review allocated extra resources to Welfare to Work programmes, including the national roll-out of Jobcentre Plus.

4.26 Table 4.1 sets out that element of the Welfare to Work programme across Government that is funded by the one-off Windfall Tax.

Table 4.1: Allocation of the Windfall Tax

£million	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04[2]	TOTAL
Spending by programme[1]								
New Deal for young people[3]	50	200	310	300	220	290	110	1480
New Deal for 25 plus	0	10	90	110	210	300	100	820
New Deal for over 50s	0	0	5	20	10	20	10	60
New Deal for lone parents	0	20	40	40	40	140	80	360
New Deal for disabled people[4]	0	5	20	10	20	50	20	120
New Deal for partners	0	0	5	10	10	30	10	60
Childcare[5]	0	20	10	5	0	0	0	35
University for Industry[6]	0	5	0	0	0	0	0	5
Workforce development[7]	0	0	0	0	0	30	170	200
ONE pilots[8]	0	0	0	5	5	0	0	10
Action Teams	0	0	0	10	60	50	20	140
Enterprise development	0	0	0	10	20	10	0	40
Modernising the Employment Service	0	0	0	40	0	0	0	40
Total Resource Expenditure	**50**	**260**	**480**	**550**	**590**	**920**	**520**	**3370**
Capital costs[9]	**90**	**270**	**260**	**750**	**450**	**0**	**0**	**1830**
Estimated Windfall Tax Margin								**0**
Windfall Tax receipts	**2600**	**2600**						**5200**

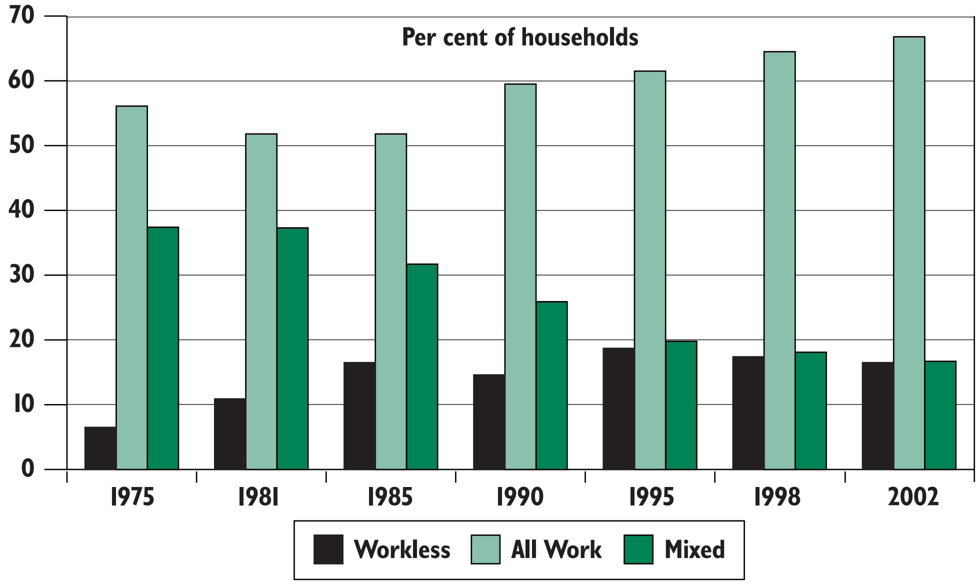
[1] Rounded to the nearest £10 million, except where expenditure is less than £5 million. Constituent elements may not sum to totals because of rounding. Figures include Windfall Tax spending in AME omitted at Budget 2002, and exclude resources from mainstream employment programmes in DEL included at Budget 2002.
[2] Windfall Tax expenditure is significantly reduced in 2003-04 as Windfall Tax resources are exhausted. Remaining in-year expenditure will be topped up with general government revenues.
[3] Includes funding for the Innovation Fund.
[4] Includes £10 million in 1999-00, an element of the November 1998 announcements on welfare reform.
[5] 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 until October 1999, after which the measure was incorporated within the Working Families' Tax Credit.
[6] Start up and development costs. Other costs of the UfI are funded from within Departmental Expenditure Limits.
[7] Includes £130 million from the Windfall Tax Margin for the second year of the Employer Training Pilots.
[8] Funding for repeat interviews. Other funding comes from the Invest to Save budget.
[9] Includes capital spending on renewal of school infrastructure, to help raise standards.

TACKLING WIDER WORKLESSNESS

4.27 In addition to rising unemployment, the 1980s and early 1990s saw changes in the pattern of employment within and across households. The employment rate of women rose from 59 per cent in 1975 to 66 per cent in 1995, although these increases were largely concentrated among women under 50, and those with higher skills. At the same time, male employment fell, particularly for those over 50, and those with lower skills.

4.28 Typically, these changes took place in different households, increasing the number of households in which all those of working age were in work, and concentrating worklessness into households in which no one was in work, as shown in Chart 4.3. Alongside a sharp increase in the number of single person households, the overall effect was a significant rise in the number of workless households to almost $3^1/_2$ million – more than one in six – by the mid 1990s. Most of these lived on low incomes.

Chart 4.3: Changes in the way households organise their work



Source: Labour Force Survey.

4.29 By this time, much of the rise in worklessness had manifested itself in economic inactivity rather than unemployment. Many people, particularly older people, were not offered sufficient help to return to work and became detached from the labour market altogether. For families with children, especially lone parents, and people on disability benefits, a lack of active help to search for jobs was compounded by poor work incentives from a tax and benefit system which did not recognise them as having the potential to return to work. Correspondingly, the number of people on inactive benefits rose substantially.

4.30 As well as being concentrated within households, employment opportunities were unequally distributed across areas of the country. In the 1980s, regional disparities in employment and unemployment rose sharply. While these disparities have subsequently narrowed, as every region has experienced falling unemployment and rising employment in recent years, pockets of high worklessness and deprivation persist throughout the country. These areas have failed to share in the rising national prosperity that economic stability has brought.

4.31 The Government is committed to helping all of those who are workless find employment and lift themselves out of poverty, not just the unemployed. In contrast to the 1980s and the early 1990s, during which time labour market programmes were overwhelmingly aimed at the unemployed, over the past five years the Government has extended assistance to all workless benefit claimants, widening the focus of its Welfare to Work policies.

Helping lone parents

4.32 Lone parents face particularly difficult choices when seeking to balance work and caring responsibilities. They make up fewer than one in ten of all households, and yet account for one in five of all workless households. The overwhelming majority of lone parents want to work and helping them to find employment is key to reducing the number of workless households and child poverty. The Government is committed to improving the choices faced by lone parents in the labour market and has introduced a range of support to achieve this. Its target is that 70 per cent of lone parents should be in work by 2010.

New Deal for lone parents

4.33 The New Deal for lone parents (NDLP) was launched nationally in October 1998. NDLP provides a comprehensive package of support, including access to a personal adviser; help with training, education and childcare; and advice on benefits, in-work financial support and self-employment. Since its introduction, eligibility for NDLP has been extended to all lone parents who are either not working or who work less than 16 hours a week.

Help with childcare

4.34 To complement the New Deal, the Government has also taken steps to improve access to childcare. Good quality, accessible and affordable childcare enables low income parents – particularly lone parents – to move into paid work and to lift their families out of poverty. It also provides all parents with opportunities to balance their work and family lives, with significant benefits for their children.

4.35 The Working Families' Tax Credit (WFTC) and the Disabled Person's Tax Credit (DPTC) provide assistance with childcare costs to lower and middle income parents, already benefiting more than three times the number of families that received the Family Credit childcare disregard at its peak. This assistance will continue, in an improved and more flexible form, as part of the Working Tax Credit from April 2003. Eligibility for the childcare element of the Working Tax Credit will be extended to include those who use approved childcare in their own homes, benefiting, among others, parents of disabled children and those who work outside conventional hours. In addition to financial support through the tax and benefit system, the Government's National Childcare Strategy helps providers of childcare to meet the growing demand for affordable and good quality care, and has created places that have helped over one million children since 1997.

4.36 The Government's strategy for helping parents to balance their work and family lives is described in Chapter 5. The Government will set out details of next steps in this strategy in the forthcoming document, *Balancing work and family life: enhancing choice and support for parents*.

Help for partners

New Deal for partners

4.37 Even in the 1990s, more than 50 years after Beveridge's original proposals, the benefit system treated partners of unemployed people – overwhelmingly women – as 'adult dependants' of the claimant – overwhelmingly men. The Government has sought to modernise the benefit system, extending the rights and responsibilities of Jobseeker's Allowance claimants to partners on an equal basis. Since April 2001, childless partners of the unemployed, where at least one partner was born after 1976, have also become joint Jobseeker's Allowance claimants. In October 2002, joint claims were extended to all childless partners of the unemployed where at least one partner was born after 1957. The Government also provides targeted support to households in which both partners are workless through the New Deal for partners – a personal adviser service for partners of benefit claimants.

Help for people with disabilities

New Deal for disabled people

4.38 To help disabled people who are able to work, the Government introduced the New Deal for disabled people (NDDP) nationally in 2001. NDDP engages those moving on to Incapacity Benefit and provides a national network of innovative job brokers to help disabled people locate and move into secure employment. Over 6,000 people have been helped into jobs through the programme.

Support in work

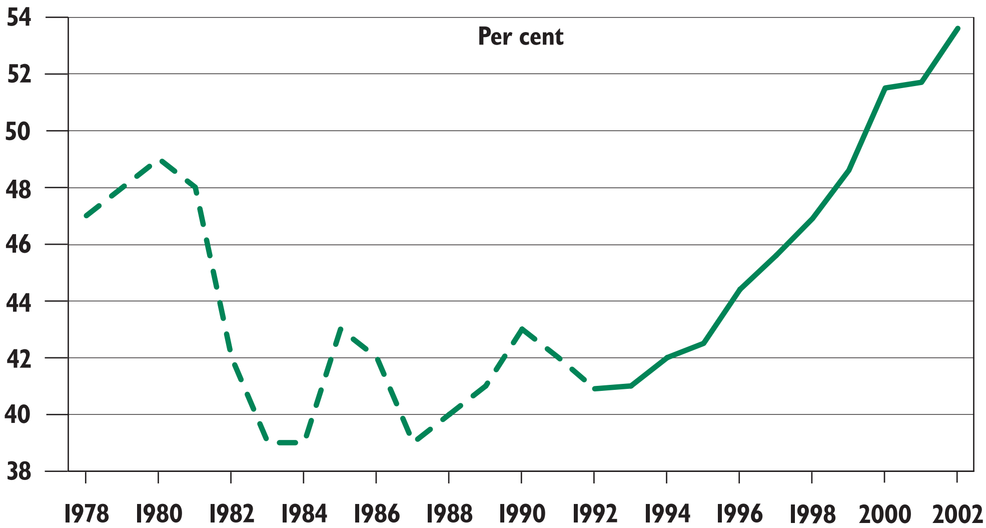
4.39 To support disabled people in employment, the introduction of a new Job Retention and Rehabilitation Pilot (JRRP) began on 1 October 2002 and live service delivery will commence in April 2003. JRRP will test the impact of additional, early intervention in support of workers at risk of losing their job through sickness. From April 2003, disabled people in work will also receive financial support through the Working Tax Credit rather than the Disabled Person's Tax Credit. The Working Tax Credit will include an element to support workers with a disability, bringing them into the mainstream system of support and increasing the guaranteed minimum income for a single disabled person working 35 hours a week on the minimum wage to £193 a week, £21 a week more than in April 2002.

Reducing worklessness

4.40 The Government's strategy has helped to deliver significant reductions in worklessness over the past five years. The number of workless households has fallen by more than 300,000 from its peak of almost 3½ million, while the proportion of children living in workless households has fallen from 18 to 16 per cent. In contrast to the experience of the 1980s and early 1990s, the proportion of workless households has remained broadly flat over the past year, despite persistent weakness in the global economy.

4.41 Employment among lone parents has also risen substantially. As chart 4.4 shows, the lone parent employment rate stood at just over 40 per cent for much of the 1980s and early 1990s, despite most lone parents saying that they wanted to work. Over the past five years, the rate has risen, from 46 per cent in 1997 to 54 per cent in 2002, and for those with young as well as older children. The Government's Welfare to Work programme has played an important part in this – over 150,000 lone parents have now moved into work with the support of NDLP.

Chart 4.4: Lone parent employment rate



Note: Data from 1978 to 1992 refers to lone mothers and is derived from the General Household Survey. Data from 1992 onwards is from the Labour Force Survey and refers to all lone parents.

4.42 Worklessness among people with disabilities has been slower to fall. While annual flows on to incapacity-related benefits have fallen by nearly a quarter since 1996, the average duration of ongoing claims has increased by more than 10 per cent to 5 years and 8 months. As a consequence, more than 2.7 million people are now claiming incapacity-related benefits – more than the combined total of lone parents and unemployed people on benefit. Helping those who are able to work move successfully back into employment is central to securing further reductions in the overall level of inactivity.

Going further

4.43 The Government recognises that significant challenges lie ahead, and not just to improve the labour market position of people with disabilities. The employment rate of lone parents has increased, but there is still more to do to hit the Government's target. Moreover, high concentrations of worklessness still exist in a number of areas of the country. The Government is now taking steps to address these challenges and to deliver effective, work focused support to all working age benefit recipients.

Jobcentre Plus

4.44 More than $4^{1}/_{4}$ million people of working age continue to live in households in which no one is working, and many workless households contain at least one person claiming an inactive benefit. In the past, the benefit system has failed to provide a work focused service to these individuals and they have not had access to the help and support available to other benefit claimants. The Government is changing this through the creation of Jobcentre Plus.

4.45 Jobcentre Plus brings together the Employment Service and those parts of the Benefits Agency dealing with working age people to deliver an active, work focused service to all working age benefit claimants, both unemployed and inactive. Anyone making a claim for benefit at a Jobcentre Plus office receives an interview with a personal adviser to discuss the opportunities available for taking up work. Claimants are given access to job vacancies, information, advice, training and support. This balancing of rights and responsibilities is central to the Government's strategy of work for those who can and security for those who cannot. Since its launch in April 2002, more than 60 Jobcentre Plus offices have already opened. **The Government aims to have opened more than 200 Jobcentre Plus offices by April 2003, and to complete the nationwide roll-out in 2006**.

4.46 Jobcentre Plus also plays an important role in matching firms' demand for staff with the available supply of workers. To enhance its service to small- and medium-sized enterprises (SMEs), it therefore intends to develop links with employer associations and other representative bodies to ensure that SMEs are given the specific help they need in the labour market, without placing undue burdens on them.

4.47 Levels of customer satisfaction are already high, but the Government aims to enhance the performance and accountability of Jobcentre Plus. From December 2002, **quarterly district performance tables will be published on the Jobcentre Plus website describing how each district has performed against its annual targets and absolute measures of labour market outcomes**.

Lone parents

4.48 Although lone parent employment rates have risen sharply, the Government recognises that more must be done if its target of a 70 per cent employment rate is to be met. The delivery of Jobcentre Plus is the most important next stage, but the Government intends to go further. As announced in Budget 2002, building on the success of NDLP, **the requirement to attend a personal adviser meeting will be extended to lone parents on Income Support with children under the age of five from April 2004**. This will ensure that all lone parents are informed about the help and support available to them. Following the success of recent pilots, **the Government is also rolling out a new national mentoring service**

for lone parents from April 2003 to provide confidential advice and support on a wide range of issues and increase the help available to those who wish to make the transition to work.

4.49 Given the important role of employers in improving access to work, **the Government has asked the National Employment Panel to consult leading employers on how best they might help lone parents into employment**. A group involving representatives of leading employers and lone parents' interest groups has now been established and will report in March 2003.

Extending help with childcare

4.50 To improve access to affordable and good quality childcare, the level of funding for childcare will more than double in real terms between 2002-03 and 2005-06. This increase forms part of a combined budget for a new integrated Sure Start, early years and childcare unit, which will rise to £1.5 billion by 2005-06. The additional funds are designed to:

- ensure the creation of at least 250,000 childcare places by 2006, including childcare provided directly in children's centres; and
- support the creation and operation of children's centres in disadvantaged areas, building, where possible, on Sure Start facilities and other existing provision. By 2006 an additional 300,000 children will have access to children's centre services.

Partners

4.51 The Government is currently considering the scope for providing further support to partners of benefit claimants under the New Deal, and is assessing whether other measures might be introduced to reduce the number of households in which both partners are out of work. Building on the success of joint claims, it is considering whether the benefit system can be further modernised to provide additional support to workless households. In addition, **compulsory work-focused interviews will be introduced for partners of all new benefit claimants and existing claimants without children from April 2004**, beyond those already having joint claim status for Jobseeker's Allowance. This will be extended to existing claimants with children once the roll-out of Jobcentre Plus is complete.

Helping those with health problems and disabilities

4.52 The Government also intends to go further to help disabled people find work. The recent Green Paper, *Pathways to work: helping people into employment*, describes how the Government intends to use the resources allocated in the 2002 Spending Review to trial earlier and more intensive support for disabled people. As well as improving referral routes between Jobcentre Plus and existing provision:

- **a new, more responsive system of work-focused interviews and innovative support for disabled people will be introduced** from autumn 2003 in six pilot areas;
- **the Adviser Discretion Fund will be extended to all personal advisers who provide return to work advice to people on Incapacity Benefit** in the same pilot areas. Jobcentre Plus advisers who handle this client group will be able to distribute funds of up to £300 per client to meet essential return to work costs; and
- **those who have claimed Incapacity Benefit for three months or more in the pilot areas will be eligible for a 12-month return to work credit of £40 a week**, assisting them in the transition to work.

Box 4.1: Ethnic minorities in the labour market

Although people from ethnic minorities have, on average, lower rates of employment than white people, this aggregate picture hides significant variation. Indian, Chinese and Black African people often fare better than white people in employment, earnings and progression, while Pakistani, Bangladeshi and Black Caribbean people experience consistent disadvantage compared with their white counterparts. These differences remain even after important explanatory factors, such as differing levels of education and skills, are accounted for. The evidence suggests significant and continuing discrimination.

People from ethnic minority groups are heavily concentrated in London and the big cities of the Midlands and the North. They are four times more likely than white people to live in the 44 most deprived areas of England. Moreover, around four-fifths of Pakistani and Bangladeshi households have an income at or below the national average, compared with just one quarter of white households.

Demographic characteristics suggest that those from ethnic minority communities are likely to make a significant contribution to future growth in the working age population, creating fresh challenges and opportunities for employers and the economy, as well as for ethnic minorities themselves. To address these challenges, the Prime Minister has asked the Cabinet Office's Strategy Unit to review the means of improving the labour market outcomes of ethnic minority groups.

The review suggests that further action is needed to prevent a deterioration in the labour market outcomes of disadvantaged ethnic groups. The Strategy Unit report will be published early next year and will propose a package of measures to deliver improvements in the future. These measures will address three priorities, including:

- **the role of schools in raising educational attainment, through reforms to existing policies, programmes and activities;**
- **the need to ensure that ethnic minority communities benefit from existing labour market programmes such as the New Deal, and the importance of increasing residential mobility and improving access to transport and childcare needs; and**
- **the need to raise and support employers' awareness of equal opportunities, and to increase the efficacy of existing equal opportunities levers.**

People from ethnic minorities

4.53 With concentrations in areas of Britain with the highest levels of worklessness, the labour market position of ethnic minority groups tends to be worse than that of the rest of the population. Unemployment rates among people from ethnic minorities can be up to four times higher, and employment rates significantly lower.

4.54 The Government has already taken steps to address the difficulties faced by ethnic minorities in the labour market. Action Teams have been introduced in 63 disadvantaged areas of Britain, many of which contain large ethnic minority communities, and a new outreach service was launched in April 2002 in five urban areas that are home to three quarters of Britain's ethnic minority population. This service aims to attract people to mainstream services, improve links between communities and employers, and provide specialist training where it may help individuals to find work. As described in Box 4.1 the Cabinet Office's Strategy Unit will report early in the new year on the further steps needed to improve the labour market position of disadvantaged ethnic groups.

Local worklessness

4.55 Rising concentrations of worklessness – particularly within inner cities, former coalfield communities and seaside towns – have led to the emergence of communities in which worklessness is no longer the exception, but the norm. Households that have experienced generations of unemployment often develop a cultural expectation of worklessness. These problems are reinforced when people rarely leave their immediate neighbourhoods, despite living close to economically vibrant areas.

4.56 Local areas that suffer from low employment rates often do not simply lack jobs. Many combine high vacancies with low employment or are found alongside other districts with large numbers of vacancies or jobs. A high proportion of residents may face multiple barriers to work.

4.57 To tackle the barriers to employment in some of the most deprived neighbourhoods and advance its long-term goal, the **Government therefore intends to pilot a programme of intensive support in neighbourhoods with very high concentrations of worklessness**. From April 2004, the pilots will begin in twelve of the most deprived neighbourhoods of the country. They will test a new approach of offering intensive support to residents within the pilot neighbourhood, to help them access the jobs that can often be found within travelling distance of where they live.

4.58 In each pilot area, residents claiming Jobseeker's Allowance will benefit from accelerated access onto the New Deal programmes after just three months of unemployment, compared with the current eligibility of six months for young people and 18 months for those aged 25 and over. Because economic inactivity is often more prevalent than unemployment in these neighbourhoods, more frequent work-focused interviews will also be introduced for all partners and lone parents, with new Incapacity Benefit claimants also given more help to ensure that employment opportunities and barriers to work are regularly discussed.

4.59 Each neighbourhood will also receive a flexible discretionary fund. This will allow personal advisers to tackle the substantial and varied barriers that prevent residents in these neighbourhoods from returning to work. The fund will provide personal advisers, working in cooperation with Local Strategic Partnerships, with flexibility to deliver services in ways that best meet the needs of the local community.

MAKING WORK PAY

4.60 Welfare to Work policies that help individuals to compete effectively in the labour market need to be supported by reforms to strengthen work incentives. The Government's strategy is designed to tackle two fundamental problems:

- the unemployment trap, when those without work find the difference between in-work and out-of-work income too small to provide an incentive to enter the labour market. In 1997, a couple with one child and one partner entering full-time work at a typical entry wage would have been just £30 a week better off than on benefit; and
- the poverty trap, when those in work are discouraged from working longer hours or from taking a better paid job because it may leave them little better off. In 1997, around 750,000 families lost more than 70 pence of every extra pound they earned through higher tax and national insurance contributions (NICs) and the withdrawal of benefit payments.

National Minimum Wage

4.61 Since it was introduced in April 1999, the National Minimum Wage has underpinned the Government's tax and benefit reforms by providing a fair minimum income from work. In line with the recommendations of the Low Pay Commission, the rates of the National Minimum Wage were increased in October 2002 to £4.20 an hour for workers aged 22 and over and to £3.60 an hour for workers aged between 18 and 21. Up to $1^1/_2$ million low-paid workers will benefit from higher minimum rates of pay as a result of the last two increases in the National Minimum Wage.

4.62 The National Minimum Wage is also helping to bridge the gap between men and women's pay. Thirty years after the Equal Pay Act, women's full and part-time earnings stand at 81 and 59 per cent respectively of men's hourly full-time earnings. This discrepancy is particularly marked among low-skilled workers. The introduction of the National Minimum Wage, along with other steps the Government is taking, has helped to address this inequality, raising the wages of up to 850,000 women and reducing the pay gap, especially for women on low earnings. The Low Pay Commission is currently considering the appropriate future rates of the National Minimum Wage and is expected to make recommendations early next year.

Making work pay for all

4.63 The Government has taken steps to make work pay at all levels of the labour market, and particularly for those on low incomes. The 10 pence starting rate of income tax has halved the marginal tax rate of nearly two million low earners, and reforms to NICs introduced in the last Parliament mean that around one million low-income earners no longer pay NICs, while retaining entitlement to contributory benefits.

Additional targeted support

4.64 In addition to this support, the WFTC and DPTC have helped to improve work incentives for families with children and people with disabilities. The WFTC and DPTC currently benefit more than 1.3 million families and over 34,000 disabled people. Budget 2002 increased the basic credit in the WFTC and the credit for couples and lone parents in the DPTC by £2.50 a week on top of indexation from June 2002.

The Working Tax Credit

4.65 Building on the success of earlier tax and benefit reform, Budget 2002 introduced a new system of support to help families, tackle child poverty and make work pay. **From April 2003, the Working and Child Tax Credits will consolidate and improve existing streams of child and in-work support**. Nine out of ten families with children will be eligible for support, with the greatest help available to those who need it most. Details of the Child Tax Credit are set out in Chapter 5.

Box 4.2: The National Minimum Wage and the tax and benefit system

The National Minimum Wage and reform of the tax and benefit system are complementary instruments in pursuit of the Government's objectives to relieve poverty and increase work incentives. By setting a floor to earnings, the National Minimum Wage provides minimum income guarantees from work. These minimum incomes are further boosted by the tax credit system. The table below shows the minimum levels of income that different household types can expect from entering work, and how these have changed since the National Minimum Wage and the WFTC were introduced in April 1999 and October 1999 respectively. It also shows the effects of the new tax credits from April 2003.

Weekly minimum income guarantees

	April 1999	October 1999	April 2003
Family 1 child, full-time work (35 hours)	£182	£200	£237
Family 1 child, part-time work (16 hours)	£136	£144	£179
Single person, no children, 25 or over, full-time work (35 hours)	£113	£113	£154
Couple, no children, 25 or over, full-time work (35 hours)	£117	£117	£183

Note: assumes prevailing rate of National Minimum Wage and that the family is eligible for the Working Families' Tax Credit and, from April 2003, the Working Tax Credit/Child Tax Credit.

As well as establishing fair minimum income guarantees that improve work incentives, the National Minimum Wage and the Government's tax and benefit reforms interact in other important ways.

The National Minimum Wage ensures a fair return from working, while the Government's tax and benefit reforms focus in-work support on those who need it most. Wages are not responsive to family characteristics and needs, such as the number of children in a household. The National Minimum Wage and a tax and benefit system that focuses support on the most vulnerable groups together help to achieve the Government's poverty objectives.

Tax and benefit reform also helps to ensure that the minimum wage can be set at a level that avoids adverse employment effects. For example, as a result of the Government's reforms, it can now guarantee a minimum income of £237 a week for a family working full-time and with one child, equivalent to a minimum wage of more than £6.30 an hour. For part-time work the guarantee is £179, equivalent to a minimum wage of more than £10.10 an hour.

4.66 The Working Tax Credit is designed to help tackle poor work incentives and persistent poverty among working people. It will consolidate the adult elements of the WFTC and DPTC and extend in-work support to workers without children or disabilities. It will also replace the New Deal 50+ Employment Credit by including a return-to-work element for people aged 50 or over who have been receiving certain out-of-work benefits for at least six months. The Working Tax Credit:

- increases the generosity of support for couples with children and lone parents over and above that provided by the WFTC. Taken alongside the Child Tax Credit, a single earner couple with two children working full-time at the National Minimum Wage will receive around £400 a year more under this new system of support than under the WFTC and Children's Tax Credit in April 2002;

- contains a childcare element in recognition of the extra costs faced by working parents with childcare needs. The scope of this help is being extended to include those who use approved childcare in their own home. Unlike the rest of the Working Tax Credit, the childcare element will be paid directly to the main carer of the children in the family, usually the mother; and
- extends eligibility to people aged 25 and over without children or a disability who work 30 hours a week or more, improving work incentives and tackling poverty among this group

4.67 Table 4.2 sets out the principal elements of the Working Tax Credit.

Table 4.2: The principal elements[1] of the Working Tax Credit

£ per year/week in 2003-04	Annual	Weekly equivalent[2]
Adult element	1,525	29.20
Couples and lone parents element	1,500	28.80
30 hours element	620	11.90
Disabled worker element	2,040	39.15
Childcare element		
–maximum eligible cost for one child		*135*
–maximum eligible cost for two or more children		*200*
–percentage of costs covered	*70*	
Threshold below which maximum Working Tax Credit is payable	5,060	
Withdrawal rate (per cent)	37	

[1] *People with severe disabilities or aged 50 or above going back to work after a period on a qualifying benefit will be entitled to extra support.*

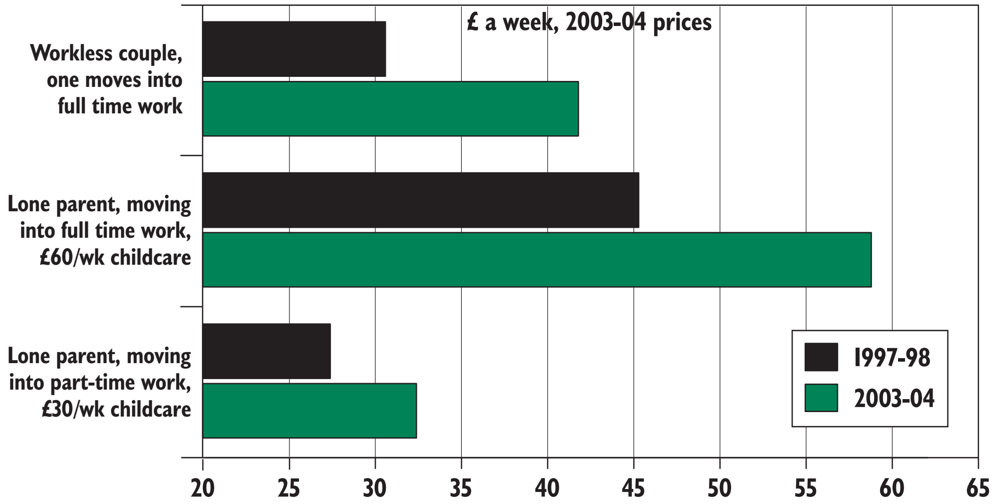
[2] *The legislation sets annual amounts, and weekly equivalents are presented to allow comparison with the present system.*

4.68 The Government has launched a nationwide awareness campaign ahead of the introduction of the new tax credits. The campaign tells people about the changes to the way in which financial support will be provided and informs them of what they may be entitled to. Further details are given in Chapter 5. From January 2003, Jobcentre Plus offices will also play a major role in disseminating information about the new tax credits and providing advice to clients on their eligibility.

The effect of the Government's reforms to make work pay

4.69 The Government guarantees a minimum income from work to help tackle the unemployment trap and ensure that work pays more than benefits. Government reforms, including the introduction of the Child and Working Tax Credits, have increased the gains to work for households with children. Chart 4.5 shows the effect on households with one child.

Chart 4.5: The gains to work for different households with one child

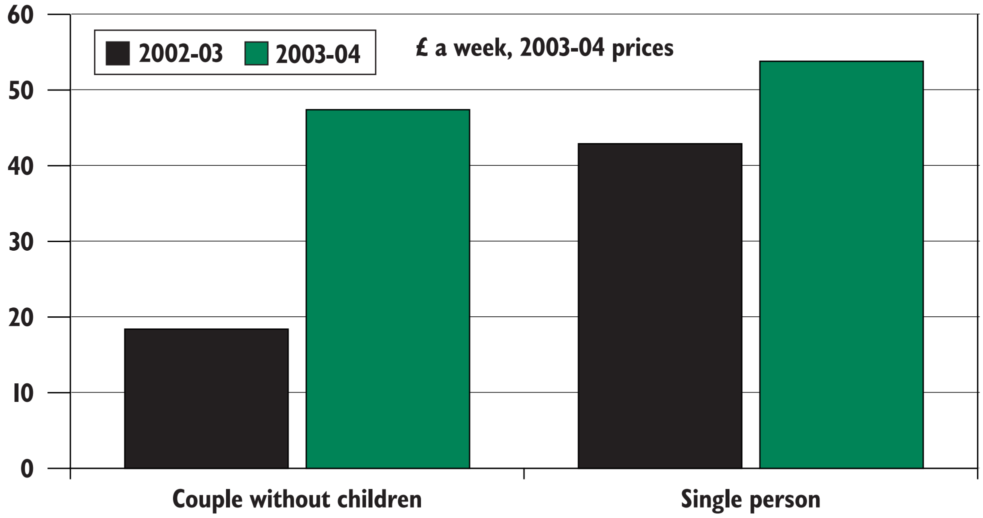


Note: the gain to work is the difference between in-work incomes (net wages and tax credits) and out of work benefits.

Support for workers without children

4.70 The extension of in-work support to workers aged 25 and over without children or a disability will significantly increase work incentives for this group too. Chart 4.6 shows how the gain to work at typical entry wages will be improved by the Working Tax Credit. Alongside the National Minimum Wage, the Working Tax Credit will ensure a higher guaranteed income from work while protecting employment. Under the new system, a couple aged 25 and over in full-time work, without children or a disability will be guaranteed at least £183 per week. This amounts to an "effective minimum wage" of £5.25 an hour net of taxes.

Chart 4.6: The gains to work for people aged 25 or over without children



Note: the gain to work is the difference between in-work incomes (net wages and tax credits) and out of work benefits.

The poverty trap **4.71** While improved gains to work are helping to tackle the unemployment trap, the Government also wants to ensure that workers have incentives to move up the earnings ladder, thereby tackling the poverty trap.

4.72 Marginal deduction rates measure the extent of the poverty trap by showing how much of every additional pound of gross earnings is lost through higher taxes and withdrawn benefit or tax credits. As a result of the Government's reforms to the tax and benefit system, the number of low income households facing marginal deduction rates of over 70 per cent has decreased steadily since 1997. Table 4.3 shows that the number of households facing marginal deduction rates of this level will have fallen by nearly half a million since April 1997 once the new tax credits are introduced.

Table 4.3: The effect of the Government's reforms on high marginal deduction rates

Marginal deduction rate [1]	April 1997[2]	April 2002[2]	April 2003[2]
Over 100 per cent	5,000	0	0
Over 90 per cent	130,000	45,000	45,000
Over 80 per cent	300,000	210,000	200,000
Over 70 per cent	740,000	255,000	260,000
Over 60 per cent	760,000	940,000	1,450,000

[1] *Marginal deduction rates are for working households in receipt of income-related benefits or tax credits where at least one person works 16 hours or more a week.*

[2] *Figures are cumulative. Before Budget 1998 based on 1997–98 estimated caseload and take-up rates; after Budget 2002 based on 1999–2000 caseload and take-up rates.*

4.73 This analysis is likely to overestimate the extent of high marginal deduction rates under the new tax credits, as it does not take into account the way in which they respond to rises in income. As they only respond to rises in income of more than £2,500 in the current year, compared with the last, recipients will not see their tax credits reduced as soon as their income rises. This feature of the new tax credits will reduce the effective marginal deduction rate in any one year. The system will, however, respond in full to falls in income as soon as they are identified, ensuring that support is provided to people in need, when they need it most.

Next steps

4.74 The Government's reforms, including the introduction of the Working Tax Credit from April 2003, improve work incentives, especially for those on the lowest incomes. However, for some people, particularly those who have been out of work for long periods, the transition to work can still be a difficult period. Entry wages are typically lower than for those already in employment, and the need to meet work-related expenses can lead many to prefer the certainty of benefits.

4.75 Easing the transition to work will help to achieve the Government's long-term employment goal. A smooth transition to work not only encourages people to seek and apply for work, it also improves their prospects of remaining in employment and progressing beyond entry-level jobs. The Government is therefore taking further steps to improve work incentives and to support job retention and advancement.

Job Grant

4.76 To provide extra help with the costs of entering a new job, the Government intends to **extend eligibility for the Job Grant and introduce a new rate of £250 for households with children**. From October 2004, the Job Grant will be available to those who move into work following six months on Incapacity Benefit or Income Support, including lone parents, or, for those aged 25 and over, Jobseeker's Allowance. As at present, Jobseeker's Allowance claimants aged between 18 and 24 will receive intensive support through NDYP, rather than be eligible for the Job Grant. These enhanced arrangements will replace the Back to Work Bonus and the lone parent Income Support run-on. They will also be complemented by further changes to additional sources of financial support, including an immediate **extension of access to the Adviser Discretionary Fund to all those who have been claiming benefits for six months or more when they return to work, to meet essential costs**.

Retention and advancement

4.77 Retaining a job and advancing in work can be particularly difficult for those who have just moved off welfare. This is particularly true for lone parents and those without qualifications. Some people continually move between low paid work and unemployment, trapped in a 'low pay, no pay' cycle. Around 25 per cent of people who leave Jobseeker's Allowance return to benefits within three months, and almost 40 per cent return within six months. The wages that people return to work on are also typically lower than for those already in work.

4.78 Budget 2001 announced a demonstration project to explore how best to improve employment retention and advancement among low paid workers and those moving off welfare. The design phase of the project, drawing on UK and international expertise, is now complete, and **the Government will now pilot new measures, including one-to-one support from a dedicated Advancement Support Adviser, and financial incentives to encourage employment retention and skills accumulation, in six areas from October 2003**. The pilots will test the effectiveness of these measures in improving employment retention and advancement for those joining ND25+ and NDLP, as well as lone parents in receipt of the Working Tax Credit working less than 30 hours a week.

Reforming Housing Benefit

4.79 Housing costs are a particular concern to many people moving into work. Evidence suggests that worklessness is concentrated among tenants, particularly those in social housing – only 49 per cent of those in local authority housing are in employment compared with 84 per cent of those in owner-occupied housing.

4.80 Housing Benefit provides help with rental costs for low income tenants in and out of work. Around 3.8 million tenants currently rely on it for help with their rent. However, the design and administration of Housing Benefit can hinder the transition to work for some people. Claimants often do not know until after they have moved into a property whether or not their entitlement will meet the cost of their rent. Moreover, delays in processing new applications after a claimant returns to employment can lead to rent arrears and debt, dissuading some people from moving into work.

4.81 The Government has taken a number of steps to alleviate the problems associated with Housing Benefit, working with local authorities and other organisations to improve administration, restructuring rents in the social sector and moving 800,000 people off Housing Benefit through higher employment and in-work support. Building on these steps, **the Secretary of State for Work and Pensions recently announced a range of further reforms to simplify and streamline the administration of Housing Benefit**, reducing its capacity to act as a barrier to work. These reforms include:

- the piloting in Pathfinder areas of a flat rate local housing allowance for tenants in the deregulated private rented sector. This will ensure that tenants know in advance what rent can be covered by Housing Benefit in these areas and ends the requirement that individual claims are referred to rent officers, simplifying and speeding up the claims process; and

- further steps to quicken and simplify the administration of Housing Benefit claims. These steps include ending the requirement that people make fresh claims whenever they take a job, a more efficient reclaim process for people whose employment ends, ensuring that Housing Benefit runs on automatically for claimants returning to work after six months or more spent unemployed while the local authority recalculates entitlement, and ending the requirement that all Housing Benefit claimants make a fresh claim annually.

4.82 **The Government also proposes to extend the Housing Benefit run-on to those who have received Incapacity Benefit or Severe Disablement Allowance continuously for at least six months,** bringing the treatment of this group in to line with that of Jobseeker's Allowance claimants and lone parents and removing a significant barrier to work for people with disabilities.

4.83 This package of reforms will lead to further improvement in the administration of Housing Benefit, reducing inefficiencies in the current system and easing the transition to work for large numbers of tenants seeking employment. It will also provide valuable evidence on which to base further action to improve and reform the functioning of Housing Benefit over the longer term.

5 BUILDING A FAIRER SOCIETY

The Government is committed to building a fairer and more inclusive society in which everyone can contribute to, and share in, rising national prosperity. Reform of the welfare state, including the introduction of the new Child Tax Credit and the Pension Credit from next year, is at the heart of the Government's strategy for supporting families with children and helping to provide security for all in old age. A fair and efficient tax system, which encourages work and saving and ensures that everyone pays their fair share of tax, underpins this programme of reform. By leading international efforts to achieve the Millennium Development Goals, the Government is determined to ensure that fairness at home is matched by genuine progress in reducing global poverty. The Pre-Budget Report describes the steps the Government is now taking to ensure that economic strength goes hand in hand with social progress and a modern tax system by:

- **publishing shortly next steps in the Government's strategy to help parents balance their work and family lives;**
- **consulting key stakeholders on the detailed implementation of the Child Trust Fund** to strengthen the saving habit and spread the benefits of asset ownership;
- **taking forward the recommendations of the Sandler review** to improve competition and efficiency in the market for long-term savings;
- **publishing on 17 December a Green Paper on pensions** setting out proposals to help those of working age plan more effectively for their retirement;
- **consulting, alongside the pensions Green Paper, on radical proposals to simplify the taxation of pensions** to increase choice and flexibility for all;
- **investing in the Social Fund** to enhance its ability to help those on low incomes manage their finances;
- **working to deliver a global new deal to tackle international poverty,** by promoting a new $50 billion International Financing Facility and improvements in aid effectiveness;
- **taking further steps to encourage charitable giving,** which include extending the Government supplement on payroll donations until 2004;
- **abolishing Royalty payments made by North Sea oil companies** to encourage long-term investment by the industry;
- **launching a new strategy to protect VAT revenues and taking further steps to tackle tax avoidance** to ensure that everyone pays their fair share of tax; and
- **consulting further on the shape of a modernised stamp duty regime** for land and buildings to be introduced late next year.

INTRODUCTION

5.1 Previous chapters have described the Government's strategy for delivering a strong and stable economy, based on high and stable levels of growth and employment and faster productivity growth. This chapter sets out how the Government is working to underpin that economic strength with fairness and social inclusion, so that every individual has the chance to fulfil their potential, regardless of their circumstances.

A modern welfare state

5.2 Since 1997, the Government has placed reform of the welfare state at the heart of its strategy for promoting fairness and inclusion. A modern welfare state should deliver an equal chance for everyone to share in rising national prosperity.

5.3 Although the world has changed greatly since Beveridge published his plans in 1942, the principles which underpin the welfare state remain those of:

- opportunity, for people to improve their circumstances and those of their families;
- security, to protect people from undue hardship that can arise from life events; and
- responsibility, of everyone to make the most of opportunities, for example through employment.

5.4 The old welfare system was failing on many counts. It was passive and reactive, delivering poor quality, fragmented services. Welfare benefits were seen as being mainly for the poor, and were stigmatising as a result. High marginal rates of withdrawal of benefits meant that people did not always see much gain from moving into work or increasing their hours. Vulnerable groups, notably children, were left behind as others benefited from rising living standards.

5.5 The new welfare system puts into practice the principles of progressive universalism, with support for all, and most support for those who need it most. Advice and support will be delivered through modern, high quality, integrated services, such as Jobcentre Plus and the Pension Service, tailored to people's circumstances. Where appropriate, financial support will be delivered through the tax system, reducing stigma. Fewer families suffer from very high marginal deduction rates when they move into work or increase their hours, and there is a renewed focus on children and pensioners.

5.6 This chapter describes how the Government is applying these principles to tackle child and pensioner poverty, promote saving throughout life, and support people with disabilities. It also describes the broader action the Government is taking to establish a modern and fair tax system and promote international efforts to achieve the Millennium Development Goals for global poverty.

SUPPORT FOR FAMILIES AND CHILDREN

Tackling child poverty

5.7 The Government's aim is for every child to have the best possible start in life. Childhood experience lays the foundation for later life. Children who grow up in poverty can experience disadvantage that affects not only their own childhood, but their experience as adults and the opportunities available to their children. Poverty places strains on family life and excludes children from the everyday activities of their peers. Many children experiencing poverty have limited opportunities to play safely, live in overcrowded and inadequate housing, and eat less nutritious food, resulting in more accidents and ill health. Children growing up in low-income households also have fewer opportunities to learn and as adults are more likely to be unemployed or earn low wages.

5.8 By the mid-1990s the UK had the highest rate of relative poverty in the EU[1]. Over the previous two decades the proportion of children living in low-income households had more than doubled, while the proportion of children living in workless households saw a similar steep rise. The Government's long-term goal is to halve child poverty by 2010 and to eradicate it within a generation.

[1] Measured as the proportion of children living in households below 60 per cent of median income.

5.9 The Government's strategy for tackling child poverty was set out alongside the November 2001 Pre-Budget Report[2]. This strategy is designed to:

- ensure decent family incomes, with work for those who can and support for those who cannot;
- support parents, so that they in turn can provide better support for their children;
- deliver high quality public services in all neighbourhoods, with targeted interventions for those with additional needs; and
- harness the power and expertise of the voluntary and community sectors, promoting innovation and good practice.

Financial support for families and children

5.10 The Government is reforming the tax and benefit system to tackle child poverty and ensure decent family incomes. The reforms ensure that support is available to all families with children, in recognition of the costs and responsibilities which come with parenthood. Those who need the greatest support, including families on lower incomes, those with children under one, and parents of disabled children, receive the most help.

5.11 Since 1997, financial support for families with children has been increased significantly. Reforms so far include:

- record increases in Child Benefit to £15.75 a week for the first child and £10.55 for subsequent children. As announced in Budget 2002, **from April 2003, the rates of Child Benefit will rise in line with indexation to £16.05 and £10.75 respectively;**
- the introduction of the Children's Tax Credit in April 2001, now worth up to £529 extra a year for around 4.6 million families and, since April 2002, up to £1,049 a year for families in the year of a child's birth;
- the introduction of the Working Families' Tax Credit (WFTC) which benefits over 1.3 million families – around 500,000 more than previously received Family Credit. On average, these families are now receiving over £40 a week more under the WFTC than under Family Credit; and
- increases in the children's allowances in Income Support and other income-related benefits, including a doubling in real terms of the rates for children under 11.

The Child Tax Credit

5.12 As part of the next steps in tax and benefit reform, Budget 2002 introduced a new system of support to help families, tackle child poverty and make work pay. **From April 2003, the Child and Working Tax Credits will separate support for adults from support for the children in a family, while providing a common framework for assessing entitlement.** The Working Tax Credit is described in detail in Chapter 4.

[2] *Tackling child poverty: giving every child the best possible start in life*, HM Treasury, December 2001.

5.13 Income-related support for families is currently provided through several different instruments and is administered by different parts of government. Levels of financial assistance for children depend on whether their parents are in or out of work.

5.14 The Child Tax Credit will provide a single, seamless system of income-related support for families with children, bringing together the assistance for children currently provided through the child elements of the WFTC, the Disabled Person's Tax Credit (DPTC), and Income Support or Jobseeker's Allowance, as well as that provided by the current Children's Tax Credit. Building on the foundation of universal Child Benefit, the Child Tax Credit will deliver:

- a secure stream of income for families with children which does not depend on the employment status of the parents, creating a stable income bridge when families move into work;
- a system in which all support for children is paid direct to the main carer in the family – usually the mother – in line with Child Benefit;
- a common framework for assessment, so that all families are part of the same system and poorer families do not feel any stigma associated with current forms of support;
- a less intrusive, annual system, under which families whose circumstances remain the same will only need to contact the Inland Revenue once a year about tax credits;
- a modern income test, which does not penalise saving, instead taking into account the income from capital rather than the capital itself; and
- a more responsive system, in which a family's tax credit award can be adjusted to reflect changes in their income and circumstances. The new tax credits only respond to rises in income in the current year of more than £2,500, so that recipients will not see their tax credits reduced as soon as their income rises.

5.15 Paid on top of Child Benefit, the Child Tax Credit will provide:

- a family element of £545 a year, or £1,090 for families with one or more children under the age of one, for all families with incomes of less than £50,000, gradually withdrawn for those with incomes above this amount; and
- a child element of £1,445 a year for each child or young person in families with incomes of up to around £13,000 a year, gradually withdrawn for families with higher incomes. Families caring for disabled or severely disabled children will receive increased child elements to reflect their greater needs. **From April 2004, the child element will be uprated at least in line with earnings rather than prices for the rest of the Parliament.**

Box 5.1: The new tax credits: "money with your name on it"

Around 5¾ million families with children are expected to benefit from the Child Tax Credit. To ensure that families understand the changes and what they might be entitled to, the Government has launched a nationwide awareness campaign, involving:

- **a national television advertising campaign, supported by radio, press and on-line publicity, and including advertising focused on ethnic minority communities. Over £9 million has been allocated to advertising;**
- **a series of 11 tax credit road-shows held throughout the country, attended by around 2,000 people and supplemented by seminars aimed at specific groups such as employers and those who work with students or people with disabilities; and**
- **harnessing the potential of intermediaries to reach audiences that have traditionally been more difficult to get to. For example, pilot projects are involving local voluntary groups in work to promote tax credit take up in their communities.**

The Government's awareness campaign was launched by the Chancellor on 16 September. As of 22 November:

- **over 2 million enquiries had been received. People can call the tax credits freephone response line (0800 500 222) or log on to the tax credits website[1], which provides comprehensive information and enables families to calculate their entitlement and make a claim on-line; and**
- **4 million forms had been sent out and so far around 1.4 million claims returned to the Inland Revenue, ahead of expectations.**

Those receiving Income Support or Jobseeker's Allowance will be moved onto the new Child Tax Credit automatically from April 2004 and do not need to claim now. Families receiving one of the existing tax credits need to make a fresh claim before 31 January 2003 to guarantee that they will begin receiving the tax credits they are due in April 2003.

[1] www.inlandrevenue.gov.uk/taxcredits.

5.16 Table 5.1 shows the weekly levels of support that the Child Tax Credit and Child Benefit will provide for families from April 2003. The precise amount a family will receive will depend on their income and circumstances, with support gradually tapered away as income rises.

Table 5.1: Levels of support for families from April 2003[1]

Family income (£ a year) *Per cent of families*	less than £13,000 *25*	less than £50,000 *85*	all families *100*
1 child	£54.25	£26.50	£16.05
2 children	£92.75	£37.25	£26.80
3 children	£131.25	£48.00	£37.55

[1] Amounts of tax credits set in legislation are annual figures. Weekly equivalent figures are used to aid comparison with the current system.

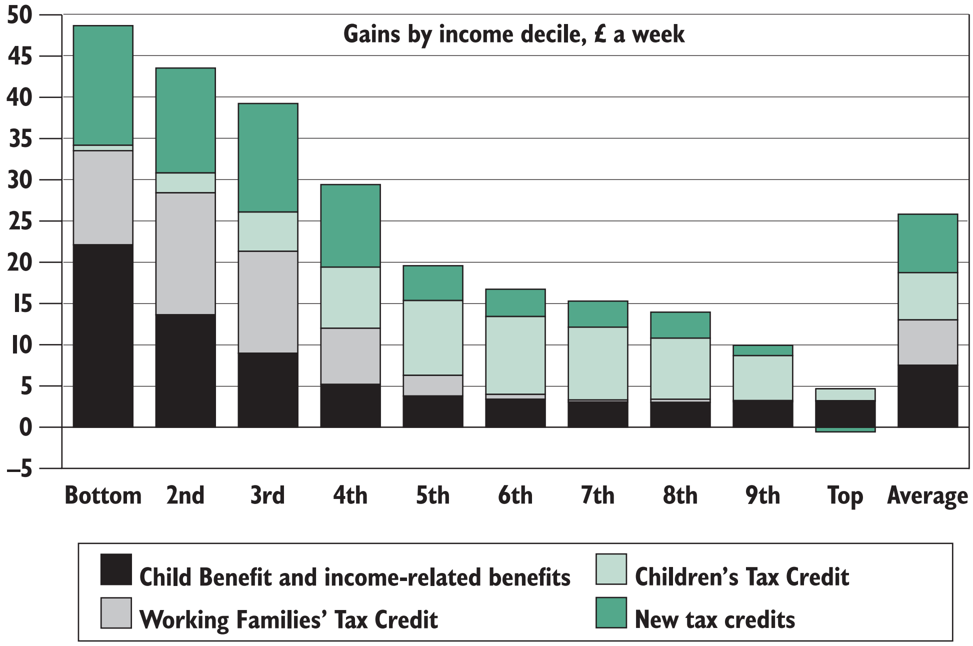
Effects of measures to support families with children

5.17 As a result of the Government's personal tax and benefit reforms since 1997, including the changes to national insurance contributions (NICs) and the income tax personal allowance announced in Budget 2002, by April 2003:

- families with children will be, on average, £1,200 a year better off, while those in the poorest fifth of the population will be, on average, over £2,400 a year better off in real terms;
- a single-earner family on half average earnings of £14,200 with two young children will be £3,460 a year better off in real terms; and
- a single-earner family on average earnings of £28,400 and with two children will be about £300 a year better off in real terms.

5.18 Chart 5.1 shows the impact of the Government's reforms since 1997, including the introduction of the new tax credits, by decile, on families with children.

Chart 5.1: Gains for families as a result of children's measures by 2003



Social Fund

5.19 In addition to support provided by weekly benefit payments and tax credits, the Social Fund provides people on low incomes with grants and loans to help them manage a wide range of unexpected or occasional costs, such as those involved in replacing large household items, setting up home after leaving institutional care, or paying for a funeral.

5.20 The Government has introduced a number of important changes to the Social Fund since 1997, including a simpler and more transparent claims process. **From April 2003, the maximum payment for the fixed element of the funeral grant will rise from £600 to £700, and £90 million will be added to the Discretionary Social Fund over the three years to 2005-06.** Combined with additional administrative improvements, this investment will enhance the Fund's ability to help those on low incomes manage their finances.

Education Maintenance Allowances

5.21 Education is a crucial influence on a child's life chances. A decent education builds employment opportunity and enhances the wellbeing of people throughout their lives. Young people from low-income families who stay on to take A levels or equivalent qualifications are much more likely to move out of low income in adult life compared with those who leave school at the age of 16[3]. In the past, too few people have aspired to continue in learning after the statutory school-leaving age, often because of a lack of financial support. In recognition of the financial barriers which prevent some young people continuing in education, **Education Maintenance Allowances (EMAs) will be rolled out across England from September 2004.** EMAs will enable more young people from poorer families to pursue education beyond the age of 16 by providing up to £1,500 a year, depending on household income.

Adoption and foster carers

5.22 The Government recognises the important contribution of parents who foster or adopt children and has decided that payments to adoptive families under the new Children and Adoption Act should continue to be free of tax. These arrangements benefit all adoptive families who receive financial support to help them meet the extra costs they face when they adopt a child. **The Government is also considering ways in which the tax system may facilitate the recruitment and retention of foster carers.**

Supporting parents: balancing work and family life

5.23 The Government is committed to helping parents balance their work and family lives. From next April, a series of reforms, including the introduction of the new Child and Working Tax Credits, will help to deliver a step change in choice and support for parents, benefiting employers, employees and children alike. Details of the Government's strategy, including next steps, will be set out in the forthcoming document, *Balancing work and family life: enhancing choice and support for parents*.

Support in the early years of a child's life

5.24 In recognition of the considerable financial pressures associated with the birth of a child, the Government is providing additional support to help parents through the early months of their child's life. New maternity, paternity and adoption leave rights will improve the help available to parents seeking to balance work and caring responsibilities. In April 2002, the standard rate of Statutory Maternity Pay (SMP) was increased to £75 a week. **From April 2003, the standard rate of SMP will rise to £100 a week and the duration of paid leave will be extended from 18 to 26 weeks. Two weeks paternity leave and 26 weeks adoption leave will also be introduced, paid at the same standard rate as SMP.**

5.25 To complement these reforms, from April 2003 parents of young children and disabled children will also have a new right to request a flexible working pattern, and employers will face a new duty to consider such applications seriously.

Childcare

5.26 Support for working parents who require childcare is also being enhanced. Access to affordable and good quality childcare is a key concern for working parents. As described in Chapter 4, the 2002 Spending Review allocated significant new resources to create new childcare places and fund the operation of children's centres which will bring together good quality childcare, early years education, family support and health services. From April 2003, the Working Tax Credit will also provide an improved system of financial assistance to help families meet the costs of childcare. In particular, eligibility for the childcare element of the Working Tax Credit will be extended to include those who use approved childcare in their own home, benefiting, among others, parents of disabled children and those who work outside conventional hours.

[3] *Intergenerational mobility among the rich and poor: results from the National Child Development Survey*, G. Johnson and H. Reed, Oxford Review of Economic Policy, Volume 12, No 1. 1996.

Working with business

5.27 Employers have an important role in helping their employees to balance their work and family lives. Such support benefits employers themselves, including by improving recruitment and retention prospects, reducing absenteeism and staff turnover, and improving productivity and business performance. The Government is therefore committed to working alongside employers to encourage them to adopt best practice and to offer flexible working opportunities throughout the workforce, including through the Work-Life Balance campaign.

Public services to tackle child poverty

5.28 Strong and dependable public services are essential to tackle the underlying causes of poverty and deprivation and their effects. The 2002 Spending Review provided substantial new investment in child-focused services, including:

- an extra £14.7 billion for education by 2005-06 – an increase of 6 per cent a year in real terms. A new Leadership Incentive Grant of £125,000 per school will enable governing bodies in schools in challenging areas to put in place good senior and middle management, and substantial increases to the School Standards Grant will help to deliver schools reforms;
- £570 million for the Children's Fund over the three years to 2005-06. Children's Fund partnerships provide targeted and coordinated local services for children at risk of social exclusion and their families. Some 85 Children's Fund partnerships are already operating and the final wave of partnerships will begin in April 2003; and
- resources to support a range of initiatives to tackle health inequalities, including better preventative health care services and targeted services for disadvantaged communities.

Children at risk

5.29 As part of the 2002 Spending Review, the Government conducted a cross-cutting review into the delivery of programmes and services to help children at risk of poor outcomes in areas such as health, education and employment. The review identified the factors that increase that risk, including growing up in poverty, poor relationships with parents, poor educational experience, low aspirations and lack of role models. Many of these factors manifest themselves early in life, but too many children only receive extra support after the onset of acute problems. The prevalence of these risk factors has also increased over time and they have become more concentrated in particular individuals and areas.

5.30 To enhance preventative services for children, the review recommended strengthening existing local partnerships and piloting new models for joint working; improving the focus of mainstream services for children and young people to ensure they respond better to those most in need; and identifying need at an earlier stage, to ensure that preventative services are available before children, young people and families reach crisis. In the light of the review, the Government is emphasising the importance of developing strategies at a local level to deliver preventative services to children. The Government also intends to **pilot new models for multi-agency working on services for children – Children's Trusts – by the end of 2003.**

5.31 As recently announced by the Prime Minister, **the Government intends to produce a Green Paper on services for children and young people at risk**, building on the analysis set out in the Children at Risk Review, carried out as part of the 2002 Spending Review. The Green Paper will bring forward proposals to improve the life chances of children at risk of a range of adverse outcomes, including truancy, educational under-achievement, offending, victimisation, teenage pregnancy, and poor mental health. The paper will examine the roles of social services and youth justice, as well as those of schools, families and communities.

Eradicating child poverty

5.32 The Government's annual anti-poverty report, *Opportunity for all*[4], sets out progress against a series of indicators measuring the different aspects of poverty. In particular, the report describes performance against the Government's Public Service Agreement target for 2004 to reduce the number of children living in relative low-income households by one quarter compared with 1998-99. By 2000-01 the number of children in low-income households had fallen by 300,000 after housing costs and by 400,000 before housing costs from a base of 4.2 million and 3.1 million respectively. The Government is therefore one third of the way towards achieving its 2004 poverty reduction target in one third of the time.

5.33 This reduction does not reflect the full impact of the Government's policies to reduce the number of children living in low-income households. By 2003–04, there will be 1.5 million fewer children living in relative low-income households[5] than there would otherwise have been, had the Government done no more than index 1997 policies to prices. This comprises both:

- the number of children living in households now lifted above the relative income level; and
- the number of children who would otherwise have fallen into relative poverty, as median real income and earnings rise.

5.34 Looking further ahead, the Government is committed to finding a measure of child poverty that will both underpin effective policy-making and enable the public to gauge progress towards the long-term goal of halving child poverty by 2010 and eradicating it within a generation. The Government has consulted[6] on four options for building on its existing poverty indicators. These are:

- headline indicators, for the five key areas of low income, worklessness, educational attainment, health inequalities and housing standards;
- a child poverty index, distilling the five headline indicators into a single measure;
- a headline measure of 'consistent poverty', combining relative low income and material deprivation; and
- a core set of indicators of low income and 'consistent poverty', incorporating an absolute low income indicator, a measure combining material deprivation with relative income, and a separate relative income measure.

5.35 The Department for Work and Pensions will publish conclusions drawn from the consultation by spring 2003. This work will inform future decisions about the role of public services and tax and benefit reform in helping to deliver the Government's long-term goal.

[4] *Opportunity for all*, Department for Work and Pensions, September 2002.

[5] Defined as having income below 60 per cent of the contemporary median.

[6] *Measuring child poverty*, Department for Work and Pensions, April 2002.

FAIRNESS FOR PEOPLE WITH DISABILITIES

5.36 People with disabilities should have the opportunity to lead independent and fulfilling lives. The New Deal for disabled people (NDDP) is helping those disabled people who can and wish to work make a successful return to employment, and the recent Green Paper, *Pathways to work: helping people into employment*, describes how the Government intends to intensify the support available to help those on Incapacity Benefit return to employment. In addition, **from April 2003, the Working Tax Credit will include support for people with disabilities**, bringing them into the mainstream system of support, while recognising the additional costs they may face when in work. All of these measures are discussed in more detail in Chapter 4.

5.37 People with disabilities who are unable to work should have financial security and support. The Disability Income Guarantee ensures that severely disabled people under 60 years of age and on income-related benefits receive a guaranteed minimum income of at least £144.45 a week for single people, and £189.95 a week for couples. From April 2002, young people disabled before the age of 20 have also been able to claim Incapacity Benefit without first having to satisfy contribution conditions, providing up to £28.10 a week in additional benefit payments.

Support for families with disabled children

5.38 In recognition of the fact that families with disabled children often need extra help, **the disabled child premium or disability element will rise in April 2003 to more than £40 a week on top of basic Income Support or tax credits**, benefiting around 80,000 children. In addition, the mobility component of Disability Living Allowance was extended to three and four year olds in April 2002, providing an extra £39.30 a week to these families.

Support for people with high care needs

5.39 Severely disabled people with high care needs who wish to work are now entitled to access the Independent Living Fund, regardless of their or their partner's earnings. This improvement in entitlement, worth an average of £130 a week to those families, recognises the additional costs attached to being severely disabled and in work. The capital limits have also been raised, extending help to people with savings of up to £18,500.

Tackling discrimination

5.40 Fairness and opportunity for disabled people requires an end to discrimination in the workplace and beyond. Following the establishment of the Disability Rights Commission in April 2000, the Government is now consulting on how best to advance disability rights within the structure of future equality machinery[7], including the proposal for a single equality commission. Following consultation last year on the recommendations of the Disability Rights Task Force and the provisions of the Employment Directive, the Government is also consulting on proposals to amend the Disability Discrimination Act in 2004 to reflect the requirements of the Directive[8].

FAIRNESS FOR PENSIONERS

5.41 A fair society guarantees security in old age. The Government has therefore introduced comprehensive reforms to tackle pensioner poverty and ensure that all pensioners are able to share in rising national prosperity. This programme of reform is underpinned by four important principles:

- security for all pensioners, through guaranteed minimum increases in the annual basic state pension and help with the costs of winter fuel;

[7] *Equality and diversity – making it happen*, Department of Trade and Industry, October 2002.
[8] *Equality and diversity – the way ahead*, Department of Trade and Industry, October 2002.

- extra financial support for the poorest pensioners, through a minimum income guarantee;
- reward for today's low and modest-income pensioners who have saved for their retirement, through the new Pension Credit; and
- a sustainable system of support which enables today's workforce to plan ahead and make decent provision for their retirement, protecting themselves against poverty in the future.

Tackling pensioner poverty

5.42 The Government's first priority has been to help those in greatest need by reforming Income Support for pensioners and introducing a more generous Minimum Income Guarantee (MIG). To ensure that more pensioners are able to share in rising national prosperity, **the level of the MIG will be raised in line with earnings throughout this Parliament**. Over two million pensioners now benefit from this support. The launch of the Pension Service in April 2002, and the Pension Credit from October 2003, will encourage more people to claim the support to which they are entitled.

Security for all pensioners

5.43 To ensure that all pensioners have security in retirement, not just the poorest, the Government has also:

- increased the basic state pension by more than inflation in each of the last two years. From April 2003, **the full basic state pension will rise further to £77.45 a week for single pensioners and to £123.80 a week for pensioner couples** – an annual increase of more than £100 for single pensioners and more than £160 for couples;
- **guaranteed that the basic state pension will rise in future years by 2.5 per cent or the increase in the September Retail Prices Index, whichever is higher;**
- introduced winter fuel payments, worth £200 per household each year for the remainder of this Parliament. Around 11 million people aged 60 or over benefit from this support each winter; and
- introduced free TV licences for households with someone aged 75 or over and free eye tests for all those over 60.

The Pension Credit: rewarding low and modest-income pensioners

5.44 In order to do more to tackle pensioner poverty and to reward saving, while providing a modern and integrated service for pensioners on low and modest incomes, **the Government is introducing the Pension Credit from October 2003**.

5.45 The Pension Credit will bring pensioners' incomes up to a guaranteed minimum entitlement and ensure that millions of pensioners who have saved modest amounts will gain from having done so. The current MIG capital regime will be revised and the MIG's intrusive weekly means-test abolished for the vast majority of pensioners. People on Housing Benefit and Council Tax Benefit will be protected to ensure that they receive the full benefit of the Pension Credit. The Pension Service will make it easier for pensioners to claim their entitlements.

5.46 On its introduction, the Pension Credit will reward pensioners whose savings, second pensions or earnings give them incomes of up to £139 a week for single pensioners and nearly £204 a week for couples. No single pensioner need therefore live on less than £102.10 a week and no pensioner couple on less than £155.80 a week.

5.47 The guaranteed minimum entitlement in the Pension Credit will be linked to the growth in average earnings throughout this Parliament so that all those receiving the Pension Credit will gain. The poorest third of pensioners will be about £250 a year better off on average than had the equivalent amount been spent on raising the basic state pension. Around half of all pensioner households will be entitled to £400 extra a year on average from the Pension Credit, with some gaining up to £1,000 a year.

Effects of measures to support pensioners

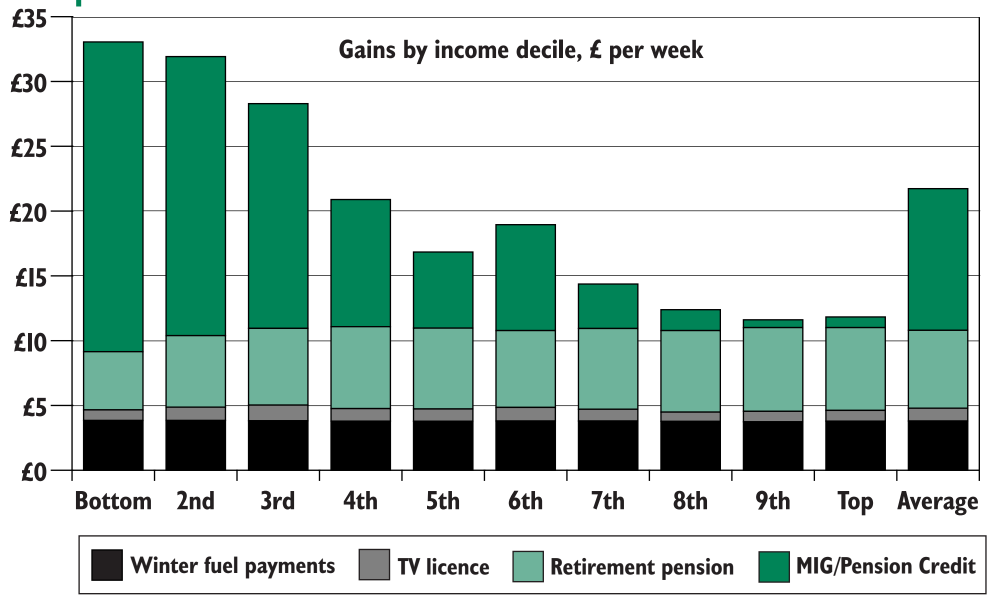
5.48 In 2002–03 the Government is spending around £6 billion extra in real terms on pensioners as a result of policies introduced since 1997. This will ensure that the poorest third of pensioners receive an additional £2.5 billion – three times more than an earnings link in the basic state pension would have provided.

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

- pensioner households will be over £1,150 a year better off in real terms – around £22.50 extra a week; and
- the poorest third of pensioner households will have gained over £1,500 a year in real terms.

5.50 Chart 5.2 shows the distributional impact, in current prices, of the Government's pensioner policies up to Budget 2002, including the Pension Credit.

Chart 5.2: Overall gains for pensioner families from pensioner policies



Support for pensioners who pay tax

5.51 While most pensioners have no income tax to pay, for those who do **the age-related personal allowances will rise in 2003-04 for those aged 65 to 74 to £6,610 and for those aged 75 or over to £6,720.** This represents an increase of £400 and £240 a year respectively over the amount that would result from statutory indexation, and will ensure that no pensioner aged 65 or over will pay tax on income of less than £127 a week. Subsequently, the age-related allowances will be raised at least in line with earnings rather than prices for the remainder of this Parliament.

PROMOTING SAVING THROUGHOUT LIFE

5.52 Saving and assets provide people with security in times of adversity, long-term independence and opportunity and comfort in retirement. The Government's strategy for promoting saving and asset ownership is focused on:

- improving the environment for saving, by maintaining macroeconomic stability and establishing an efficient market in financial services, regulated by the Financial Services Authority (FSA);
- creating the right incentives for saving, by ensuring that the tax and benefit system does not unfairly penalise savers and by assisting those on lower incomes; and
- empowering individuals by providing greater financial information, improved access to honest and straightforward advice, and simpler, easier to understand savings products.

5.53 To help deliver this strategy, the Government is developing a series of savings products suitable for each stage in a person's life cycle. The design of these products will ensure that, as the scale of saving increases, proceeds from one product may be rolled into the next, so helping people to progress up the savings ladder.

Saving Gateway

5.54 The Saving Gateway helps those who would otherwise have difficulty starting on the savings ladder. The Saving Gateway is an account targeted at individuals from low-income groups, typically those at the start of their working lives. It aims to increase incentives to save through a Government-funded match of all money saved, up to a limit. Consumer research suggests that matched contribution schemes[9] may be more effective than tax relief in encouraging saving by low and moderate earners, who tend to be less financially literate. Tailored financial information and education are provided alongside Saving Gateway accounts to help individuals make informed saving choices. For many younger or low-income individuals, the account provides an effective bridge to other forms of saving, such as Individual Savings Accounts (ISAs).

[9] The Irish Special Saving Incentive Scheme and Individual Development Accounts in the USA are both structured and marketed as matched savings accounts.

Box 5.2: The Saving Gateway: piloting a new approach

As announced in Budget 2002, the Government launched a number of Saving Gateway pilot projects in August 2002. The pilots are being run in conjunction with the Community Finance and Learning Initiative, led by the Department for Education and Skills. The Halifax plc is providing branch, staff and account management services in the pilot areas[1].

Operating in Gorton, Tower Hamlets, Cumbria, Cambridgeshire and Hull, the pilots will involve up to 1500 participants in total. The Saving Gateway account will last for 18 months and each pound saved by participants will be matched with a pound from the Government. Participants will be able to save a maximum £25 per month up to an overall account limit of £375 of savings, £750 with matching funds. As of 20 November 2002, 250 pilot Saving Gateway accounts had been opened with total contributions of nearly £6,000.

The pilots have been designed to provide a regular stream of information and data and will be evaluated to assess their effect on saving behaviour. Further development of the Saving Gateway, including the appropriate level of the match rate and the criteria to be used to determine eligibility, will follow in light of evaluation evidence.

[1] A single financial services provider was selected for the pilots for evaluation purposes. For a national rollout it is envisaged that a consortium of providers would offer the Saving Getaway.

The Child Trust Fund

5.55 Attitudes to saving and assets are often shaped early on in life. Financial education delivered through the National Curriculum and by the FSA and certain voluntary organisations is helping children and young people understand the advantages of saving. The Child Trust Fund (CTF) would build on these foundations, strengthening the saving habit and spreading the benefits of asset ownership to all.

5.56 The CTF would be a universal account, opened for all children at birth, with an endowment paid by the Government. Founded on the principle of progressive universalism, every child would receive an endowment, with those from the poorest families receiving the largest lump sums. The CTF would advance the Government's goal to promote saving opportunity by ensuring that all young adults, regardless of their families' circumstances, start their adult lives with immediate access to a stock of assets. Funds would be accessible at the age of 18 and could be rolled over into other saving products such as ISAs, reinforcing the lifetime saving habit.

5.57 The Government has consulted[10] on two proposals for delivering the CTF:

- open market competition, under which providers would be able to enter the market on satisfaction of a set of entry conditions similar to the way the market for ISAs is managed; and

- a licensed provider approach, under which provision would be limited to a panel of licensed providers, with licenses issued through competitive tender for a fixed number of years.

5.58 Following the consultation process[11] the Government has decided, on balance, in favour of open market provision. Existing open market provision with product regulation has succeeded in delivering high quality and efficiently priced products, as evidenced by ISAs and stakeholder pensions. The open market approach would also maximise the scope for a variety of providers to enter the CTF market – from high-street banks and building societies through

[10] *Delivering saving and assets*, HM Treasury, November 2001.

[11] Forty six formal responses were received during the consultation process. Of the 44 that addressed the choice of delivery model, 20 preferred an open market, 11 preferred licensed providers, 3 suggested alternative approaches, and 10 registered no distinct preference.

to friendly societies – thereby allowing families to build on their existing relationships with national and local providers. While an open market could generate more complex choices for consumers, it would still be compatible with providing a default option for parents who do not wish to choose between many competing providers. The specification of product rules and provision of information and education would further limit the risk that parents are forced into making inappropriate choices.

5.59 The Government will now consult with key stakeholders on the detailed implementation of the Child Trust Fund, including the structure and value of endowments, consumer protection, fund investment options, and methods of delivering financial information, education and advice. The Government will also consider the relationship between the CTF and the suite of 'stakeholder' investment products recommended by the Sandler review and described below.

Individual Savings Accounts

5.60 Individual Savings Accounts (ISAs) are the Government's primary vehicle for tax-advantaged saving and have helped to make saving, and the benefits of saving, simple for ordinary investors to understand. The flexibility of ISAs ensures that funds can be accessed to take advantage of opportunities at key life stages – for example, to provide the deposit for a house. In time, ISAs could also provide a suitable product for savers seeking to move on from the Saving Gateway or the CTF.

5.61 ISAs continue to be extremely popular. Over 14 million people have an ISA – nearly 6 million more than had a TESSA or PEP in 1998-99, their last and most successful year. Subscriptions to cash ISAs rose by 18 per cent during 2001-02 – around £2.5 billion – to over £17 billion. This increase helped to offset a decline in subscriptions to equity ISAs probably resulting from the uncertain investment climate – overall ISA subscriptions fell by just four per cent over the year. Nearly £100 billion has now been subscribed to ISAs since their launch in 1999.

The Sandler review of retail savings

5.62 In June 2001, the Government appointed Ron Sandler, former CEO of Lloyd's of London, to conduct a review of the long-term savings industry. The review, which reported in July 2002, examined the markets for medium and long-term retail savings in the UK, identifying the competitive forces and incentives that drive the industries concerned and analysing the potential policy responses.

5.63 The Government has welcomed the review's compelling analysis of the lack of competitive intensity in the retail savings market. **The Sandler review made six major recommendations, addressed at the Government and the FSA, all of which are being taken forward in various ways:**

- a series of safer and easier to understand 'stakeholder' investment products with capped charges, prudential restrictions on investment profile and the ability to exit on reasonable terms. Regulation will be built into the products, opening the way to a streamlined system of sales regulation. The Treasury has established a working group of industry and consumer representatives to assist it in producing a specification for these products, and will issue a consultation document in the new year;

- reform of with-profits policies, including an 'ideal model' that would be transparent to support investor decisions, and clearly separate policyholders' and shareholders' interests while retaining the smoothing features so many investors have found valuable. The FSA will consult shortly on how to take forward the issues raised by the review, both for the proposed new 'stakeholder' funds and for existing funds;

- an increased and ring-fenced consumer education budget for the FSA and better coordination of the Government's work on financial education. The FSA has welcomed this suggestion and will be consulting more fully on its long-term strategy for consumer education next year. The Treasury has already begun work to coordinate the government effort devoted to financial education;
- reform of the market for the distribution of investment products, including specific recommendations about how independent financial advisers should be remunerated. The FSA has welcomed the review's recommendations and has taken them into account in its recently announced decision on reform of the 'polarisation' requirement and on intermediaries' remuneration;
- a set of investment principles for providers of retail investment products, building on the approach set out by the Myners review. The review proposes that this disclosure should, in most cases, be voluntary. The Treasury agrees that this disclosure should help produce a more transparent, better-informed and hence more competitive system. Unit trusts already disclose much of this information. The FSA will be considering how these principles should apply to with-profits funds as part of its ongoing work on with-profits. If the industry fails to disclose voluntarily, the Government will consider requiring it to do so, as recommended by the review; and
- removing distortions and reducing complexity in the savings industry caused by the taxation system, in order to increase consumer understanding, reduce the cost of savings advice and strengthen competitive forces. As well as consulting on the simplification of pensions tax and on the VAT treatment of fund management, the Government is considering the review's other tax proposals as part of the Budget process and will discuss their implications with the industry in the coming months.

5.64 The review also recommended the creation of a level playing field in the VAT treatment of fund management. HM Customs and Excise will now consult the industry on a range of options, and would be particularly interested to receive views on the example cited in the Sandler review that the VAT exemption for pension fund management fees be extended to those levied by non-life companies.

Saving for retirement

5.65 Saving for a pension should be a key consideration for most individuals throughout their working lives. While wealth accumulated for retirement will often include an ISA, a house or a business, pensions will for most people provide the principal source of income in retirement in the form of an annuity.

5.66 As more people look forward to longer and healthier lives, it is all the more important that they fulfil their potential at work and that they save, in order to maintain living standards in retirement. The Government provides a foundation of support in retirement through the basic state pension, the MIG and, from October 2003, the Pension Credit, which will guarantee minimum incomes in retirement and ensure that people see the benefits of having saved. Some 18 million people stand to gain following the introduction of the State Second Pension in April 2002. The Government also helps adults to make the most of their working lives, through support to help the unemployed and inactive find and succeed in work, and through a range of products to help people save throughout their lives, including stakeholder pensions.

Stakeholder pensions

5.67 Launched in 2001, stakeholder pensions have extended the opportunity to build pension savings to previously excluded groups. Stakeholder pensions provide a safe, flexible and low cost way for moderate earners to save for retirement and are now available through the workplace to the majority of those currently without a private pension. Many existing schemes exceed the minimum requirements set by the Government and low stakeholder charges have helped to exert downward pressure on pension charges generally. The Government's integrated approach to saving ensures that individuals can roll over money saved in ISAs into stakeholder pensions, subject to annual limits.

Pensions Green Paper

5.68 In addition to providing a foundation of support for pensioners, the Government also encourages and facilitates private pension provision. It does so by helping individuals to make informed choices about the level of income they want in retirement and to plan their saving and working patterns accordingly. The financial services industry can facilitate such choices by developing a simpler, more transparent market in which trusted and trustworthy providers sell simple, good-value products to informed consumers. Employers also have an important responsibility as providers of and contributors to occupational pension schemes and as sources of information about pensions options.

5.69 The Government believes that there is more to do to strengthen the framework of partnership between the Government, individuals, employers and the financial services industry that has long been a key strength of the pensions system in the UK. Building on measures introduced to date, **the Government will publish on 17 December a Green Paper on pensions** setting out proposals for renewing this partnership for the future to enable those of working age to plan more effectively for a secure retirement. The Green Paper will build on the conclusions and recommendations of three reviews into different aspects of pensions provision commissioned by the Government into the regulatory regime for private pensions[12], the taxation and administration of occupational pensions, and the operation of the market for medium and long-term retail savings, including personal pensions[13].

Simplifying the taxation of pensions

5.70 There are currently eight different tax regimes for pensions and within these regimes there are different rules concerning the levels of contributions and the levels of benefits. This proliferation of regimes and rules creates complexity that makes pensions difficult to understand and explain, constrains people's choices about when and how to save, and imposes unnecessary administrative burdens on employers, individuals and pension providers.

5.71 In March 2001, the Government launched a review of the tax regimes governing occupational pensions, led by the Inland Revenue in partnership with the pensions industry, and drawing on a wide range of evidence, including that presented in the Sandler review of retail savings. The review studied the various tax regimes and their impact on employers, pension providers and individuals who save in pensions. In the light of the findings of the Inland Revenue review, **the Government now intends to consult the pensions industry and other interested parties on radical proposals to simplify the taxation of pensions.** Details of the Government's proposals will be published alongside the pensions Green Paper.

Annuities

5.72 Annuities provide a financially efficient and secure means of turning pension capital saved through defined contribution pension arrangements into income that lasts for the whole of an individual's retirement. The Government wants to deliver increased product choice and flexibility for consumers in the annuities market. **Further proposals to make the annuity market function more efficiently will be included in the forthcoming consultation on simplifying pensions tax.**

[12] *A simpler way to better pensions: an independent report by Alan Pickering*, July 2002.

[13] *Medium and long-term retail savings in the UK: a review*, Ron Sandler, July 2002.

A MODERN AND FAIR TAX SYSTEM

5.73 A modern and fair tax system encourages work and saving, keeps pace with developments in business practice and the global economy and raises sufficient revenue to fund the Government's objective of establishing world-class public services. To ensure that the burden of tax does not fall unfairly on compliant taxpayers, loopholes giving scope for avoidance must be closed. Everyone – individuals and businesses – should pay their fair share.

Income tax and national insurance contributions

5.74 As announced in Budget 2002, to deliver the largest ever sustained increase in NHS spending, while meeting other priorities and ensuring sound public finances over the medium term, **the income tax personal allowance for those aged under 65 and the national insurance contributions (NICs) threshold will be frozen in 2003-04.** Other rates and thresholds will increase in line with inflation. **From April 2003 there will also be an additional one per cent NIC paid by employers, employees and the self-employed on all earnings above the NICs thresholds and lower profits limit.**

5.75 For the third year in a row, **Class 2 NICs will be frozen at £2.00 per week. Class 3 voluntary contributions will rise in line with inflation.**

Charitable donations

5.76 The Government recognises the important contribution that charities make to the life of the nation. Millions of people in the UK give to charities and other voluntary organisations, and the Government wants to develop this relationship by encouraging further donations of time, money and assets. To help to achieve its goals, the Government will therefore **extend the existing 10 per cent Government supplement on donations to charities through the payroll for one further year until 2004.** This will build on the success of the existing scheme, through which donations have now risen to more than £72 million. The Government will continue to work with the voluntary and corporate sectors to promote a culture of giving. As described in Chapter 6, the Government will publish shortly a discussion document setting out the next steps in its strategy to promote volunteering and giving.

Modernising stamp duty

5.77 The existing stamp duty regime allows many large commercial land transactions to take place without incurring a charge, and **the Government therefore intends to introduce a new regime for stamp duty on UK land and buildings late next year.** The Government's proposals for a modernised stamp duty regime were published alongside Budget 2002[14]. Stamp duty should apply fairly to similar transactions and should be supported by a modern compliance regime balanced by proper appeal rights. The Government continues to consult interested parties on these proposals, and intends to introduce legislation for the new regime in Finance Bill 2003. Draft clauses covering the main charge will be published shortly, alongside a summary of responses to the consultation. The Government is continuing to develop proposals to reform lease duty and the charge on indirect transactions.

[14] *Modernising stamp duty on land and buildings in the UK*, Inland Revenue, April 2002.

Taxation of foreign company branches

5.78 As announced in Budget 2002, **from 1 January 2003 capital will be attributed to a UK branch for tax purposes based on the amount of capital that would be needed if the branch were an independent company.** This measure brings the UK tax system closer into line with established, international practice and will mean that UK branches pay a fair share of corporation tax which reflects the profits they make from activities carried out in the UK.

5.79 The Government has consulted those affected and interested parties on the practical details of implementation and legislation. Building on these discussions, the Government is now publishing updated, draft legislation and draft guidance. There will be further discussions with interested parties on the practicalities of incorporating existing interpretation and practice into this legislation. This will help to ensure a smooth and timely implementation, delivering certainty and consistency going forward.

North Sea tax regime

5.80 Budget 2002 introduced important changes to the North Sea tax regime to ensure that it strikes the right balance between encouraging long-term investment and providing a fair share of revenue derived from a national resource. Companies now pay a 10 per cent supplementary charge on North Sea profits and receive a 100 per cent first year allowance for capital expenditure in the North Sea. Budget 2002 also announced the Government's intention, subject to consultation, to abolish Royalty payments. **The Government has now consulted interested parties and has decided that Royalty payments will be abolished with effect from 1 January 2003.** This decision recognises the important contribution that mature fields can make to the future of the North Sea and will deliver a significant boost to companies investing in these fields.

Residence and domicile

5.81 Budget 2002 announced a review of the residence and domicile rules as they affect the tax liabilities of individuals. The residence rules determine an individual's liability to UK tax. People who are UK resident and domiciled pay tax to the UK exchequer on their worldwide income. Similar rules govern liability to inheritance tax. Those residents who are not domiciled in the UK pay tax on their foreign income and gains only when these are remitted to the UK. The Government values a dynamic and open economy, and supports the international interchange of skills and expertise. However, the current rules determining residence and domicile have developed over the past 200 years, are complex and poorly understood, and do not reflect the reality of today's more integrated world.

5.82 In Budget 2002 the Government set out the principles that would underpin any modernisation: the rules should be fair, clear, easy to operate and support the competitiveness of the UK economy. The Government welcomes the comments received in response to the Budget announcement, and invites further contributions to inform the ongoing work in this area. Since the Budget, the Government has been considering implications for the current rules of increasing international labour mobility, particularly among those with high skills, and is now taking further steps – described in Chapter 3 – to ensure that the UK economy can benefit from the expertise available in the growing global market for skilled labour. The Government has also looked at the interaction between increasing labour and capital mobility and the Government's commitment to creating a tax system which ensures that individuals make a fair contribution to investment in public services. Building on this work, the Treasury and the Inland Revenue will assess how the current rules work in practice, and will publish a background paper to aid discussion of how the rules compare with the Government's principles.

Bingo

5.83 Following the success of its reforms to general betting duty and pools betting duty, when the Government replaced tax on players' stakes with a tax on betting companies' gross profits, Budget 2002 announced that the Government would consider the scope for extending the gross profits model to the taxation of bingo. A consultation exercise formally ended on 31 October, and the proposal has received widespread support from the bingo industry. The Government will now examine, in consultation with the industry and players, the detail of how a gross profits tax can work, with a view to announcing changes to the taxation of bingo in Budget 2003.

Tackling tax abuse

Tackling tobacco smuggling

5.84 Tobacco smuggling undermines the Government's health objectives and involves serious and widespread criminality. In March 2000, the Government launched a new strategy[15] for tackling tobacco smuggling, designed first to slow the upward trend in smuggling and subsequently put it into decline within three years. The strategy included a target for 2001-02 to hold the share of the UK cigarette market taken up by smuggling to 22 per cent.

5.85 The initial success of the strategy has been maintained in its second full year. Almost 2.6 billion cigarettes destined for the UK market were seized in 2001-02, and more than five billion have been seized in the first two years of the strategy. HM Customs and Excise investigators have also broken up 60 major organised crime gangs involved in smuggling huge volumes of illicit cigarettes.

Tackling cross-Channel smuggling

5.86 Without any action, the share of the UK cigarette market taken up by smuggling was forecast to have reached 31 per cent by 2001-02. As a result of the Government's strategy, the smuggled market share has instead been held at 21 per cent. While the Government remains concerned about the level of tobacco smuggling, it welcomes the fact that the strategy has succeeded in stopping the growth in the share of the market taken up by smuggled cigarettes for the first time since records have been maintained.

Tackling VAT losses

5.87 The strategy has also succeeded in reducing the revenue evaded annually through smuggling of alcohol and tobacco by cross-Channel passengers from £1.5 billion to £290 million. To reinforce action against smugglers, protect the rights of honest shoppers, and make clear the distinction between the two, the Economic Secretary to the Treasury announced on 29 October the second stage of the Government's strategy, details of which are set out in *Protecting indirect tax revenues,* published alongside this Pre-Budget Report.

5.88 **The Government now intends to apply its approach to tackling tobacco and other excise duty fraud to tackling leakages of revenue in the VAT system.** VAT revenue losses have their origins in a wide range of non-compliance problems, from organised criminal fraud and abusive tax avoidance schemes to mistakes made by businesses when compiling and submitting tax returns. The Government's new strategy, set out in detail in *Protecting indirect tax revenues,* will:

- increase the pressure on 'missing trader' VAT fraud, by speeding up the identification and challenge of suspect traders;
- increase the number of challenges brought against abusive VAT avoidance schemes; and
- combine enhanced support, education and advice for compliant and newly-registered businesses with a range of specific measures to target businesses which choose not to comply or which fail to register when they should.

[15] *Tackling tobacco smuggling,* HM Customs and Excise and HM Treasury, March 2000.

5.89 The strategy will seek to stop the long-term growth in the percentage of VAT that goes uncollected, and by 2005-06 reduce it to 12 per cent, the level seen ten years ago. The measures in the strategy are designed to produce more than £2 billion per year in additional revenues by 2005-06. This is the Government's aim, but in line with the audited, cautious approach underlying the public finances a lower figure of £1.4 billion a year by 2005-06 has been included in the public finances forecast. Futher details are set out in Annex B.

Tackling unfair tax avoidance

5.90 As well as acting to prevent illegal smuggling and fraud, the Government is also committed to closing loopholes in the tax system which allow some people to avoid paying their fair share of tax, increasing the burden on other taxpayers and giving those who use avoidance schemes an unfair advantage. The Pre-Budget Report announces further steps, to be implemented immediately, including:

- **measures to counter the avoidance of tax and national insurance contributions through the abuse of Employee Benefit Trusts.** Chapter 3 gives details of a new statutory corporation tax deduction that will provide tax certainty for those companies using employee share schemes to encourage productivity;
- **legislation to prevent businesses claiming accelerated allowances** on investment in industrial buildings by entering into artificial transactions;
- **changes to the controlled foreign companies rules** to close a loophole that allows some companies selling extended warranties, credit protection policies and similar products to UK customers to escape UK taxation on the profits; and
- **action to prevent companies avoiding the payment of VAT on the sale of freehold buildings**.

INTERNATIONAL POVERTY REDUCTION

5.91 As well as tackling poverty at home, the Government is playing a leading role in international efforts to fight global poverty and achieve the Millennium Development Goals (MDGs). The MDGs are global targets for 2015. They include halving the proportion of people living in extreme poverty, reducing child and maternal mortality, the achievement of universal primary education, and the reversal of the spread of HIV/AIDS, malaria and other killer diseases.

5.92 The Government believes that fulfilment of the MDGs requires a new deal for the global economy, with all countries meeting their shared obligations:

- developing countries accepting their primary responsibility for their own development, through good governance and policies that favour growth and investment and meet the basic needs of their people; and
- developed countries recognising that international support through open markets, reforms to improve aid effectiveness and significant increases in aid flows for poverty reduction are needed alongside the best efforts of the developing world.

Trade **5.93** Under this new deal, all countries must recognise that international trade, properly managed, is essential to increase prosperity and reduce global poverty to meet the MDGs. Full global trade liberalisation could lift at least 300 million people out of poverty by 2015. The Government is committed to making trade work for developing countries, and to ensuring that any trade liberalisation is properly sequenced, with development concerns fully taken into account.

5.94 The Government continues to work for implementation of the commitments agreed at the World Trade Organisation's Doha Ministerial meeting in 2001. These include measures to build the capacity of developing countries to engage effectively in the world trading system and to improve market access for poor countries. The Government will also continue to press for significant reform of the European Union's Common Agricultural Policy in the present Mid-Term Review. This is especially important as developed country subsidies to agriculture amount to one billion dollars a day – seven times the level of overseas development assistance.

Improved aid **5.95** The Government is proposing a new international compact to improve the quality and poverty focus of aid. There are significant potential gains to be had from better use of the existing $50 billion of annual aid flows. In particular, reform and better allocation of poor quality aid could make it 50 per cent more effective in reducing poverty. Reforms should include a refocusing of EU assistance on poorer countries, implementation of the European Commission's proposals on untying aid, and the development of stringent codes and standards that permit more rigorous scrutiny of the quality of bilateral aid programmes.

5.96 Such a compact would enable aid to be committed in a predictable way and over the longer term and so provide better value for money. It can be used much more effectively by developing countries – for example, to reduce poverty through long-term investment in health and education. Higher aid volumes are also needed to secure economies of scale and the additional gains from investing across several sectors simultaneously. This approach requires greater coordination between donors, and better harmonisation of the activities of international institutions and the Regional Development Banks in the poorest countries. Crucially, it provides the right incentives for developing countries themselves to fulfil their responsibility to improve governance and implement sound policies.

5.97 As part of this new compact the Government would be prepared to submit its own programme to an internationally agreed new scrutiny process. The Department for International Development (DfID) has already introduced long-term financing frameworks in several countries. By 2005-06, 90 per cent of the UK's bilateral aid resources will be spent in low-income countries where research shows it can be used best. Last year the Government untied 100 per cent of its aid, and now provides more aid through direct budget support. The UK is seeking to work more closely with bilateral and multilateral donors to reduce transaction costs in aid for developing countries.

5.98 The 2002 Spending Review increased the UK's aid commitments to developing countries from 0.32 per cent of national income in 2002-03 to 0.4 per cent by 2005-06. This represents the largest ever increase in UK aid, and a near doubling in real terms since 1997, underlining the Government's commitment to the UN target of 0.7 per cent. It fulfils the UK's obligation under the EU's commitment to reach an aid ratio of 0.39 per cent by 2006.

Box 5.3: International Financing Facility

The World Bank and the United Nations estimate that an additional $50 billion in aid from the international community will be needed each year if the MDGs are to be achieved by 2015. The significant increases in aid pledged by the EU and US in March 2002 could total $12 billion by 2006 and will make an important contribution to meeting the MDGs. However, they still fall far short of what is required.

To bridge the gap between what has been pledged and what is required, the Chancellor has proposed a new $50 billion International Financing Facility (IFF) to leverage pooled resources to finance the investment needed. This facility would capitalise on long-term commitments from donors, and leverage additional financing through the issue of development bonds on international capital markets. Additional aid could then be disbursed in the form of grants and concessional loans to developing countries.

The commitment by donors to provide additional funding to 2015 and beyond, would allow a commensurate commitment in aid flows over the longer term to developing countries, and avoid the short-term volatility that is so damaging to investment planning and development spending. Crucially, developing countries would be able to budget for substantially higher aid flows over the medium term to tackle poverty. An IFF would also promote a balanced distribution of resources and coordination between donors.

The Government stands ready to provide the clear long-term commitment to developing countries that is needed. But full international cooperation is essential. To build global support and consensus, the Government will shortly be publishing a new prospectus for the IFF, setting out the key features of the Facility and outlining the steps that the international community must take to ensure that the MDGs are achieved.

Debt relief

5.99 The Government continues to be a leading advocate of debt relief through the Heavily Indebted Poor Countries (HIPC) initiative. Twenty-six countries will benefit from debt relief worth $62 billion already committed under the initiative, reducing their debt payments by around $1.3 billion each year. The UK stands ready to cancel £1.9 billion of debt in total and is already providing 100 per cent debt relief to those countries that have demonstrated a commitment to poverty reduction. The Government has also pledged $375 million to multilateral institutions to support the HIPC initiative.

5.100 Debt relief must however lead to a sustainable exit from indebtedness. The Government believes that the provision of debt relief at Completion Point should be flexible and take account of exogenous shocks, such as reduced export earnings resulting from falls in commodity prices. At the Annual Meetings of the World Bank and IMF in September, the Government helped to secure agreement to the need for additional funds, of up to $1 billion, to ensure that the HIPC initiative provides a robust exit from unsustainable debt. The Government is ready to contribute its full share of up to $120 million.

Africa

5.101 This year the Government has made Africa a high priority. At the G8 Summit in June, the Government endorsed a New Partnership for Africa's Development, a common vision that the prime responsibility for Africa's future lies with Africa itself, and that a new outlook will require a strong commitment to reform and sustained political leadership. In turn, developed countries must share the benefits of globalisation, ensuring Africa can benefit from the opportunities it provides. The 2002 Spending Review established, for the first time, a £1 billion annual bilateral programme for Africa by 2005-06.

Universal primary education

5.102 The Government is working closely with other countries to ensure that every child has access to primary education. Today, 113 million children – 75 million of them in Commonwealth countries – have never been to school. Since 1997, DfID has committed over £700 million to help to deliver universal primary education in developing countries. The Government will expand this support by a further £1.3 billion over the next five years, with the objective of assisting developing country governments to place an extra 20 million children into school by 2006. To provide strategic support to the goal of universal primary education in the Commonwealth, the Government has also launched a new Commonwealth Education Fund. The Fund is chaired by the Governor of the Bank of England and managed by Action Aid, Oxfam and Save the Children Fund. The Government will match pound-for-pound, including tax relief, contributions from business and Comic Relief's Sports Relief in 2002.

Tackling the diseases of poverty

5.103 Every year almost 6 million people die from HIV/AIDS, malaria and tuberculosis. To step up the fight against these diseases, the Government has played an influential role in establishing a new international Global Health Fund. International commitments to the Fund now stand at $2.1 billion, of which the Government has so far pledged $200 million over five years. Since 1997, DfID has also agreed new bilateral commitments worth over £1 billion to help strengthen the capacity of health systems in poor countries.

5.104 To reinforce this work, Budget 2002 introduced a new tax measure to encourage research and development (R&D) into vaccines and medicines for the prevention and treatment of specific diseases threatening lives in poor countries. The credit extends existing R&D incentives, providing 50 per cent relief on qualifying expenditure. The Government is also seeking to encourage responsible donations of medical supplies and equipment to developing countries, by allowing companies to deduct from their taxable profits the cost of donations made for humanitarian purposes.

6 DELIVERING HIGH QUALITY PUBLIC SERVICES

The Government's long-term goal is to deliver world class public services through investment and reform while ensuring that taxpayers receive value for money.

The 2002 Spending Review set departmental spending plans for the three years up to 2005-06, and five years for the NHS, within the overall envelope for total public spending set in Budget 2002 and consistent with the fiscal rules. These plans deliver substantial extra investment into public services:

- **current spending will rise in total by 3.3 per cent a year in real terms in 2004-05 and 2005-06;**
- **public sector net investment is projected to rise from its 1.8 per cent of GDP target in 2003-04, to 2 per cent of GDP by 2005-06 and to 2¼ per cent by 2007-08;**
- **UK spending on the NHS will increase by an average of 7.4 per cent a year in real terms over the five years to 2007-08; and**
- **over 75 per cent of additional spending will be allocated to the key priorities of health, education, personal social services, transport, housing and criminal justice.**

To ensure that the resources are available to meet the UK's defence and overseas needs in the fight against global terrorism, the Pre-Budget Report provides an additional provision of £1 billion this year to be held in a special reserve.

The Government is determined to secure value for money. In each area of public service delivery, resources allocated in the 2002 Spending Review are tied to reform and results. The Pre-Budget Report describes how the Government is delivering reform, based on:

- **clear long-term goals that focus service providers on the key outcomes the Government is seeking to achieve;**
- **independent audit and inspection to ensure that departments and agencies are held accountable for their performance, including through a new independent Commission for Healthcare Audit and Inspection, a Comprehensive Performance Assessment in local government and the new Police Standards Unit;**
- **maximum local flexibility and discretion to innovate to ensure that local service providers can respond to local conditions and demand, with new freedoms for high-performing local authorities, Regional Development Agencies, further education colleges and hospitals; and**
- **increased transparency about what is being achieved, with regular web-based reporting of progress against targets from April next year.**

INTRODUCTION

6.1 The Government's long-term goal is to deliver world-class public services through sustained increases in investment and reform, while ensuring that taxpayers receive value for money. Strong and dependable public services are vital to extend opportunity, tackle poverty, ensure security and improve the quality of life for all. They also lay the foundations for a successful, high productivity economy.

6.2 Through its action to maintain macroeconomic stability, the Government has already delivered significant and sustained investment in Britain's public services. The departmental spending plans set in the 2002 Spending Review build on these foundations, ensuring that resources are available for priority services, consistent with the fiscal rules. This chapter describes how the Government is increasing investment in priority public services, while ensuring that, in each area of public service delivery, resources are tied to reform and results.

PROVIDING RESOURCES

6.3 Sound public finances that are sustainable over the economic cycle are not only essential to ensure economic stability, they are also necessary for sustainable investment in public services. The fiscal rules, described in detail in Chapter 2, are the foundation of the Government's public spending framework, ensuring that the public finances are sustainable over the economic cycle and that spending and taxation impact fairly between generations. The rules have important consequences for the budgeting regime, removing the past discrimination against investment and ensuring that borrowing for investment is conducted in a responsible way. A new analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report.[1]

6.4 To help departments plan for the medium term, the Government has introduced a system of firm and fixed Departmental Expenditure Limits (DEL) for departmental spending stretching over three years, and reviewed every two. Expenditure items that are large, potentially volatile and demand-led – such as social security benefits and debt interest payments – are collectively known as Annually Managed Expenditure (AME). These items are subject to tough scrutiny twice a year as part of the Budget and Pre-Budget Report process to ensure that spending does not threaten fiscal stability. Taken together, DEL and AME add up to Total Managed Expenditure (TME).

6.5 Because they are based on prudent and cautious assumptions, the Government's spending plans for 2002-03 remain robust despite heightened uncertainty in the global economy. Total public spending is planned to rise by 4.4 per cent in real terms over the year as a whole, consistent with the plans for significant investment in public services set out in the 2000 Spending Review. **To ensure that the resources are available to meet the UK's defence and overseas needs in the fight against global terrorism, the Pre-Budget Report provides an additional provision of £1 billion this year to be held in a special reserve.**

6.6 Within existing spending plans, departments are able to draw on their accumulated stock of end-year flexibility (EYF). EYF allows departments to retain resources not fully spent at the end of the year for use in future years, helping them to plan more effectively and avoiding wasteful end-year surges in departmental spending. This year departments have chosen to draw down £2.9 billion to add to their authorised spending limits. As has been the case in previous years, the Government expects this net addition to spending to be more than offset by the end of the year by under-spends elsewhere within DEL.

[1] *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, November 2002.

Releasing resources for priorities

The 2002 Spending Review

6.7 Prudent management of the public finances has allowed the Government to sustain and increase the resources available for key public services, while continuing to meet the fiscal rules. The 2002 Spending Review established departmental spending plans for the years 2003-04 to 2005-06, consistent with the firm 'envelope' for total public spending set out in Budget 2002. This 'envelope' allows:

- current spending to rise in total by 3.3 per cent a year in real terms in 2004-05 and 2005-06;
- public sector net investment to rise from its target of 1.8 per cent of GDP in 2003-04, to 2 per cent of GDP by 2005-06 and to 2 1/4 per cent by 2007-08, to continue to address the legacy of under-investment in Britain's public infrastructure, while comfortably meeting the sustainable investment rule; and
- UK spending on the NHS to increase by an average of 7.4 per cent a year in real terms over the five years to 2007-08.

Box 6.1: Funding long-term improvements in healthcare

In Budget 2001 the Chancellor commissioned an independent review of the long-term trends and resource needs that will affect the health service in the UK over the next 20 years. In his report to the Chancellor in April 2002, Derek Wanless concluded that health spending would need to rise substantially over the next 20 years, and most rapidly in the short-term so as to deliver improvements in standards as quickly as possible.

In Budget 2002, the Chancellor accepted the Review's recommendations and announced that UK NHS spending would grow by 7.4 per cent a year in real terms over the next five years. By 2007-08, total UK health spending is projected to reach 9.4 per cent of GDP. To deliver the largest ever sustained spending growth in the history of the NHS, while meeting the fiscal rules and other priorities, Budget 2002 raised national insurance contributions (NICs) by one per cent for employers, employees and the self-employed on all earnings above the NICs threshold from April 2003; and froze the income tax personal allowance for those aged under 65 in 2003-04.

The Government believes that general taxation and NICs provide affordable, comprehensive cover for healthcare as the costs are spread as widely and fairly as possible. They allow the Government to fund healthcare, through the NHS, that is free and accessible to all on the basis of need and not ability to pay. Because the range of medical treatments is growing, and some are more expensive than ever, the risks to a family's finances would be unmanageable if the costs were met from charges or insurance payments. Mr Wanless also concluded that the current funding system is both a fair and efficient one.

Evidence from other countries suggests that charges deter the sick from seeking treatment, to their own detriment and that of their dependents. Private insurance would fail to help those in greatest need, tend not to extend to chronic or emergency care, and be more expensive than the alternatives due to its administrative costs. Social insurance systems reflect the regional or local organisation of healthcare, in contrast to Britain's national service, and may bear disproportionately on employers.

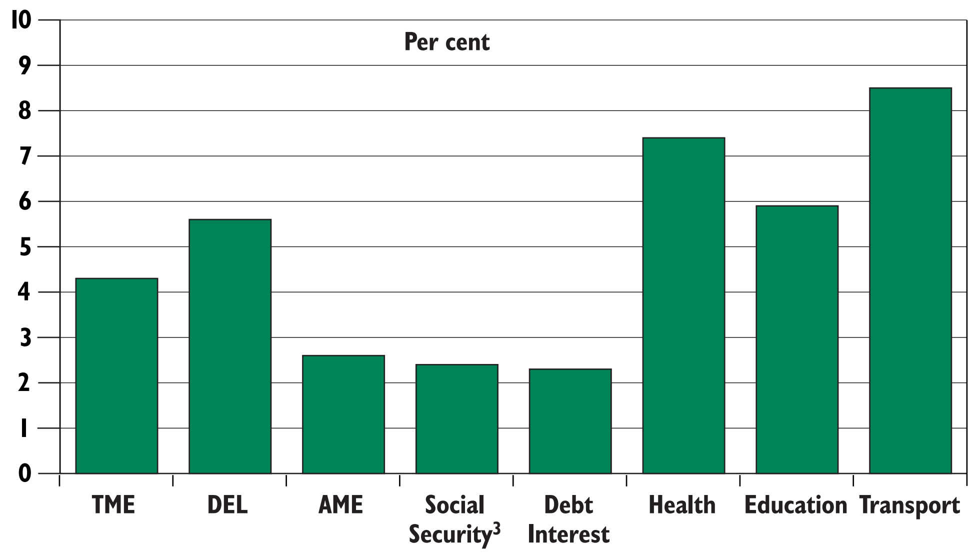
In contrast, NICs offer several advantages as a source of revenue funding. Unlike indirect taxes, and because the new one per cent payment will extend beyond the upper limits for profits and earnings, they reflect people's ability to pay. While most of those in work will contribute, pensioners will not. NICs are also levied on employees and employers, ensuring that all those with an interest contribute to reform of the health service.

6.8 Overall, total public spending (TME) will rise by 4.3 per cent a year on average in real terms over the period of the 2002 Spending Review. Within this, the Government has been able to target additional resources more effectively on priority public services within DEL, due to savings in AME. For example:

- between 1996-97 and 2005-06, social security payments are forecast to grow by just 1.9 per cent a year in real terms, compared with over 4 per cent between 1991-92 and 1996-97; and
- debt interest payments have fallen by £7 billion since 1996-97 and are expected to fall by 3.7 per cent a year on average in real terms between 1996-97 and 2005-06, compared with an annual average real terms increase of over 6 per cent between 1991-92 and 1996-97.

6.9 Overall, social security, tax credits and debt interest payments will amount to just 23 per cent of the additional public spending planned over the three years to 2005-06, compared with 57 per cent between 1991-92 and 1996-97. Chart 6.1 illustrates how these savings have been channelled into priority services so that, within the fiscal rules, education spending can grow by 5.9 per cent, UK health spending by 7.4 per cent and UK transport spending by 8.5 per cent a year. A detailed breakdown of departmental spending up to 2005-06 is provided in Table B15.

Chart 6.1: Releasing resources for priorities[1,2]



[1] Real annual average growth in spending, 2002–03 to 2005–06.
[2] The growth rates for DEL and AME take account of reclassifications between DEL and AME which have no impact on overall public spending, including increased employer contributions within DEL for NHS and teachers' pension schemes (explained in Annex B). These increases have not been added to the UK health and education growth rates, as they affect only the balance between DEL and AME and do not represent increased spending in these areas overall.
[3] Includes personal tax credits.
Source: HM Treasury.

6.10 When locally-financed expenditure (LFE) – spending financed directly from revenues raised by local government – is included, spending on the key priorities of education, health, personal social services, transport, housing and criminal justice will account for over 75 per cent of the additional total spending on DEL and LFE between 2002-03 and 2005-06.

6.11 Within total public expenditure growth of 4.3 per cent a year in the three years to 2005-06, spending in AME is set to grow at 2.6 per cent, allowing DEL to grow at 5.6 per cent, after taking into account reclassifications between DEL and AME. Total DEL is £63 billion a year higher in 2005-06 compared with 2002-03.

Box 6.2: Public sector pay

To ensure stability and value for money in public services, public sector pay rises, just as in the private sector, must be set at a sustainable rate and be justified by productivity, with all resources used responsibly. Public sector pay represents a significant element of spending on public services. The Government is determined to ensure that these resources are used effectively and that pay policy supports reform and delivery of public services.

Responsibility in setting pay is essential to ensure value for money for the public. In an environment of economic stability with low and stable inflation, unnecessarily high public sector pay bills divert resources away from other expenditure, such as better equipment in hospitals and modern schools to improve the environment for teachers and children. Against a backdrop of low inflation, large increases in basic pay across the board are neither fair nor likely to deliver the best outcomes for the public.

A number of elements are critical to responsible pay setting. Pay must be considered as part of a wider package for employees. Job satisfaction, good terms and conditions and flexible working practices should be taken into account; all have a part to play in improving delivery. In addition, public service providers need to consider the use of alternative delivery methods, such as electronic delivery, where this could prove more cost-effective and deliver more choice to the end user.

Policy on public sector pay is designed to support improvements in public service delivery. In the past, pay scales were nationally determined, and reward was based on time served. Pay systems were rigid and lacked the flexibility to tackle particular employment challenges, or to motivate and reward service delivery.

Those who work in public services perform a vital role, and deserve to be rewarded fairly. Pay systems must promote fair employment practice. They should support and encourage diversity of staff so that the public sector reflects the communities it serves. They should also ensure equal pay for equal jobs across the public sector. To support public service delivery, however, pay systems need to give managers the freedom to recruit, retain and motivate the right number of people with the right skills in particular locations. Pay systems should reward individual employees based on their skills, merit and experience; seek to raise and encourage performance by explicitly linking pay to performance; and allow flexible responses to particular local skill needs and issues.

Pay must also be allowed to vary at the local level, according to local pressures. In the private sector, pay differentials of up to 50 per cent exist between different parts of the country. Unless public sector organisations take these differentials into account, service quality will be at risk and both employees and service users in large parts of the country will suffer.

Resource and capital budgets

Resource accounting and budgeting

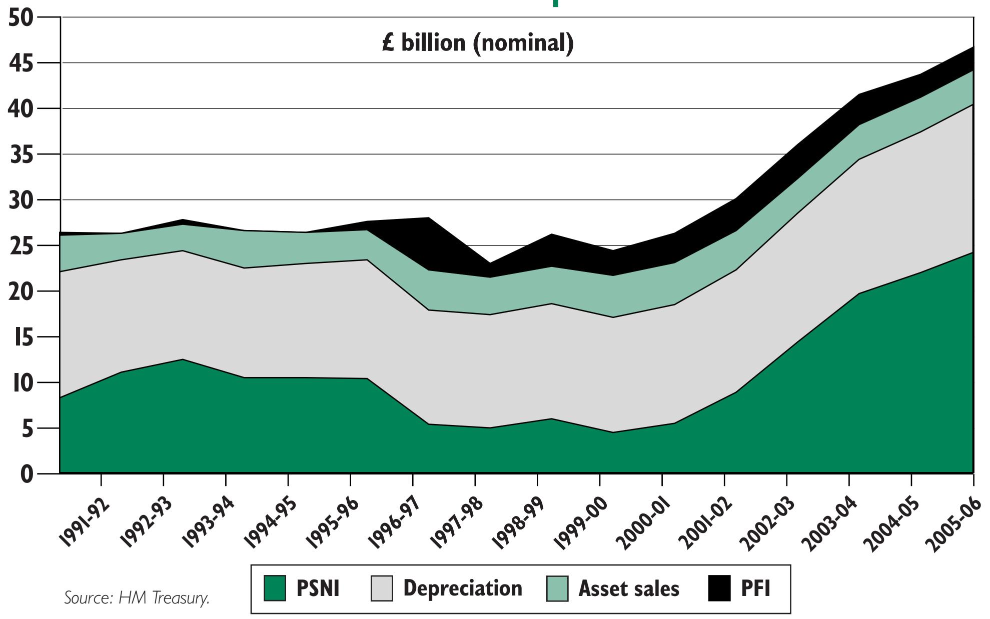
6.12 The 2002 Spending Review completed the transition to full resource budgeting. For the first time, departments' spending limits have been set on a full resource basis, and include the full economic costs of holding and using capital assets and of incurring longer-term liabilities. The introduction of resource accounting and budgeting (RAB) brings accounting by departments into line with generally accepted accounting practice in the private sector. The implementation and operation of RAB is overseen by an independent financial reporting board that reports directly to Parliament.

Capital budgets

6.13 Within total DEL, budgets are split between capital and resource spending. Resource expenditure is that which is needed for the day-to-day running of an organisation, including pay, rent and the procurement of goods and services. Capital spending covers spending on goods and services that are expected to be used for a longer period, including new buildings, equipment and IT systems. Over the three years to 2005-06, capital spending within DEL is set to grow by 9.6 per cent a year on average in real terms, while resource spending is set to grow by 5.1 per cent a year.

6.14 The focus on capital spending reflects the Government's commitment to reverse two decades of under-investment in the nation's infrastructure. Public sector net investment (PSNI), which measures increases to the public sector capital stock, is set to increase to 2 per cent of GDP by 2005-06 - a five-fold increase compared with 1997-98. Total UK investment in public services, which includes PSNI, depreciation, recycled proceeds from asset sales and investment under the Private Finance Initiative (PFI), will rise to over £46 billion in 2005-06, compared with £23 billion in 1997-98. The vast majority of this increased investment originates in the public sector, with PFI accounting for an estimated 10 per cent this year. The Government will use the discipline of the market to deliver value for money and extend PFI in public procurement to new projects worth £30 billion and to include large-scale regeneration projects, while recognising the limits to markets in areas such as healthcare, education,defence and policing.

Chart 6.2: UK total investment in public services



Source: HM Treasury.

Box 6.3: Public Private Partnerships

Public Private Partnerships (PPPs) are a key element in the Government's strategy for delivering high quality public services and a more competitive economy. Drawing on the best of the public and private sectors, PPPs provide additional resources for investment in public services and help to ensure that this investment is managed more efficiently.

Private sector investment through PPP contracts typically makes up around 10 per cent of total investment in any one year. Over the next three years, the Government expects that contracts worth at least £12 billion will be signed, with many other deals in procurement. PPP contracts are only pursued where they represent the best value for money option. Where this is the case, they offer a number of important benefits. Since the private sector is not paid until the contracts are complete, there are greater incentives to transfer risk to the private sector to deliver on time and within budget. Moreover the private sector can sometimes be more likely to challenge inefficiency and promote innovative ways of delivering services.

PPPs are already being utilised to deliver successful projects, including:

- **the biggest hospital building programme in the NHS. Eleven hospitals built under PFI contracts are already operational and a further 13 are under construction. Successful projects to date include the new Dartford and Gravesham hospital – an acute general hospital on the Darent Valley site, which consolidates services from three hospitals into a single modern, flexible accommodation. The hospital was open in just 44 months – far quicker than would have been the case under a conventional public procurement;**
- **funding of the Ten-Year Transport Plan. Around £56 billion is expected to be funded through private sector finance, including PPPs. Successful projects to date include the extension of the Docklands Light Railway, which was completed in 1999. This project had a capital value of £200 million, and was delivered within budget and two months early, in time for the Millennium celebrations; and**
- **improving schools. Forty-eight schools PFI projects have been signed, with a total capital value of £1.3 billion, and covering 550 schools. Successful projects to date include the Barnhill Community School in Middlesex – a new school providing state of the art facilities to educate 1,450 children.**

THE PUBLIC SPENDING FRAMEWORK

6.15 The Government is committed to ensuring that resources invested deliver value for money for the taxpayer and achieve the outcomes that the public want and expect. The quality of public services depends not only on how much the Government spends, but also on how effectively it spends it.

6.16 Increased resources will only lead to improved public services if they are allocated and used efficiently. A modern and effective framework for the planning and control of public spending is needed to improve the quality and cost-effectiveness of public services. The Government's public spending framework is designed to deliver:

- consistency with a long-term, prudent and transparent regime for managing the public finances as a whole;
- the measurement of success by policy outcomes rather than resource inputs;
- strong incentives for departments and their partners in service delivery to plan over several years and plan together where necessary; and

- the proper costing and management of capital assets to provide the right incentives for public investment.

6.17 Since 1997, the Government has introduced a series of important reforms to deliver these objectives. Alongside the transition to full end-year flexibility and resource accounting and budgeting, described earlier in this chapter, these reforms include:

- firm and fixed plans for departmental services spending stretching over three years, and reviewed every two. These Departmental Expenditure Limits (DELs) provide departments with the certainty they need to plan effectively over the medium term;
- Public Service Agreements (PSAs), described below, which set out the improvements in public services that the Government is committed to achieving;
- longer-term budgets for health and transport of five and ten years respectively, reflecting the need to plan beyond the three-year horizons of firm DEL plans to provide stability in specific areas;
- central funds, including the Invest to Save Budget and the Capital Modernisation Fund, which reward innovative policy ideas on a competitive basis; and
- a National Asset Register[2], the first of its kind in the world, to improve the way in which the public sector asset base is managed. The Register helps departments to use their assets more effectively and to judge whether individual assets are still required.

6.18 The Government is now considering the scope for developing the budgeting framework, devolving budgets still further and allowing greater local flexibility and discretion to try out new and innovative ways of working. In particular, the Government believes there is a case for looking at:

- extending the cascading of three-year spending plans and end-year flexibility from departments to executive agencies and other major budget holders;
- simplifying the spending control regime, by removing the existing distinction between discretionary and non-discretionary provision which is both bureaucratic and limits departments' flexibility to transfer funds to where they are most needed;
- reducing administration cost controls for those departments that can demonstrate their ability to manage their resources effectively;
- switching from restrictions on how money is spent to greater accountability for results. For example, departments which provide top-up funding to local agencies should apply conditions relating to results, rather than how the money is spent; and
- modernising the civil service pay remit process by giving departments greater control over the detailed pay negotiation and settlement process, while retaining strategic controls at the centre.

[2] *The National Asset Register*, HM Treasury, Cm 5221, July 2001.

Delivery planning

6.19 With support from the Treasury and the Prime Minister's Delivery Unit, departments are putting in place effective delivery plans which set out robust and clear milestones towards achieving their PSA targets. Delivery plans show how delivery will be achieved over the target period, through effective implementation of reform and with the minimum bureaucracy. Departments will publish a summary of their plans in the form of Service Delivery Agreements. To further assist departments in this work, the Government recently re-appointed the Public Services Productivity Panel, originally established in 1998, to help identify and remove obstacles to productivity enhancing measures and the implementation of challenging PSA targets.

Pay and workforce Strategies

6.20 With decisions on pay-setting devolved to individual Secretaries of State, departments are also developing pay and workforce strategies to underpin their delivery plans. The workforce is an integral part of delivery. Departments must have the right people with the right skills in the right locations, if the Government's programme of public service reform is to be delivered and PSA targets are to be achieved. The development of robust pay and workforce strategies will help departments to take more control of pay and workforce issues. They will also allow departments to assure central government that pay and workforce issues are being well managed and that departments are well placed to deliver.

Departmental Investment Strategies

6.21 To ensure that new investment and existing assets are used effectively, departments also need a coherent long-term strategy to guide their investment decisions. Departmental Investment Strategies (DISs) describe departments' plans for investment over the next three years. For each department, DISs explain the contribution that investment will make to the achievement of objectives, as well as the department's plans to manage its asset base more effectively and to ensure it derives value for money from its investment programme. DISs also set out plans for working with the private sector to improve the delivery of public services. Draft DISs informed the conclusions of the 2002 Spending Review. **Consistent with the Government's objective to promote transparency in public service delivery, Departmental Investment Strategies for each department will be published shortly.**

PUBLIC SERVICE REFORM

6.22 Reform of the public spending framework has helped to ensure that additional resources made available for public services are allocated and used effectively. However, modernisation of public service delivery is also crucial to ensure that resources deliver the outcomes that the public demands and that the public sector is held accountable for its performance. New resources must be matched with reform to deliver results.

6.23 Effective public service delivery requires the devolution of power to service providers to encourage the flexibility and creativity that are needed to meet local consumer demands. However, local initiative must be constrained by clear long-term goals and go hand-in-hand with strengthened local accountability, so that innovation does not put at risk shared commitments to the highest quality public services. As with other services, citizens will rightly continue to expect higher quality, more choice and greater flexibility in public services to suit their circumstances. However, where the Government is committed to public services free at the point of use and available to all on the basis of need, it is important to ensure that choice is not promoted at the expense of equity or efficiency, particularly where there are market failures and capacity constraints.

6.24 The 2002 Spending Review set out the Government's comprehensive programme of public service reform. This programme is underpinned by a commitment to four important principles:

- clear long-term goals, set by the Government;
- independent and effective arrangements for audit and inspection to improve accountability;

- maximum local flexibility and discretion to innovate within a framework of targets and robust accountability arrangements; and
- transparency about what is being achieved.

Long-term goals

6.25 Public Service Agreements (PSAs) are central to the Government's strategy for improving public services. The PSAs published as part of the 2002 Spending Review[3] set targets for the full range of public services, detailing the outcomes that departments are required to deliver with the money allocated to their expenditure programmes. Instead of focusing on the resources going in to public services, PSAs focus on the outcomes that the public really care about, such as better health, educational achievement, and lower levels of crime. PSAs are an integral part of the Government's spending plans.

6.26 Far from strengthening central control, PSA targets, by setting out clearly and simply what outcomes the Government aims to achieve, can allow departments to withdraw from old-fashioned centralised controls over the means of delivery. They can do this by setting a target, empowering local delivery bodies with the freedom and flexibility to achieve it, and ensuring the right accountability framework is in place to deliver value for money. This avoids the need for day-to-day central interference, increasing freedom for delivery bodies. Departments which consult those responsible for service delivery before targets are set are more likely to be successful when it comes to implementing them. Although the methods will vary depending on the nature of the targets, all departments should consult delivery bodies at the target formulation stage.

Box 6.4: PSA floor targets and neighbourhood renewal

The Government is committed to levering up the performance of public services in deprived areas towards the national average. The 2000 Spending Review set specific Public Service Agreement 'floor targets' to ensure that everybody, wherever they live, can expect decent standards of public service provision. The 2002 Spending Review rolled forward and strengthened these floor targets, including by:

- **setting new schools floor targets for achievement by 11, 14 and 16 year olds;**
- **maintaining a target to reduce inequalities in health outcomes by 10 per cent, as measured by infant mortality and life expectancy at birth;**
- **setting a new target to reduce the gap between those Crime and Disorder Partnership areas with the highest crime and the best comparable areas; and**
- **extending the floor target on housing conditions to cover the private as well as the social housing sector.**

These targets are supported by additional resources allocated in the 2002 Spending Review. On top of increased mainstream resources, the Neighbourhood Renewal Fund has been extended to provide £450 million in 2004-05 and £525 million in 2005-06 to deprived local authority areas in England. At a local level, neighbourhood renewal is overseen by Local Strategic Partnerships (LSPs), which have been set up across England to bring together public, private, community and voluntary sector partners to coordinate solutions to tackle social exclusion.

[3] *2002 Spending Review: Public Service Agreements 2003-2006*, HM Treasury, CM 5571, July 2002

Independent audit and inspection

6.27 Independent and effective arrangements for audit and inspection are vital if departments and agencies are to be held accountable for performance against their targets. Increased freedom and flexibility must be matched with greater accountability for the resources used. Such arrangements should separate responsibility for setting standards from responsibility for assessing whether they are being achieved. The Government is taking a number of steps to strengthen existing arrangements, including:

- setting up a new independent Commission for Healthcare Audit and Inspection to monitor performance and the use of resources, publish information, carry out local inspections and oversee independent complaints procedures;
- integrating the work of the Social Services Inspectorate and the National Care Standards Commission into a single independent inspectorate for social care services;
- consolidating and developing the role of the new Police Standards Unit, working alongside Her Majesty's Inspectorate of Constabulary; and
- establishing a single housing inspectorate to drive up performance for all types of social landlord, replacing the current separate inspection regimes.

Maximum local flexibility

6.28 Within the framework of targets and accountability arrangements, service deliverers should have maximum local freedom, flexibility and discretion to innovate, respond to local conditions and meet differing consumer demands. While devolution may not be practical in certain cases, such as in defence, in general national standards can only be delivered effectively by devolution and delegation, matched with accountability for performance and transparency about results. This framework gives local providers the opportunity to design and develop services around the needs and priorities of their communities, helping to ensure that the highest quality public services are available not just to a few but to all. Additional freedoms and flexibilities for local service providers are given in return for high performance, increasing the incentives on all service providers to raise standards.

6.29 The Government is committed to promoting prosperity in all regions of the UK. Because public service priorities may differ across regions, to be most effective spending should be targeted on the particular priorities they face. In the 2002 Spending Review, for the first time, the Government invited regional institutions to set out their view of the key public service priorities to promote prosperity in their regions. Departments were required to take these views into account in preparing their own priorities for resource allocation. In response, the 2002 Spending Review established a new PSA target to reduce the persistent differences in economic performance between regions over the longer term.

Box 6.5: A strong and independent voluntary sector

The Government believes in a robust and independent voluntary and community sector that has the capacity, where it wishes, to engage with the Government to deliver world-class public services. In September, the Treasury published the conclusions of the cross cutting review into the role of the sector in public service delivery. The review highlighted the additional value that the sector can bring, from designing and planning services to direct service delivery. The sector is a key partner in delivering government policies and the Government is committed to creating a framework in which it can continue to flourish and be strong. The Government is committed to implementing the review in full by 2006, by:

- **getting the funding relationship right, ensuring that contracts cover the full costs of services;**
- **building capacity within the sector to enable it to work with Government to deliver the shared goal of world-class public services; and**
- **implementing in full the Compact between government and the sector to reinforce the independence of the sector and ensure an open and transparent relationship with government.**

The Government has matched these commitments with resources. Some £93 million will be available over the 2002 Spending Review period to implement the review, and an additional £125 million will be invested in a new *futurebuilders* fund to assist voluntary and community organisations in their public service work. The Treasury is leading on the design of *futurebuilders*, in cooperation with the sector. Funding will be directed to those organisations directly involved in delivering key public services in health and social care, crime and social cohesion, education and learning, and support for children and young people.

Schemes that work across these boundaries will be welcomed. The fund will be open to organisations new to service delivery as well as existing ones and will promote innovative ways of delivering services, as well as replicating existing good practice.

In addition to these steps, the Strategy Unit has also set out far reaching recommendations for reform of the legal and regulatory framework for charities. These recommendations reinforce the principle of public benefit as the common factor in charitable status, introduce a new legal form for charities – the Charitable Incorporated Organisation – and a new tailor-made legal form solely for small, locally-based social enterprises – the Community Interest Company.

The Government recognises that volunteering presents opportunities for individuals to gain new skills, aids personal development and helps build strong and cohesive communities. It also contributes significantly to the economy. It has been estimated that the economic contribution of volunteers amounts to over £15 billion, and the Government therefore has a strong interest in seeing the voluntary principle thrive. The Chancellor and the Home Secretary will publish shortly a discussion document setting out the next steps in the Government's strategy on volunteering and giving. As part of this strategy, the Government will seek to pilot a scheme to help young people from lower income backgrounds taking a year out after school or training to volunteer in community projects. It will also consult business on a new Corporate Challenge to encourage support for charities and the voluntary sector.

6.30 The Government is taking forward its commitment to the devolution of service delivery in a number of ways. For example:

- local authorities which the Comprehensive Performance Assessment (CPA) shows to be performing well will gain new freedoms. Individual local authorities can already negotiate local PSAs which offer freedoms and flexibilities in return for the adoption of challenging PSA targets. More details of the new freedoms and flexibilities that will be available to local authorities are described later in this chapter; and
- Regional Development Agencies (RDAs), tasked with promoting economic development and regeneration in the English regions, have been given considerable new financial flexibilities as well as additional resources and responsibilities. As described in Chapter 3, a single RDA fund has been introduced in place of separate funding streams from five sponsor departments, and overall funding will rise to £2 billion by 2005-06. In return, the RDAs will be required to meet stretching new performance targets.

Transparency

6.31 The Government is determined to ensure that the public receives regular and reliable information about the progress being made against PSA targets, strengthening accountability for performance. The 2000 Spending Review introduced departmental Technical Notes and Service Delivery Agreements, which set out respectively for the public how performance against targets will be measured and the key steps that departments will take to deliver them. In March 2002, the Government also invited the Comptroller and Auditor General to externally validate the data systems underlying the targets, drawing on the work, and recognising the independence and authority, of the National Statistician and the Audit Commission.

6.32 In view of the importance of transparency and accountability, the Government is now introducing further major reforms in public reporting:

- starting from now, **departments will publish progress against their PSA targets twice a year** – in the autumn, as well as in their spring departmental reports;
- starting from now, **the Treasury website will provide links to departments' PSA progress reports** as well as to the new Technical Notes, Service Delivery Agreements, and Departmental Investment Strategies, as they are published. This will allow the public to access the full range of published departmental material from a single portal; and
- starting from next April, the Government will introduce **regular web-based reporting of progress against all the new PSA targets.**

6.33 The degree of transparency embodied in public reporting of performance against PSA targets at the national level needs to be matched by similar arrangements at the local level, to ensure that all service providers can be held accountable for the outcomes they are delivering for local people. A number of reforms are being introduced across Government to ensure this is so. For example, the CPA will bring together and publish evidence on local authorities' performance against their responsibilities; the publication of school examination results provides parents with local information about achievement; star ratings for the NHS, first published in July 2002, will be published every year; and the Home Office will publish comparisons of police force performance across a range of responsibilities at regional force level from 2004-05.

Putting principles into practice: the next steps

6.34 These principles provide a clear framework for delivering long-term improvements in public services. Alongside devolution of power and flexibility, and on the basis of transparency about what is achieved, public service providers that perform well should be rewarded with greater resources and additional flexibility in how they use them. Conversely, problems in failing institutions should be dealt with quickly and decisively. This section describes how the Government is putting these principles into practice, setting in train a number of reforms designed to enhance the performance of priority public services.

Reforming education

6.35 A well developed process of localised target setting is now enabling individual schools and their Local Education Authority (LEA) to plan the scale and timing of reforms necessary to achieve both local and national targets for 11, 14, and 16 year-olds.

6.36 The Government is creating new opportunities for local freedom and innovation. The School Standards Grant (SSG) – paid to every headteacher – has been increased; by 2003–04, SSG will be worth £50,000 a year to a typical primary school, and £165,000 to a typical secondary school. Several policy developments are rewarding improvement or sustained high performance at the school level, both through financial incentives and less regulation or lightened inspection. The new Education Act builds on these local freedoms and incentives by offering new powers to innovate and deregulate, including on the curriculum and staffing arrangements.

6.37 To ensure that no school is held back in making the best use of new local opportunities, the Leadership Incentive Grant (LIG) will strengthen leadership and help schools in the most challenging areas. £125,000 for each school in the partnership will be paid from April 2003 to 1,400 eligible secondary schools. Details of the allocation of funding will be announced shortly, with funding being conditional on the quality of collaborative working. As part of the process of leadership change, the Department for Education and Skills (DfES) and OFSTED are working together to develop a set of leadership criteria for transforming standards, against which excellent school leadership will be judged, and which will be incorporated in a new OFSTED inspection framework from next year. LEAs will work with partnership in schools, OFSTED and DfES to ensure consistent assessment and maximum scope for innovation in leadership change. LIG will challenge more school leaders to demonstrate some of the attributes traditionally associated with entrepreneurs, including greater innovation.

6.38 The PSA target for all schools to be able to benchmark their expenditure and pupil attainments against comparable schools has been achieved, giving all headteachers new insights with which to refine their reform plans. In addition, discussions are well advanced on proposals to remodel the school workforce and make full use of all the skills and members of school teams.

Delivering better healthcare

6.39 Having provided the extra funding for healthcare described in Box 6.1, the challenge now is to ensure it delivers results. The Government has set out the outcomes it aims to deliver, and is introducing significant reforms to the structure and funding of the National Health Service (NHS) to promote efficiency and equity and to shift resources and decision-making closer to local people. Nonetheless, while the largest hospital building programme ever is underway, capacity constraints remain. It is therefore essential that the NHS uses its resources in the most efficient manner to deliver the 'fully engaged' scenario described in the Wanless report.

6.40 Primary Care Trusts (PCTs) are central to the Government's strategy for decentralising and devolving power in the NHS to local communities. First introduced in April 1999, the number of PCTs has since risen to more than 300. Run by GPs, nurses, other health and social care professionals, and representatives of patients and the community, PCTs are responsible for determining the health needs of local people and commissioning the right mix of services to meet them. They are also responsible for integrating health and social care services to ensure that both systems work together for patients. In 1997, GP fund-holders controlled just 15 per cent of the NHS budget. Today, family doctors and nurses in PCTs control around half of the budget and this is expected to rise to three-quarters by 2004. Building on the model of greater flexibility and reduced bureaucracy already being established for high performing local authorities, the Government is establishing new NHS Foundation Trusts which will provide for financial freedoms and flexibilities for hospitals with a track record of success. The Government is ensuring that these freedoms and flexibilities are balanced by the need to deliver better treatment for NHS patients and to safeguard taxpayers' money.

6.41 The Government is committed to providing patients and the general public with comprehensive and easy to understand information on the performance of their local health services. Since 2001, information on the relative performance of all NHS trusts providing acute hospital services has been made publicly available. As described earlier, to further enhance audit and accountability, a new independent Commission for Healthcare Audit and Inspection will be established to monitor and publish information about performance and the use of resources, including in an annual report to Parliament. It will also carry out local inspections and oversee independent complaints procedures.

Improving criminal justice

6.42 The Government is introducing a number of reforms to modernise and improve police performance across all forces. Plans to increase delegation to the front line are going ahead, with £50 million of annual funding allocated to Basic Command Units in high crime areas for use in implementing innovative schemes to address local priorities. The Police Standards Unit is establishing new frameworks that will allow resources to be assessed against the delivery of key outcomes, and plans are also being finalised for local police force commanders and Basic Command Units to make annual police performance information available to every household. The Police Standards Unit and the Home Office are working to implement new powers given to police authorities under the Police Reform Act to take action in cases where police forces are performing poorly. Reforms to pay and working conditions within the police are also proceeding, in an effort to modernise all police forces while providing incentives to officers in the highest crime areas.

6.43 In addition, the Government intends to ensure that prison and probation deliver sanctions that deter offenders and reduce re-offending, while achieving greater value for money. To improve transparency and address examples of failure, performance benchmarking will be introduced for prisons over the next seven years, and failing prisons will be contracted out. The operational management of correctional services will be separated from contracting strategy, standard-setting and performance management.

Better housing

6.44 The key challenges for the Office of the Deputy Prime Minister are to deliver a step change in housing supply in high pressure areas, to tackle the growing problems of low demand and abandonment in parts of the North and Midlands, and to continue to improve housing conditions, in the social and private sectors, for the more vulnerable. The Deputy Prime Minister has already announced major reforms to ensure delivery, including through fundamental reform of the planning system, strengthened regional machinery to ensure coherent spatial, economic and housing strategies, and a unified housing inspectorate to drive up standards in social housing. Further details will be announced in January when the Deputy Prime Minister launches an action programme for sustainable communities. Chapter 3 describes a series of major reforms to the way in which decisions on housing are taken, including the establishment of new regional housing bodies.

Freeing up local government

6.45 In line with last year's Local Government White Paper,[4] the Government is taking firm action to ensure that all local authorities see a significant reduction in Whitehall controls, with high performing authorities receiving a radical package of freedoms and flexibilities. As announced by the Office of the Deputy Prime Minister on 26 November, the amount of central government revenue and capital support that is ring-fenced will be reduced, giving all councils greater control over their spending. In addition, the number of plans that councils must produce for central government will be reduced by over 75 per cent, and all inspection activity will in future be carried out on a coordinated and targeted basis.

6.46 The best councils will see even greater freedoms. The Comprehensive Performance Assessment (CPA) for upper tier authorities will be published in December. Councils that the CPA process has shown to be excellent will benefit from the removal of all revenue and capital ring-fencing, except for direct grants to schools. They will be required to produce just two plans - a Best Value Performance Plan and a Community Strategy - and will be exempt from most inspection activity for a three-year period. Excellent local authorities will be invited to participate in a new Innovations Forum, within which central and local government will explore ways of eliminating bureaucratic barriers to local innovation and excellence. They will also have more freedom to use fine income, new opportunities to trade, and be exempted from the Government's reserve capping powers. The Government is keen to devolve power and responsibility as much as possible, but is ready to take action where authorities are performing badly. With the support of the local government community as a whole, it will therefore ensure that poor councils put in place effective recovery plans that provide their communities with the decent public services that they deserve.

6.47 The Government recognises the importance of greater financial freedoms for all local authorities. As well as the measures described above, the Government is introducing a new prudential regime for borrowing. These policies add up to a substantial package of increased financial freedoms for local authorities. However, the Government recognises that authorities remain concerned about the strategic issue of the balance of funding between central and local government and the impact that this has on their ability to raise additional revenue. As stated in the Local Government White Paper, the Government will establish a high-level group, involving Ministers and senior figures from local government, to consider all aspects of the balance of funding, reviewing the evidence and looking at reform options. As described in Chapter 7, the Government plans to consult on a new proposal to allow local authorities to retain some or all of any increases in business rates revenue to spend on their own priorities.

DELIVERING RESULTS

6.48 Alongside additional resources, the comprehensive programme of reform the Government has put in place aims to deliver significant improvements in public services. With more money invested, more results are required.

6.49 Public Service Agreements (PSAs) are designed to improve performance by ensuring that all those involved in public service delivery can focus on clear long-term goals. Clear targets, against which performance is regularly monitored, also help policy makers to identify where further action might be needed. As described earlier in this chapter, departments will now publish progress reports against their PSA targets twice a year – once in the spring and once in the autumn. Departments are currently in the process of publishing their first autumn performance reports. This section summarises some of their content.

[4] *Strong Local Leadership – Quality Public Services*, Department for Transport, Local Government and the Regions, CM 5237, December 2001

Health **6.50** The Department of Health is responsible for over £58 billion this year. Its aim is to transform the health and social care system so that it produces faster, fairer services that deliver better health and tackle health inequalities. The NHS has made good progress towards meeting many of its objectives and PSA targets, though some areas need to be addressed:

- mortality rates from cancer and coronary heart disease fell by nearly 7 and 14 per cent respectively in the three years to 2000, against a 20 per cent reduction target by 2010;
- the number of people waiting over three months for an out-patient appointment has almost halved since 2000, against a target of a maximum three month waiting time by 2005. Over the same period, the number of in-patients waiting over 12 months also fell by more than half, against a target of a maximum six month waiting time by 2005; and
- challenges remain to tackle the delayed discharge of older people from hospitals, improve the life chances of children in care, and strengthen accident and emergency provision.

Education **6.51** The Government plans to spend around £45 billion on education and skills in England this year. Important improvements have continued in all areas, though progress has not always been as fast as the Government wanted, highlighting the scale of the challenge in some areas of provision. In 2002:

- over half of all 16 year olds achieved five A*-C grades at GCSE, exceeding the target;
- 75 and 73 per cent of 11 year olds achieved required standards in literacy and numeracy respectively, building on the substantial gains made over the last few years though falling a little short of the targets of 80 and 75 per cent; and
- the Government is on track to meet its target of helping 750,000 adults gain basic skills by 2004.

Crime **6.52** The Government's aim is to build a safe, just and tolerant society. Nearly £15 billion will be spent this year on the fight against crime, and the Home Office, the Lord Chancellor's Department and the Crown Prosecution Service have all been set challenging targets. While further progress is needed in some areas, significant results have been achieved in others:

- overall crime levels, as recorded in the British Crime Survey, have fallen;
- by the end of March 2002, vehicle crime had fallen by 8.8 per cent, and domestic burglary by 9 per cent, against respective reduction targets of 30 per cent by 2004 and 25 per cent by 2005 compared with 1998-99 levels. In the two years to 2002, vehicle crime has fallen by 14 per cent and domestic burglary by 23 per cent;
- recorded robberies have increased by 35 per cent since March 2000 against a targeted 14 per cent reduction by 2005. However, since the Street Crime Initiative (SCI) began, the number of robbery offences in the ten SCI police force areas has fallen by 28 per cent; and
- figures for July 2000 reveal a 14 per cent fall in the reconviction rates of young offenders since 1997, well ahead of the targeted 5 per cent reduction by 2004.

Transport **6.53** The Government's Ten-Year Plan for Transport sets ambitious targets to be delivered by 2010, supported by more than £180 billion of public and private spending. The Secretary of State for Transport will report shortly on progress toward delivering the Plan's ambitious objectives and the department is conducting a review to re-assess the way ahead, and to roll forward the Plan into the next decade. The baseline for congestion, against which performance will be measured, will be published alongside the progress report. Progress has been made in a number of areas:

- the number of deaths or serious injuries from road accidents has continued to decline - falling by 15 per cent compared with the average over the period 1994 to 1998, against a target of 40 per cent by 2010. For children, the decrease has been 27 per cent over the same period, against a target of 50 per cent by 2010;
- bus and light rail use increased by 1.1 per cent in 2001, although there are regional variations, against a new combined local public transport target of 12 per cent by 2010;
- network capacity on the London Underground increased by 2.5 per cent and reliability improved by 7 per cent compared with last year, in support of the Government's target to reduce journey times by increasing capacity and reducing delays; and
- the rail network was hit hard by the consequences of the accident at Hatfield, which led to extended disruption to services. Subsequently there has been a steady recovery in rail performance, though passenger levels are not yet at where they were pre-Hatfield. Passenger use increased by 2.6 per cent compared with 2000-01, against a target increase of 50 per cent by 2010 from 2000 levels.

Housing **6.54** Over eight million people live in more than four million local authority and housing association homes. The availability and condition of social housing, and the systems through which people gain access to it and help with its costs, are vitally important for tackling poverty and regenerating deprived neighbourhoods. By 2005-06, investment in housing in England will have risen by £1.1 billion from this year's level to £5.9 billion. Through existing investment and reform, the Government:

- has enabled local authorities to reduce the backlog of council homes needing repairs by around 180,000 dwellings, with around 660,000 additional council houses benefiting from new investment;
- is on course to bring a third of non-decent social housing – around 500,000 homes – up to a decent standard between 2001 and 2004, as part of its long-term target to make all social housing decent by 2010;
- is building up to 22,700 affordable homes through the Housing Corporation in 2003-04, exceeding its social housing target for 2001-04; and
- has met six years early its target that, by 2008, 60 per cent of additional housing should be provided on previously-developed land and through conversions.

Box 6.6: Investing in better infrastructure

The Government has delivered a significant increase in capital investment to reverse the decline seen over the previous two decades. This investment has been underpinned by Departmental Investment Strategies to ensure that capital programmes are delivered effectively. Significant results have been achieved.

In education:

- **20,000 schools have benefited from building improvements since 1997. By 2003-04, a typical secondary school will receive direct capital funding of around £75,000 and a typical primary school around £22,000. By 2004, over 650 schools will have benefited from rebuilding or major renewal;**
- **the computer to pupil ratio in primary schools is now 1:9.7 and 1:6 in secondary schools. These ratios will be improved to 1:8 and 1:5 respectively by 2004; and**
- **553,000 childcare places had been created by June 2002, helping over one million children.**

In health:

- **over 1,300 GP premises have been upgraded. 10,000 GP practices and 1,000 hospitals are now connected to NHSnet, which handles 1.5 million messages per day with usage rising by 8 per cent a month; and**
- **an £8.5 billion hospital programme is now underway – the biggest in NHS history. By 2008, of the 68 major hospital schemes so far approved to proceed, over 50 will be operational with all of the remaining schemes under construction. The extra investment will allow an increase in treatment capacity equivalent to over 10,000 beds.**

In transport:

- **£4 billion has been invested in rail carriages. Since 1997, over 4,000 new carriages have been ordered, of which over 1,400 are already in service. Over 2,100 railway stations have been improved and 17 new stations built.**

In crime:

- **as a result of the 2000 Spending Review, the Home Office has allocated further funding of £146 million to its existing CCTV initiative, for 683 new CCTV schemes. 500 schemes are now in place and the remainder will be in operation by March 2003. Early findings from a number of implemented schemes have shown a very positive impact on crime reduction.**

7 PROTECTING THE ENVIRONMENT

Sustainable development is vital to ensure a better quality of life for everyone, today and for generations to come. Economic growth and social progress must be balanced with action to protect and improve the environment. The Government is using a range of economic instruments to address the many challenges posed by sustainable development, tackling local environmental threats and controlling and reducing emissions of the gases responsible for climate change and poor air quality. The Pre-Budget Report describes the steps the Government is now taking to protect and improve the environment, including:

- **publishing details of its strategy for using economic instruments** to tackle environmental problems;
- **further action to improve waste management**, by:
  - consulting on a revenue neutral proposal to **increase the landfill tax escalator** to £3 per tonne in 2005–06 and to increase the rate of tax by at least £3 per tonne in future years, on the way to a medium- to long-term rate of £35 per tonne; and
  - **reforming the Landfill Tax Credit Scheme** to ensure that funds more effectively promote sustainable waste management, while continuing to support local community environmental projects.
- **consulting on a new proposal to allow local authorities to retain increases in business rates revenue** to spend on their own priorities;
- **a new tax incentive to encourage donations towards the running costs of Urban Regeneration Companies**;
- **further steps to promote cleaner fuels**, including through a new low rate of duty on bioethanol;
- **announcing the next steps towards introducing a lorry road-user charge** to ensure that all lorry operators contribute to the cost of using UK roads, regardless of nationality;
- discussing with stakeholders the role of **economic instruments in encouraging the aviation industry to take greater account of its environmental impact**; and
- **consulting further on the use of economic instruments** both to promote household energy efficiency and to address the environmental impacts of agriculture.

INTRODUCTION

7.1 The Government's Sustainable Development Strategy aims to deliver a better quality of life for everyone, today and for future generations. This requires action to improve and preserve the quality of the environment. The Government is determined to meet the challenges of climate change, poor air quality and environmental degradation in urban and rural areas, ensuring that economic and social development goes hand in hand with progress on the environment.

A strategy for environmental taxes

7.2 The Government believes that, in general, markets provide the best means of allocating an economy's resources in the private sector. This is as true for environmental resources as for others. However, where markets do not price environmental costs properly, economic instruments such as environmental taxes or measures such as tradeable permits can be used to improve the price signals that are given, recognising the dynamic and long term nature of responses within markets.

7.3 Taxes and other economic instruments can provide incentives for behaviour that protects or improves the environment. For both consumers and businesses, these instruments can enable environmental goals to be achieved at the lowest costs and in the most efficient way. By internalising environmental costs into prices, they help to signal the structural economic changes needed to move to a more sustainable economy. They can also encourage innovation and the development of new technologies.

7.4 The Government has discussed its approach to environmental taxation with a range of stakeholders. Following these discussions, it is now setting out in detail its strategy in *Tax and the environment: using economic instruments*, published alongside this Pre-Budget Report. The strategy reaffirms the Government's commitment to its Statement of Intent on environmental taxation, first published in 1997.

7.5 *Tax and the environment* describes how economic analysis provides a framework to help determine how best to reconcile the factors which influence decisions on environmental intervention, taking into account the long time horizons which may be involved. It illustrates how economic tools should be used to appraise the costs and benefits of actions, and to identify the most efficient methods of intervention.

7.6 The strategy also provides a framework for the development and implementation of environmental economic instruments. Key features include:

- the importance of early and extensive consultation;
- early signals of the choice of instrument and then details of the tax rate or other measure, to provide sufficient lead times for households and businesses to plan changes and make the necessary investment; and
- exploring revenue neutral packages to reduce excessive impacts on business competitiveness and specific groups, as well as supporting new technologies to reinforce the behavioural change.

7.7 The correction of environmental market failures reflects the Government's wider strategy for improving the UK's productivity performance, described in Chapter 3. The removal of environmental market failures will help to ensure that the productivity of natural resources is maximised alongside the productivity of the other inputs used in production processes.

7.8 This chapter explains how the Government is using economic instruments to meet four broad environmental objectives:

- tackling climate change and improving air quality;
- improving waste management;
- regenerating Britain's towns and cities; and
- protecting Britain's countryside and natural resources.

TACKLING CLIMATE CHANGE AND IMPROVING AIR QUALITY

Tackling climate change

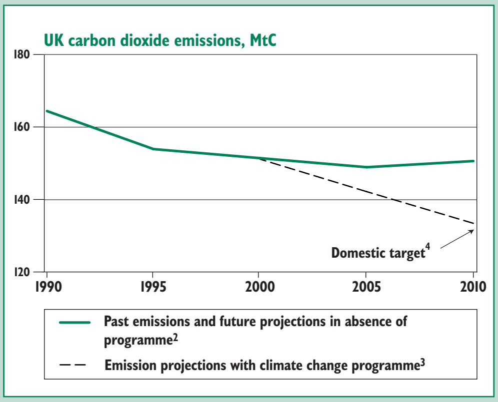
7.9 There is strong evidence that global temperatures are rising. The 1990s included seven of the ten warmest years on record, and sea levels are rising by 1.5 millimetres a year[1]. The problems of climate change are felt across society and cause harm to the natural environment. Those most severely affected are often the least well equipped to deal with the consequences. The Government is therefore taking important steps to address this challenge, controlling and reducing emissions of the gases responsible for global warming.

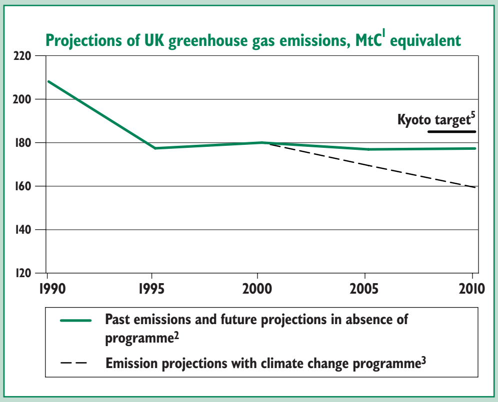
7.10 The Kyoto Protocol commits the UK to reducing greenhouse gas emissions to 12.5 per cent below 1990 levels between 2008 and 2012. Along with other members of the European Union, the Government ratified the Protocol on 31 May 2002. The Government's climate change programme is designed to take the UK well beyond its Kyoto target and towards the Government's own, more demanding, goal of a 20 per cent reduction in carbon dioxide emissions by 2010.

7.11 UK carbon dioxide emissions increased in 2000 and 2001, and provisional data based on the first six months of 2002 suggest that a further increase is likely this year. This reflects some reduction in nuclear output, lower gas burn because of current higher prices, and a levelling out of improvements in the energy intensity of the economy. Road transport emissions remained flat in 2001. The Government nonetheless remains confident that the Climate Change Programme provides an effective framework of action to deliver the UK's commitments, and the forthcoming Energy White Paper will set out the role of the energy system in delivering reductions in carbon dioxide emissions, along with other issues..

Box 7.1: Emission projections and targets

The charts below show the historic emissions and projected effect to 2010 of all the quantifiable measures set out in the UK climate change programme. Along with additional measures, such as public awareness campaigns, emissions should be reduced further so that the UK's carbon dioxide emissions reach 20 per cent below 1990 levels by 2010.





[1] The six greenhouse gases are carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, and sulphur hexafluoride.

[2] Includes the effects of the Renewables Obligation, the climate change levy, (including the previous exemption for CHP and exemptions for renewable energy), and the fuel duty escalator.

[3] Includes the estimated effect in 2010 of all the quantifiable measures set out in the UK's climate change programme, and released in the UK's Third National Communication on Climate Change.

[4] Domestic target is 20 per cent below 1990 levels by 2010.

[5] Kyoto target is 12½ per cent below 1990 levels by 2008–12.

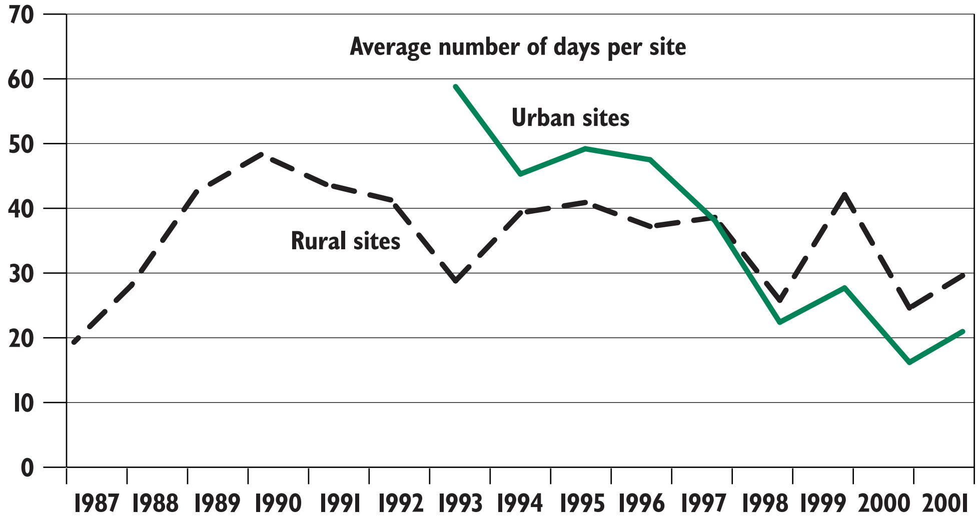
Source: The UK's Third National Communication to the United Nations Framework Convention on Climate Change, DEFRA, 30 October 2001

[1] *UK climate change programme*, DETR, 2000.

Improving air quality

7.12 Poor air quality poses risks to human health, quality of life and the natural environment. Chart 7.1 shows the number of days of poor air quality each year. In general, air quality in the UK is improving, especially in urban areas. But much more remains to be done. The underlying trend in rural air quality is less clear, reflecting variability in levels of ozone – the main cause of pollution in rural areas. Moreover, exposure to air pollution continues to be associated with hospital admissions and premature deaths each year.

Chart 7.1: Days when UK air pollution is moderate or higher[1]



[1] Sites added to the network after 1997 are excluded.
Source: NETCEN, DEFRA.

Business

Climate change levy

7.13 The climate change levy (CCL) and its associated measures encourage business to improve energy-efficiency and reduce emissions of carbon dioxide, the principal greenhouse gas. The package is broadly revenue neutral for business, with CCL revenues recycled back to business principally by means of a 0.3 percentage point reduction in employer national insurance contributions (NICs).

7.14 The package of measures associated with the CCL includes exemptions for new forms of renewable energy, 80 per cent discounts for eligible sectors that have negotiated agreements to increase energy efficiency and reduce emissions, and support to help all businesses use energy more efficiently. In addition, Budget 2002 announced that **the Government intends to exempt from the levy electricity generated from combined heat and power plants sold via licensed electricity suppliers and that generated from coal mine methane**, in view of the environmental benefits of these forms of generation. The exemptions are subject to EU state aids approval.

7.15 Budget 2002 also announced that the Government would consider options for extending relief to certain processes which compete with those benefiting from the dual-use or non-fuel use exemptions. This relief was introduced by extra-statutory concession in July 2002.

The Carbon Trust and energy efficiency

7.16 The Carbon Trust, an independent company funded principally from recycled CCL revenues and the existing Energy Efficiency Best Practice programme, works to support energy-efficiency improvements and investment in low-carbon technologies by business. The programme includes:

- the Action Energy programme, which provides business with independent information to help save energy and reduce carbon emissions;
- administration of the enhanced capital allowance (ECA) scheme for investments in energy-saving technologies; and
- the Low Carbon Innovation Programme, through which the Trust is developing flexible support to encourage the development of new low-carbon technologies. The Trust has recently launched the foundation part of this programme.

Investment in energy-saving technologies

7.17 Enhanced capital allowances for investments in approved energy-saving technologies were introduced in 2001 and currently cover over 2,500 approved products. To build on this success, Budget 2002 added a number of new technologies to the ECA scheme, including heat pumps for space heating, radiant and warm air heaters, solar thermal systems, compressed air equipment and refrigeration cabinets and compressors. The existing technology class for boilers and add-ons was also expanded to include oil-fired boilers. The new Energy Technology List took effect from 5 August 2002 and spending incurred since then on these technologies and products can qualify for enhanced 100 per cent first-year allowances. The addition of these groups will be worth £15 million during their first full financial year, 2003–04.

7.18 The Government has also expanded the ECA scheme so that spending incurred from 17 April 2002 on qualifying equipment for leasing may qualify for the allowances, provided that capital allowances would be available under the normal rules for plant and machinery leasing. The Government continues to consider new technologies for inclusion within the scheme.

Emissions trading

7.19 Trading under the UK Emissions Trading Scheme (ETS), the world's first economy-wide greenhouse gas emissions trading scheme, has made an encouraging start. In the first stage of the scheme, 34 direct participants committed to a total reduction of 1.1 million tonnes of carbon (MtC) a year by 2006 in return for an incentive worth £150 million after tax. The UK ETS has been successful in establishing for the first time a market price for carbon – an important signal of companies' abatement costs and an aid to the future development of cost-effective policies for the reduction of greenhouse gas emissions, both in the UK and internationally.

7.20 Participation in the scheme is expanding. Companies with CCL negotiated agreements can now use the scheme to trade allowances in order to meet their emissions reduction targets at the lowest possible cost and secure re-certification for 80 per cent CCL discounts. From this autumn they are also able to sell any over-achievement of their targets into the trading scheme. A majority of the 44 sectors with agreements are expected to take advantage of the flexibility this offers. A third entry route to the ETS, in which organisations will be able to generate emissions allowances from specific emission reduction projects, is currently under development.

Renewable energy

7.21 The Government is committed to ensuring that 10 per cent of electricity is supplied from renewable sources by 2010, subject to the cost to consumers being acceptable. Direct support for renewable energy, worth over £260 million, will be provided between 2001 and 2004. Most forms of renewable energy are also exempt from the CCL.

7.22 The Renewables Obligation for England and Wales and the comparable Scottish Obligation came into effect on 1 April 2002. The Obligations require electricity suppliers to supply 3 per cent of their output from renewable sources in 2002-03, excluding electricity from large-scale hydroelectric stations and energy recovery from the incineration of mixed waste. The proportion of electricity to be supplied from renewable sources is forecast to rise to 10.4 per cent of all licensed electricity sales by 2010-11, by which time the market incentive provided is expected to be worth over £750 million per year. Consultation on similar arrangements for Northern Ireland is under way.

Households

7.23 Encouraging greater energy-efficiency in the home is key to reducing fuel poverty and carbon emissions. Government programmes, including the Energy Efficiency Commitment and the Affordable Warmth Programme, are encouraging and assisting domestic consumers to reduce their energy consumption, ensuring that households contribute to efforts to meet the UK's emissions targets.

VAT on energy-saving materials

7.24 Budget 2002 introduced further measures to promote energy-efficiency in the home, extending the reduced 5 per cent rate of VAT to the grant-funded installation of factory-insulated hot water tanks, micro combined heat and power systems, and renewable energy heating systems in the homes of those on lower incomes. The extended coverage came into effect on 1 June 2002.

Economic instruments

7.25 The Government has also consulted on the potential for using economic instruments to improve household energy efficiency[2]. Once responses to the consultation have been fully considered, **the Government will consult further on specific measures to promote greater energy efficiency by households**.

Transport

7.26 In recent decades rising economic activity and increased incomes have generated a higher demand for personal travel and the transport of goods and services. A safe, clean and efficient transport system is crucial to sustaining economic growth, generating higher productivity and safeguarding the environment. The Government is pursuing three related objectives to address these issues:

- in the long term, to assist the switch to a low-carbon economy, including zero emissions transport;
- over the medium term, to establish incentives for greener transport; and
- in the short term, to encourage the use of the best widely available fuels and vehicles.

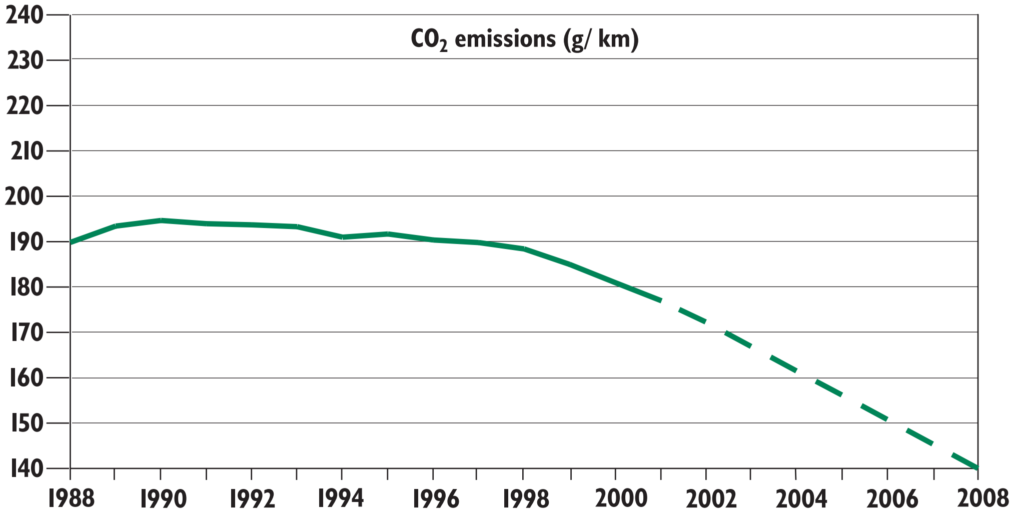
7.27 Important steps have already been taken to advance these objectives, including new duty incentives and other tax reforms to promote the use of cleaner fuels and vehicles. Chart 7.2 illustrates how carbon dioxide emissions from new cars have fallen in recent years and are expected to fall further by 2008 in the light of the voluntary agreement between the European Community and car manufacturers. Box 7.2 describes the Government's longer term strategy to facilitate the introduction and take-up of low-carbon vehicles and fuels[3].

---

[2] *Economic instruments to improve household energy efficiency: a consultation document*, HM Treasury and the Department for the Environment, Food and Rural Affairs (DEFRA), July 2002.

[3] *Powering future vehicles – the Government strategy*, the Department for Transport, the Department of Trade and Industry, DEFRA and HM Treasury, July 2002.

Chart 7.2: Carbon dioxide emissions from new cars



Source: Data from 1995 to 2001 is based on DVLA monitoring. Data prior to 1995 is estimated from average new car fuel consumption figures. The petrol average new car fuel consumption data is from Transport Statistics Great Britain. An equivalent diesel figure was calculated for 1994 at 22 per cent better than petrol fuel consumption. This figure was used for all previous years in this chart, in the absence of other data. Data from 2001-2008 is a linear progression.

Box 7.2: Powering future vehicles: a strategy for low-carbon transport

The Government is committed to providing a fiscal regime that encourages the use of cleaner fuels and vehicles. The July 2002 strategy document, *Powering Future Vehicles*, sets out the Government's proposals to make the UK a world leader in the global move to clean, low-carbon transport. The Government's objectives are:

- **to promote the development, introduction and take-up of new vehicle technologies and fuels; and**
- **to ensure the full involvement of the UK automotive industry in these new technologies.**

The strategy sets stretching new targets for cleaner road transport by 2012, including that 10 per cent of all new cars sold will have carbon dioxide emissions not exceeding 100 grammes/kilometre (g/km) at the tailpipe, and that 600 or more buses coming into operation each year will be low-carbon. The strategy also describes the actions the Government will take to achieve these targets, including:

- **further work to promote the research, development and demonstration of new technologies;**
- **efforts to encourage consumer take-up of low-carbon vehicles and to overcome existing market barriers;**
- **steps to ensure effective regulation of the industry;**
- **measures to facilitate infrastructure development;**
- **steps to allow transport to play a part in the UK emissions trading scheme; and**
- **work and collaboration with international partners on these issues.**

Fuel duties and cleaner fuels **7.28** Differential rates of duty can help to encourage the rapid use of more environmentally-friendly fuels and have stimulated the development of new technologies to improve the environmental performance of road vehicles. Duty incentives introduced by the Government have already encouraged industry to convert unleaded and diesel sales for road vehicles to ultra-low sulphur petrol (ULSP) and ultra-low sulphur diesel (ULSD), leading to important reductions in the impact of motoring on local air quality.

Sulphur-free fuels **7.29** Sulphur-free fuels offer further environmental benefits over ultra-low sulphur fuels, delivering greater long-term reductions in carbon dioxide emissions when used in new engine technologies, and further air quality improvements. The Government is aware, however, that there is a risk of a net increase in carbon dioxide emissions in the short term if this fuel is introduced too early. The Government will therefore discuss with the oil industry and vehicle manufacturers the role of a duty incentive for sulphur-free fuels, taking into account the industries' medium-term investment plans, the environmental benefits of these fuels, and relevant discussions at an EU level.

Biodiesel **7.30** A new duty rate for biodiesel, set at 20 pence per litre below the ULSD rate, was introduced in July 2002, to support the production of this fuel and allow the UK to benefit from the reduced greenhouse gas emissions it can offer. Biodiesel is now establishing a market across the country; more than 300,000 litres were sold in October – a five-fold increase in sales since the introduction of the duty incentive – and it is expected that biodiesel will be available at over 80 fuel retailers by the end of the year.

Bioethanol **7.31** In April 2002, the Government invited bids for fuel duty reductions or exemptions to support research and development into a range of alternative fuels. All the qualifying bids covered bioethanol. In the light of new environmental data and new research[4], **the Government intends to introduce a new duty rate for bioethanol set at 20 pence per litre below the prevailing ULSP duty rate**. The Government will discuss with stakeholders when to introduce this incentive with a view to announcing decisions in Budget 2003. This differential will offset the additional production costs of bioethanol and allow the UK to benefit from the reduction in greenhouse gases and local polluting effects that this fuel can offer. While the new duty rate will apply to bioethanol produced from any feedstock, the Government is particularly keen to support the development of bioethanol from ligno-cellulosic feedstocks, such as straw or forestry residues, as this looks likely to offer particular environmental advantages. Production of ligno-cellulosic bioethanol is at a comparatively early stage of development, and the Government will therefore consider how best to give it further support.

Road fuel gases **7.32** Road fuel gases can offer important reductions in particulates and nitrogen oxide emissions compared with conventional fuels. Following progressive duty reductions, liquefied petroleum gas is now supplied at over 1,100 forecourts, and a number of haulage operators are using lorries fuelled by natural gas. The Government is committed not to increase the duty on road fuel gases in real terms until 2004 at the earliest. As part of the Green Technology Challenge, Budget 2002 introduced 100 per cent first-year capital allowances for investments in natural gas refuelling infrastructure.

Hydrogen **7.33** Hydrogen has the potential to lead to zero-emissions transport and most experts predict that it will be an important fuel for the future. As announced in Budget 2002, subject to the outcome of a Green Fuel Challenge pilot project, **the Government intends to exempt hydrogen from fuel duty for a limited period in the future** to encourage further development and early take-up. **The Government will discuss with stakeholders the issues raised by the taxation of hydrogen fuel production for road transport** to ensure that the necessary analysis

[4] See for example *Energy and greenhouse gas balance of biofuels for Europe – An update*, CONCAWE, April 2002; *Well-to-wheel analysis of energy use and the greenhouse gas emissions of advanced fuel/vehicle systems – A European study*, L-B-Systemtechnik Consultancy, September 2002; and *Ethanol emissions testing*, AEA Technology, March 2002.

is in place to implement the exemption and to make decisions about the fiscal framework in the future. Budget 2002 also introduced 100 per cent first-year capital allowances for investments in hydrogen refuelling infrastructure. Next year, three hydrogen fuel cell buses will be deployed in London for a trial period and **the Government intends to support this project by exempting the fuel used from fuel duty under the Green Fuel Challenge.**

Pilot projects for alternative fuels

7.34 In addition to those for hydrogen fuel cell buses, Budget 2002 announced that **the Government is also introducing fuel duty exemptions for two further pilot projects involving the capture, compression and use of landfill gas in vehicles and the testing of methanol in vehicles and in refuelling infrastructure**. These projects are expected to begin later in the year.

VED for cars

7.35 Since 1997, the Government has progressively reformed vehicle excise duty (VED) to provide incentives for motorists to choose more environmentally-friendly vehicles and to continue the shift towards taxing usage rather than ownership. From March 2001, VED for newly registered cars has been based on carbon dioxide emissions and fuel type. To increase incentives to use cleaner cars, Budget 2002 froze VED rates for cars and introduced a new low-carbon band offering a £30 discount for cars with emissions not exceeding 120 grammes per kilometre (g/km). Motorists are now able to save up to £100 of VED each year by choosing the most efficient and least polluting cars. To help consumers understand the environmental impact of the car they intend to purchase, the Government has consulted on proposals for a comparative, colour-coded labelling scheme and is piloting two different formats of comparative car label, based on the current VED bands and the EU A-G banded energy label.

VED for vans

7.36 Following discussions with industry and other stakeholders, **Budget 2002 announced the introduction of a new lower VED rate of £105 from March 2003 for vans meeting the challenging euro-IV environmental standard.** These vans offer significantly lower levels of harmful emissions, particularly in urban areas. The discount will be reviewed in the run-up to this standard becoming mandatory in 2006.

VED for motorcycles

7.37 Following consultation, Budget 2002 introduced a reformed motorcycle VED system to reflect developments in the motorcycle fleet and the environmental benefits that motorcycles can offer. As a result of these reforms, 600,000 motorcyclists are now paying lower rates of VED.

E-licensing

7.38 The Government intends to introduce e-licensing and telephone licensing by 2005, enabling vehicle keepers to pay their VED over the internet or the telephone. The Government will begin to roll-out e-licensing for cars and vans less than two years old in November 2003. It will continue to ensure that valid insurance and roadworthiness certification remains in place through electronic links with insurance and MoT databases. Existing counter services through Post Offices and DVLA Local Offices will also remain in place.

Company car tax

7.39 Companies purchase approximately 50 per cent of all new cars sold in the UK and about 20 per cent of all vehicle miles are made in company cars. To promote the use of cleaner company vehicles, a new system of company car taxation was introduced in April 2002. The new system is based on carbon dioxide emissions to encourage company car drivers to switch to more efficient cars that are less harmful to the environment. A comprehensive evaluation system is underway to establish the environmental impact of these reforms. Independent surveys suggest that the reforms are already leading to environmental improvements in company cars.

Business tax incentives for low-carbon cars

7.40 To complement the new company car tax system and low-carbon VED band, the Government has introduced 100 per cent first-year capital allowances for the purchase of business cars with carbon dioxide emissions not exceeding 120g/km. These allowances provide further support to the market for cleaner, more efficient cars.

Fuel scale charges **7.41** As announced in Budget 2002, **the Government will restructure from 2003-04 the fuel scale charge that applies to employees who receive free fuel for private use in a company car.** In future, the charge will be related to carbon dioxide emissions and will include the same discounts for cleaner fuels and premiums as the company car tax system. This restructuring will be revenue-neutral and will make the system more environmentally-friendly. It will also allow a proportionate reduction in the annual charge if an employee receiving free fuel decides to opt out during the course of the year.

Company vans **7.42** Budget 2002 also announced that the Government would review the tax treatment of the private use of vans provided by employers, taking into account environmental benefits, fairness and modern working practices. The Government will discuss with industry and other key stakeholders how best to achieve this, with a view to launching a formal consultation next year. The Government will consult in particular on how to simplify the legislation for shared vans and on the scope for encouraging environmentally-friendly vans.

Lorry road-user charging **7.43** The Government recognises the important role that road haulage plays in a successful and high-productivity economy and is committed to supporting action by the haulage industry to become more competitive and less environmentally damaging. It believes that all lorry operators using UK roads should make a fair contribution towards the costs they impose, irrespective of nationality.

7.44 As announced in Budget 2002, **the Government intends to introduce a lorry road-user charge based on distance travelled in 2005 or 2006.** The Government has consulted widely on options for introducing a charge[5] and published a first progress report in April 2002[6]. It remains committed to ensuring that the UK haulage industry does not pay any more as a result of the introduction of the new charge and will introduce offsetting tax reductions for the industry. The Government is now establishing a Road Haulage Forum sub-group, including representatives of the haulage associations and other key stakeholders, to discuss work related to the charge and to take it forward. It is also undertaking a joint government-industry visit to review German plans to introduce similar reforms.

7.45 **The Government will publish a second progress report early next year,** outlining the results of work on how to implement and procure the lorry road-user charge and offsetting tax cuts.

Box 7.3: Reforming the taxation of the haulage industry

Work to introduce a distance-based lorry road-user charge alongside offsetting tax reductions for the industry is being taken forward in three key areas:

- **the Government is examining in detail the technical options for administering the charge and offsetting tax reductions, and options for procuring the system. This work is at an advanced stage and will be outlined in detail in the forthcoming second progress report. The Government hopes to issue Invitations to Tender in 2003;**
- **the Government is seeking to improve its ability to analyse the potential impact of different charging rates and criteria by commissioning new, more detailed statistics and by upgrading its modelling ability for these reforms; and**
- **the Government is pursuing European legislative reforms to secure the optimal legislative framework.**

This work programme was discussed at a special seminar in April 2002 and at a meeting of the Road Haulage Forum. The Government continues to seek stakeholders' views on the best way forward.

[5] *Modernising the taxation of the haulage industry: a consultation document*, HM Treasury, November 2001.
[6] *Modernising the taxation of the haulage industry: progress report one*, HM Treasury, HM Customs and Excise and the Department for Transport, Local Government and the Regions, April 2002.

Review of bus subsidies

7.46 The Government is currently undertaking a review of bus subsidies, to ensure that funds are used effectively to improve services and to help meet the Government's transport, environmental and social objectives. The review is focusing on the Bus Service Operators' Grant and other mechanisms of bus subsidy. It will not lead to a reduction in the overall level of Government support for bus transport. The Government has consulted[7] on options for reform and is currently considering the responses received.

Aviation

7.47 The Government recognises both the important economic benefits that aviation offers and the need to ensure that the industry faces an appropriate set of economic incentives to deliver an efficient environmental outcome. Following the Budget announcement on the role of economic instruments to encourage the aviation industry to take more account of its environmental impact, and this year's wide-ranging consultation on the future development of air transport, **the Government will discuss with stakeholders the most effective economic instruments for ensuring that the industry is encouraged to take account of, and where appropriate reduce, its contribution to global warming, local air and noise pollution.** The Government will set out its plans in its Air Transport White Paper next year.

IMPROVING WASTE MANAGEMENT

Waste strategy

7.48 Effective management of waste is an essential component of an environmentally-sustainable economy. The waste stream contains resources which can be re-used or recycled to deliver economic value. Waste also has important impacts on environmental issues such as climate change and the local environment. The UK can no longer continue to rely on cheap landfill as a simple means of disposing of waste. Some progress has been made in recent years to increase recycling, but the overall volume of municipal waste continues to grow. Further action is therefore needed to stimulate changes in waste management practice across all sectors of the economy.

7.49 The Strategy Unit is today publishing a report to the Government, following its review of waste policy[8]. The Strategy Unit report sets out the case for reducing volumes of waste. It proposes a package of measures to promote sustainable waste management, stressing the need to promote recycling and develop alternatives to landfill as the primary means of waste disposal. The report also identifies the need for a robust delivery strategy and more effective structures to support implementation of waste policy. This Pre-Budget Report sets out the first step in the Government's response, and shows how the tax system will be used to help achieve the changes in behaviour that are required.

Landfill tax

7.50 The landfill tax, currently set at £13 per tonne for active waste, encourages efforts to minimise the amount of waste generated and to develop more sustainable waste management techniques. It contributes to the achievement of the Government's waste strategy targets through the diversion of waste away from landfill.

7.51 The current landfill tax escalator, introduced in 1999, commits the Government to raise the standard rate of tax for active waste by £1 per tonne each year until 2004-05, by which time it will have reached a rate of £15 per tonne. As announced in Budget 2002, there is a strong case for increasing the tax rate significantly in future years to provide incentives for the development of alternatives to landfill and to reduce the volume of waste disposed in this way. **The Government will therefore consult on a revenue neutral proposal to increase the landfill tax escalator to £3 per tonne in 2005-06 and to increase the rate of tax by at least £3 per tonne in future years, on the way to a medium- to long-term rate of £35 per tonne.**

[7] *Review of bus subsidies: a consultation paper,* Department for Transport, August 2002.

[8] *Waste not, want not*, Cabinet Office Strategy Unit, November 2002.

The Government's intention is that increases will be introduced in a way that is revenue neutral to business as a whole. The Government will consult with stakeholders on options for the package, including the recycling of revenue, before making its decisions.

Landfill Tax Credit Scheme

7.52 The Government recognises that the Landfill Tax Credit Scheme (LTCS) has supported many worthwhile community and environment projects that have improved the quality of the environment at the local level. The Government has reviewed the role of the scheme in consultation with key stakeholders. The scheme has also been successful in generating local community involvement in such projects. However, there is less evidence that the LTCS has delivered a step change towards more sustainable waste management, and it has also been criticised for its administrative complexity and for failing to deliver value for money for the tax which is forgone. Recent changes have improved the administration of the scheme, but will not deliver the strategic and coherent approach to waste management which is needed.

7.53 **The Government has therefore decided to reform the LTCS from 1 April 2003**. The level of funding for the replacement schemes will be capped at the value of the tax which would have been forgone in 2002–03 if all the available tax credits had been claimed by landfill operators. Approximately one third of the funding, around £47 million, will continue to be made available through a reformed tax credit scheme for spending on local community environmental projects, ensuring that the current level of support for these types of projects is maintained. The remainder, £100 million in 2003–04 rising to £110 million in 2004-05 and 2005-06, will be allocated to public spending to encourage sustainable waste management. The design of the public spending programme will be determined following further work on the management of waste policy. The Devolved Administrations will be responsible for these programmes in their regions.

7.54 Tax credits which have already been claimed by landfill operators, or which may be claimed until March 2003, will need to be spent under the existing LTCS arrangements. This will ensure that projects which have been allocated tax credit funding will continue to benefit until such time as they are completed.

7.55 In the light of LTCS reform, the Government will announce its final decisions on sustainable waste management spending, and on the administration of the tax credit scheme for local community environmental projects, over the coming months. Reducing the rate of growth of waste volumes and increasing recycling through national kerbside recycling schemes and secondary market development will be priorities for additional investment.

7.56 Consistent with the Government's approach to improving the delivery of public services, additional resources must be accompanied by reform and based on a cost-effective delivery strategy. The Government has identified three priority steps to take waste policy forward. First it will consider all the Strategy Unit's recommendations, and, with the close involvement of the Delivery Unit, agree the robust delivery mechanism necessary to deliver waste minimisation and higher recycling rates. Second, it will consider options for recycling revenue in order to the gain the greatest impact on waste minimisation and recycling, for decisions in Budget 2003. Third, since partnership with local government is critical to successful delivery, it will ensure that mechanisms are developed in line with the Government's objective to deliver more freedom and flexibility to local service providers. To coordinate activities across government, the Economic Secretary to the Treasury will chair a ministerial group, to report in Budget 2003, involving the Department of Environment, Food and Rural Affairs (DEFRA), the Office of the Deputy Prime Minister (ODPM) and the Department of Trade and Industry.

Waste incineration tax **7.57** Budget 2002 announced that the Government would consider the case for an economic instrument for incineration. There are a range of issues associated with developing an effective waste management and disposal mix. The Government will therefore commission a review of the environmental and health effects of all waste management and disposal options. The case for using economic instruments for incineration will be considered in light of this work, and in consultation with other stakeholders. The Government will also consider how the use of economic instruments can be extended to provide a more comprehensive and coherent framework for waste management.

Waste reduction **7.58** It will also be important to minimise the volume of waste produced. This will require significant changes in household behaviour as well as action by the manufacturing and service sectors and by waste disposal authorities. The Government has ruled out the introduction of a national tax on household waste. In keeping with the freedoms and flexibilities agenda endorsed by the Local Government Association, the Strategy Unit has proposed that local authorities should be able to develop innovative waste minimisation solutions, provided that adequate recycling facilities are available.

Waste oils **7.59** Waste Strategy 2000 included a commitment to examine ways of enhancing the competitiveness of regenerated, or recycled, oils. The Government has reviewed the tax treatment of waste oil used as a fuel and has decided not to proceed with consultation on this option. Instead, it believes that other options for stimulating regeneration in waste oil may be more effective.

REGENERATING BRITAIN'S TOWNS AND CITIES

7.60 Physical, economic and social deprivation continue to affect many of Britain's urban areas. Towns and cities need to provide an attractive physical environment if they are to encourage enterprise and employment, attract investment, foster strong communities and deter unsustainable development in the countryside. The Government is therefore taking active steps to promote regeneration:

- economically, by promoting enterprise and investment in deprived areas through the Regional Development Agencies (RDAs) and Local Strategic Partnerships (LSPs), and the 2,000 Enterprise Areas and other measures described in Chapter 3;
- socially, through increased investment to ensure higher standards of public service delivery in the poorest neighbourhoods; and
- physically, through a range of measures to bring land and property into use and to improve the attractiveness of public space described in this section.

Urban policy **7.61** The Urban White Paper set out a package of fiscal measures worth £1 billion over five years to encourage the physical regeneration of Britain's towns and cities. The measures include a 150 per cent accelerated tax credit for the costs of cleaning up contaminated land, 100 per cent first-year capital allowances for creating flats for letting over shops and other commercial premises, and targeted VAT reductions to encourage the renovation and conversion of existing residential properties.

7.62 The Government has also exempted from stamp duty all property transactions up to £150,000 in the 2000 most deprived areas of the UK, and intends to **exempt all commercial property transactions in these areas from stamp duty**, irrespective of value. The Government is now actively seeking EU state aids clearance for this measure.

Urban Regeneration Companies

7.63 Urban Regeneration Companies are independent companies that engage the private sector alongside public sector partners such as local authorities, RDAs and English Partnerships in order to develop and implement regeneration strategies in urban areas. The Government has consulted on the possibility of giving tax relief on companies' donations to URCs and now **intends to introduce a new tax incentive to encourage donations toward the running costs of URCs,** helping them to play an effective role in stimulating regeneration and enterprise in many of Britain's urban areas. Regeneration encouraged by the URCs within the 2000 Enterprise Areas will also benefit from the range of Government support available in these areas, as described in Chapter 3.

Public spaces

7.64 Safe, clean and attractive local environments matter greatly to people and can help to achieve other key policy objectives, including crime reduction, healthier communities, social inclusion and increased economic well-being.

7.65 A cross-cutting review on improving public spaces was held as part of the 2002 Spending Review. The review found that better targeted mainstream funding was the key to sustainable improvements. A cross-government report[9] was published in October 2002 describing the steps now being taken to improve the quality of local environments, building on the significant increases in investment in mainstream public services allocated in the 2002 Spending Review. These steps include:

- consultation on the powers, rights and responsibilities of local authorities and others in relation to the maintenance of the local environment[10];
- a new expanded role for the Commission for Architecture and the Built Environment (CABE) with a new CABE unit to advise Government on the provision and maintenance of parks and green spaces; and
- development of a new measurement methodology to help local authorities report on levels of local environmental cleanliness in their area.

Business Improvement Districts

7.66 Partnership between business and local authorities has an important role to play in fostering urban and community regeneration. Business Improvement Districts (BIDs) will enable local authorities and business communities to work together on specific schemes, subject to local ratepayers agreeing to a levy to fund the BID. They will contribute to the safety, cleanliness and attractiveness of streets and public spaces and encourage development and growth within urban areas. Provision to introduce BIDs is included in the draft Local Government Bill, published in June 2002. ODPM is currently preparing guidance on how to implement BIDs in consultation with business and local authority groups.

Regeneration and growth incentives for local government

7.67 BIDs are a key part of the Government's approach to developing the new partnerships necessary at the local level to foster regeneration and create dynamic local economies. However, the Government believes that there is more to do to deliver a new regional economic policy that exploits the indigenous strengths in each region and city and provides the necessary flexibility and resources to allow powerful regional and local initiatives to work.

[9] *Living places: cleaner, safer, greener*, Office of the Deputy Prime Minister, October 2002.
[10] *Living places: powers, rights and responsibilities,* DEFRA, October 2002.

7.68 The Government therefore intends to explore ways in which it could build on the local government reforms outlined in Chapter 6 by **allowing local authorities to retain some or all of any additional increases in business rates revenue to spend on their own priorities**. The aim would be to provide incentives to local government to promote economic growth and regeneration, while at the same time generating additional resources to address local priorities. This is consistent with the Government's approach to localism that is also reflected in the wider review of the balance of funding for local authorities announced in the December 2001 local government white paper, *Strong local leadership – quality public services*.

7.69 Under any proposals, the additional revenue raised would come from increases in the tax base generated by local authorities successfully encouraging growth, and not from increasing the tax on existing business. The money raised would be genuinely additional to local authorities and they would be free to decide how to spend it, in line with the policy to minimise ring-fenced grants. The Government will set out proposals for consultation during 2003.

Abandoned vehicles

7.70 Abandoned vehicles are a blight on Britain's towns and cities. The Finance Act 2002 includes outline powers to reform the vehicle registration system to ensure that owners of all vehicles can be traced and that effective sanctions exist for motorists who evade their tax obligations, abandon their vehicles or commit other offences. The Government has now established a working group involving key stakeholders from the police, motoring organisations, the motor industry and others, to discuss how to implement these powers in the most effective manner.

PROTECTING BRITAIN'S COUNTRYSIDE AND NATURAL RESOURCES

7.71 The Rural White Paper, published in November 2000, sets out the Government's approach to delivering a countryside that is sustainable – economically, socially and environmentally. In tackling environmental threats to the countryside, the Government is applying the principles which underpin its wider environmental strategy, addressing market failures through a range of economic instruments. This section describes the action that the Government is taking to:

- reduce the environmental impact of aggregates extraction;
- minimise the environmental impact of agriculture;
- reduce water use and improve water quality; and
- support Britain's rural economy and communities.

Aggregates quarrying

Aggregates levy

7.72 The extraction of aggregates imposes a range of environmental costs, including noise, dust, visual intrusion, loss of amenity and damage to biodiversity. The aggregates levy, introduced in April 2002, incorporates these environmental costs into the price of virgin aggregate and encourages the use of alternative materials, such as wastes from construction and demolition, that would otherwise be disposed of to landfill. It also promotes greater efficiency in the use of virgin aggregate and the development of alternative materials, such as waste tyres. The levy was set at a rate of £1.60 per tonne on virgin aggregate commercially exploited in the UK.

7.73 Following EU state aids approval, the Government is phasing in the levy for aggregates used in processed products in Northern Ireland in view of the special circumstances of this sector. The rate for aggregates used in these products has been set at zero for the first year of the levy, and will rise by 20 percentage points each year for five years.

7.74 As announced in the November 2001 Pre-Budget Report, the Government has examined industry proposals for delivering additional environmental benefits through the aggregates levy by encouraging the positive use of aggregates waste. Following informal discussion with industry, the Government will shortly consult formally in order to gather further information on the issues involved.

Sustainability Fund

7.75 To help businesses and communities affected by the extraction of aggregates, the introduction of the aggregates levy was accompanied by a new Aggregates Levy Sustainability Fund (ALSF), as well as a 0.1 percentage point reduction in employer national insurance contributions. The ALSF in England was launched in April 2002 and is seeking to reduce the environmental damage caused by extraction in three ways:

- reducing the demand for primary aggregates, by promoting greater use of alternatives and supporting more sustainable practices in construction;
- promoting environmentally-friendly extraction and transport, by funding projects to develop cleaner and quieter lorry transport and encouraging the use of rail and water transport; and
- reducing the effect of local aggregates extraction, by funding of biodiversity projects and the conservation of geological features.

7.76 The ALSF will run initially for two years, with £29.3 million available each year in England. The devolved administrations are currently developing their own proposals for use of the Fund in their regions. The National Assembly for Wales has recently consulted on use of the Fund in Wales.

Agriculture

7.77 Agriculture, like many other forms of business, is associated with a range of environmental issues, including nutrient pollution. As announced in Budget 2002, the Government has carried out an initial review of the environmental impacts of agriculture and the case for using economic instruments to tackle these. The findings of this review will be published with the Government's forthcoming Sustainable Farming and Food Strategy. **The Government is now considering in more detail the options for using economic instruments to address the most pressing environmental impacts of agriculture and will consult with stakeholders in 2003.**

Pesticides **7.78** The Government is committed to minimising the adverse environmental impact of pesticide use, consistent with adequate crop protection. A voluntary agreement on measures to reduce the environmental damage caused by pesticides was entered into by the industry and other stakeholders in April 2001. Provided this voluntary initiative is fully implemented, the Government believes it should be the most effective way of reducing the environmental impacts of pesticides and remains committed to this approach.

7.79 Implementation of the voluntary initiative has been generally satisfactory. Good progress has been made in assessing the current approach of farmers to the use of pesticides and in the production of good practice guidance. However, more progress is required in certain areas. In particular, targets and measures of success for the initiative have not yet been finalised between DEFRA and the industry, and incentives for encouraging farmer participation are not sufficiently advanced. The Government values the work already completed by the signatories and will continue to press for more rapid progress. However, the Government is carrying out further work and analysis on a possible tax or other economic instrument, should the voluntary initiative fail to deliver its objectives within a reasonable timescale.

Persistent pollutants

7.80 The Government has researched the use of economic instruments to tackle persistent pollutants[11]. Following discussions with the Chemicals Stakeholder Forum, it now intends to work with the industry to develop a voluntary agreement to address the impact of nonylphenols. The Government will consider the option of using economic instruments should a voluntary approach prove unsuccessful.

Water quality

7.81 While there have been significant improvements in water quality in recent years, the EU water framework directive requires more attention to be paid to the ecological quality of water. The Government is working to implement the directive and published recently for consultation details of its priorities for water policy over the longer term[12]. The Government's strategy takes into account the economic, social and environmental issues involved in water policy and seeks to ensure better integration with other policies. The European Commission is expected make legislative proposals in the near future on bathing water, groundwater, priority hazardous substances and sewage sludge.

Enhanced capital allowances **7.82** The Government has considered proposals received under the Green Technology Challenge for using tax incentives to encourage more sustainable water use and improvements in water quality. As announced in Budget 2002, subject to EU state aids approval, **the Government intends to introduce enhanced capital allowances for investment in specific technologies in 2003.** A short-list of technologies has now been established and work is continuing to determine which are most appropriate to support through tax incentives.

Supporting Britain's rural economy and rural communities

7.83 The Government is committed to improving the quality of life of people in rural areas. While many rural areas are prosperous, the economic performance of certain areas and sectors continues to lag, and some groups and communities continue to experience difficulties accessing key services. The 2002 Spending Review therefore set a new Public Service Agreement target to reduce the gap in productivity between the least well performing quartile of rural areas and the English median, and to achieve measurable improvements in the accessibility of key services to rural people.

[11] *Scope for the use of economic instruments for selected persistent pollutants*, RPA for DEFRA, 2002.

[12] *Directing the flow: priorities for future water policy*, DEFRA, November 2002.

Rural enterprise and productivity

7.84 To help achieve this target, the Spending Review allocated an additional £15 million to support work by the RDAs to encourage rural enterprise and business growth, increasing the overall size of the RDAs rural development budget to £50 million by 2005–06. This is in addition to existing support provided through the £100 million market town regeneration programme; the extension of mandatory 50 per cent business rates relief to qualifying small village shops, pubs and petrol stations; the Farm Diversification Scheme for small-scale non-agricultural enterprises on farms; and the regeneration activities of the England Rural Development Programme and European Structural Funds, which have budgets of £1.6 billion and £130 million respectively for the period 2000 to 2006.

Rural communities and services

7.85 The Government is determined to ensure that people living in the countryside have access to high quality public services. A revised Rural Service Standard, published in August 2002, sets out the Government's objectives to ensure that key public services meet the needs of rural people. The significant increases in funding for health and education announced in the 2002 Spending Review will contribute to achieving these objectives. Progress has already been made in a number of important areas:

- increased funds have been made available to help resource sharing, administrative support and the adoption of new technologies, including the £80 million a year Small Schools Fund. Only five rural schools have closed since 2000;
- by 2004, 100 new primary care mobile units and 5,000 intermediate care beds will be available in rural areas. NHS Direct is also now available throughout England offering major benefits to people living in rural areas;
- the Housing Corporation has exceeded its targets for approving affordable homes in small rural settlements in each of the last two years, and programmes such as the Rural Exception and restrictions on right to buy in rural areas are helping to ensure the availability of affordable housing in rural areas;
- £239 million has been allocated for new and improved rural transport services, while the Rural Bus Challenge has supported 1,900 new or improved bus routes in England since 1998; and
- the new rural police fund has injected an extra £30 million into rural policing in 2001–02 and 2002–03.

Second and long-term empty homes

7.86 **The Government intends to give local authorities the flexibility to reduce to a minimum of 10 per cent the current 50 per cent council tax discount on second homes. Authorities will also have the power to remove or reduce the 50 per cent discount on long-term empty homes.** Provisions putting the measures into effect are contained in the Local Government Finance Bill.

Sustainable farming and food

7.87 The forthcoming Sustainable Farming and Food Strategy sets out the Government's vision for the future of these industries alongside proposals to help realise this vision. The 2002 Spending Review allocated £500 million over three years to implement the strategy, including pilots of an entry-level agri-environment scheme, a new network of demonstration farms, and new structures to encourage cooperation in agriculture and the dissemination of research results. These measures will help to deliver productivity increases in the farming industry and improve environmental performance. The Government has recently consulted on reforms to corporation tax with the aim of reducing distortions and unnecessary complexity, and a major exercise to modernise stamp duty is also underway. In taking forward these proposals, the Government will take into account the need to minimise distortions that create barriers to innovation and diversification in the rural economy, and the recommendations of the Policy Commission on Food and Farming[13].

[13] *Farming and food: a sustainable future*, DEFRA, 2002.

Box 7.4: Forestry and sustainable development

Following a review of the administrative arrangements of the Forestry Commission post-devolution, DEFRA and the Treasury have commissioned a review into the economic rationale underpinning the Government's policy goals for forestry in England and the role of forestry in the Government's sustainable development strategy. A particular issue is whether it is appropriate for the role of provider of incentives, regulator and commercial operator to be located within a single organisation. The findings of the review will help to ensure that Government intervention in forestry is both streamlined and based on use of the most appropriate tools. The terms of reference for the review have been agreed by the Treasury, DEFRA and the Forestry Commission, and include:

- **to carry out an examination of the economic rationale which underpins the Government's forestry policy goals in England, to include a critique of the England Forestry Strategy;**
- **to consider the role of forestry in the Government's strategies for sustainable development in England and internationally; and**
- **in the light of findings which emerge from the examination, to make recommendations on the most appropriate organisational structure for delivery of this role in the context of the wider review of environmental and rural delivery arrangements across DEFRA and its agents, to establish how they can be rationalised and how the quality of delivery could be improved.**

The relevant economic analysis will be carried out shortly. DEFRA are commissioning an independent company to undertake this work and initial results are expected in February.

ENVIRONMENTAL APPRAISAL OF POLICY MEASURES

7.88 The Government is committed to appraising the environmental impact of Budget measures and will continue to make available the methodology underpinning the figures presented in the appraisal tables. Table 7.1 shows how Budget measures sit alongside other policies as part of the Government's approach to the environmental elements of sustainable development. Table 7.2 sets out the environmental impact of measures introduced in recent Budgets which have a significant effect on the environment or which serve an environmental purpose. The Government aims to ensure that policy design, appraisal and evaluation take account of costs and benefits, the precautionary principle, and the need to internalise costs by making the producer pay.

7.89 As part of its commitment to transparency and public reporting of key performance indicators, the Government will separately publish the appraisal tables on the Treasury website. The tables will be updated based on information from monitoring of indicators and evaluation of specific schemes.

Table 7.1: The Government's policy objectives and Budget measures

Policy objective	Sustainable development indicator[1]	Data indicating recent trends	Recent Government measures
Tackling climate change and improving air quality	Emissions of greenhouse gases	Between 1999 and 2000 emissions of the basket of six greenhouse gases showed no significant changes. Since 1990 they have fallen by 13 per cent[2]	*Other Government measures* • Climate Change Programme, DETR November 2000 • Emissions Trading Scheme, DEFRA August 2001 • Air Quality Strategy for England, Scotland, Wales and Northern Ireland, DETR January 2000 • Ten Year Plan for Transport, DETR July 2000 • Powering Future Vehicles, DfT et al, July 2002 *Budget measures* • Climate change levy package • Reduced rate of VAT on the installation of energy saving materials • Road fuel duty • Green Fuel Challenge • Reforms to car, lorry, van and motorcycle VED • Company car tax and fuel scale charge reform, and authorised mileage allowance payments • 100 per cent first-year allowances for cars with low carbon dioxide emissions, and hydrogen and natural gas refuelling infrastructure • Green travel plans – using tax incentives to promote their development
	Days when air pollution is moderate or higher	Number of days with moderate or high air pollution increased from 16 in urban sites and 25 in rural sites in 2000 to 21 in urban sites and 30 in rural sites in 2001[3]	
	Road traffic	Traffic levels in 2001 were 1.2 per cent higher than in 2000[4]	
Improving waste management	Waste arisings and management	Proportion of household waste being recycled was over 11 per cent in 2000–01, an increase of 1 per cent over the previous year[5]	*Other Government measures* • Waste Strategy 2000, DETR May 2000 *Budget measures* • Landfill tax and landfill tax credit scheme
Regenerating Britain's towns and cities	New homes built on previously developed land	In 2001, 61 per cent of new housing was on previously developed land, increasing from around 54 per cent in the early 1990s	*Other Government measures* • Urban White Paper, DETR November 2000 • Package of measures to tackle abandoned vehicles *Budget measures* • Capital allowances for flats over shops • Tax relief for cleaning up contaminated land • Stamp duty exemption for disadvantaged areas • Reforms to the VAT treatment of conversion and renovation activity
Protecting Britain's countryside and natural resources	Populations of wild birds	In 2000 the decline in farmland birds – halving since 1977 – continued to level off. Woodland birds increased to their highest level since 1990[1]	*Other Government measures* • Rural White Paper, DETR November 2000 *Budget measures* • Aggregates levy and Sustainability Fund
	Chemical river quality	In 2001, 95 per cent of rivers in the UK were of good or fair chemical quality, little change from 2000[5]	

[1] *Achieving a Better Quality of Life, DEFRA January 2002 – latest data from www.sustainable-development.gov.uk.*

[2] *The main six greenhouse gases are: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perflourocarbons, sulphur hexaflouride.*

[3] *2001 results were slightly poorer than for 2000 (the best year to date), mainly due to the weather.*

[4] *After adjustment for the effect of the September 2000 fuel protest and foot and mouth disease in 2001, growth is still 1.2 per cent.*

[5] *Municipal Waste Management Survey, 2000-01, DEFRA. As the headline waste sustainable development indicator has not yet been updated this currently relates to the core indicator on household waste.*

Table 7.2: The environmental impacts of Budget measures

Budget measure	Environmental impact[1]
• Climate change levy package	Savings of at least 5 MtC[2] per year by 2010[3, 4].
• Reduced rate of VAT on the installation of energy-saving materials	Reduction of 0.1 MtC per year by 2010[5].
• Reduced rate of VAT on domestic fuel and power	Estimated to increase emissions by 0.2 MtC per year by 2010[4].
• Road fuel duty differentials[6]	The shift to ULSP from ordinary unleaded is estimated to have reduced nitrogen oxide emissions by 1 per cent, carbon monoxide emissions by 4 per cent and emissions of volatile organic compounds by 1 per cent per year between 2001 and 2004. The shift to ULSD from ordinary diesel is estimated to have reduced emissions of particulates by 8 per cent and nitrogen oxides by up to 1 per cent per year between 2001 and 2004. The reduced rate for biodiesel could save up to 0.2 MtC per year by 2010[6]. The road fuel gas differential will result in a reduction in emissions of particulates and nitrogen oxides.
• Green Fuel Challenge	Identify fuels which could result in reductions in emissions of carbon dioxide and local air pollutants. Potential waste policy benefits.
• Reforms to car, lorry, van and motorcycle VED	Reductions in emissions of carbon dioxide and local air pollutants.
• Company car tax reform	Savings of 0.05 to 0.1 MtC in 2002-03. In the long run savings are estimated at between 0.5 and 1 MtC per year[8].
• Fuel scale charge reform	Programme of five-year increase in the fuel scale charge is estimated to have reduced the number of drivers in receipt of free fuel by over 150,000[8]. Expected to reduce carbon dioxide and local air pollutant emissions. Restructuring the fuel scale charge in 2003 to relate it to carbon dioxide emissions and to include the same discounts and premiums as in the company car tax system will reduce emissions of carbon dioxide and local air pollutants.
• Authorised mileage allowance payments	Reductions in emissions of carbon dioxide and local air pollutants.
• 100 per cent first-year allowances for cars with low carbon dioxide emissions, and hydrogen and natural gas refuelling infrastructure	Reductions in emissions of carbon dioxide and local air pollutants.
• Green travel plans	Reductions in emissions of carbon dioxide and local air pollutants.
• Air passenger duty (APD)	Reductions in emissions of carbon dioxide and local air pollutants.

Table 7.2: The environmental impacts of Budget measures (continued)

Budget measure	Environmental impact[1]
• Capital allowances for flats over shops	Bringing empty space over shops back into the residential markets, helping to create greater urban diversity while reducing the pressure for new greenfield development.
• Tax relief for cleaning up contaminated land	Increases in the clean up of contaminated land.
• Stamp duty exemption for disadvantaged areas	Regeneration and improved functioning of property markets in Britain's most disadvantaged areas.
• Reforms to the VAT treatment of conversion and renovation activity	Reduced pressure on greenfield site development due to the better use of existing buildings.
• Aggregates levy and Sustainability Fund	Reductions in noise and vibration, dust and other emissions to air, visual intrusion, loss of amenity and damage to wildlife habitats.
• Landfill tax and landfill tax credit scheme	Encourages waste producers and the waste management industry to switch away from landfill towards waste minimisation, re-use and recycling

[1] *These estimates are subject to a wide margin of error.*

[2] *Million tonnes of carbon.*

[3] *There are a number of difficulties involved in estimating the emissions savings from the individual components of the climate change levy, including the need to avoid double counting. Of the 5MtC per year by 2010; the levy and exemptions account for 2.0 MtC, the negotiated agreements account for 2.5 MtC and energy efficiency measures account for 0.5 MtC. A related measure, the emissions trading scheme, is forecast to save 1.1 MtC per year by 2006.*

[4] *Based on the DTI energy model.*

[5] *Using NETCEN emissions models – further detail on the methodology used is provided in NETCEN's January 2000 report UK Road Transport Emissions Projections. Between 1997 and 1999, the fuel duty escalator is forecast to have reduced emissions by 1 to 2.5 MtC per year by 2010. The reductions in fuel duty in Budget 2001 are estimated to have increased emissions by between 0.1 and 0.2 MtC per year by 2010.*

[6] *DfT modelling.*

[7] *Based on Inland Revenue modelling.*

A THE ECONOMY

While UK GDP growth has strengthened since the beginning of 2002, recovery in the world economy currently has less momentum than was expected at Budget time. Since then, sharp falls on global equity markets – with the S&P 500 and FTSE 100 indices both currently down between 20 and 25 per cent since March – and continued uncertainty about the strength of recovery, have prompted falls in confidence in nearly all G7 economies. International conditions have continued to be a major influence on UK economic developments and prospects as an uncertain outlook for global demand has deterred companies from investing and stepping up production. In the face of the present uncertainties, the Government remains vigilant to potential risks surrrounding economic prospects.

The economic stability delivered by the Government's macroeconomic reforms has nonetheless left the UK economy in a relatively strong position. The lowest rates of unemployment since the 1970s, subdued inflation and historically low interest rates have all helped cushion domestic consumer demand from external weakness, ensuring that the UK continues to experience the longest unbroken economic expansion on record. Sound fundamentals also mean the economy is well placed to respond positively when the world economic recovery gathers pace.

The Pre-Budget Report economic assessment shows slightly below trend growth until the middle of next year, in lagged response to this year's global uncertainty and equity price falls, and stronger growth thereafter as global financial conditions and demand improve:

- **UK GDP growth is expected to be 1.6 per cent this year, below the Budget 2002 forecast. From mid-2003, a strengthening in the pace of global recovery should allow the UK to achieve a temporary period of non-inflationary above trend growth, rising to between 3 and 3½ per cent in 2004;**
- **a rebalancing of growth becomes gradually more evident over the forecast horizon. In particular, household consumption growth is expected to moderate, as the delayed effects of stock market falls and weaker income growth take hold, and the appetite for further increases in debt recedes;**
- **investment growth is forecast to pick up from next year. Strengthening global demand, reduced uncertainty and improvements in corporate finances are expected to encourage firms to replace existing assets, bring deferred capital spending back on stream and begin expanding capacity again. Higher demand for investment goods and rising external demand should help the manufacturing sector to build on the stabilisation in output seen through this year; and**
- **RPIX inflation is expected to fall marginally below target next year, with downward pressure from slack in the economy, but to edge up to its 2½ per cent target during 2004 as the effects of a pick-up in import prices and the economy accelerating back to trend work through.**

INTRODUCTION[1,2,3]

A1. This annex discusses economic developments since Budget 2002 and provides updated forecasts for the UK and world economies in the period to 2005. It begins with an overview of developments and prospects in the world economy. In the light of this, it then outlines the Government's latest assessment of the UK economy followed by a more detailed discussion of sectoral issues and risks.

THE WORLD ECONOMY

Table A1: The world economy

	Percentage changes on a year earlier unless otherwise stated				
		Forecast			
	2001	2002	2003	2004	2005
Major 7 countries[1]					
Real GDP	1/2	1 1/2	2 1/4	3	2 3/4
Consumer price inflation[2]	1 1/2	1 3/4	1 1/4	1 1/2	1 1/2
World trade in goods and services	1/2	2	5 1/2	8 3/4	7 1/2
UK export markets[3]	1	1 1/2	5	8	6 1/2

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

[2] *Final quarter of each period. For UK, RPIX.*

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

Overview

A2. Last year, even before the events of 11 September, economic growth slowed significantly and simultaneously in the US, Europe and Japan, the first synchronised slowdown in three decades and the sharpest slowdown in world growth since 1974. For the US and the Euro-area, last year's slowdown brought to an end a period of continuous growth stretching back to the beginning of 1993. Twenty of the world's biggest economies have been, or still are, in recession. Only decisive action by policy-makers, particularly in the aftermath of the terrorist attacks on the US, ensured that the slowdown was relatively short-lived.

A3. During the first half of 2002, a recovery in world trade and industrial production provided clear evidence that a global economic recovery was underway. However, the immediate outlook for the world economy has weakened in more recent months as corporate accounting scandals, further declines on global equity markets, developments in the Middle East and rising oil prices have compounded existing uncertainty over the strength of the global recovery. Consequently, the global economic recovery currently appears to have less momentum than was anticipated earlier in the year.

A4. As at the time of the Budget, the US is expected to lead the global recovery, with growth in the Euro-area following. However, compared with the Budget forecast, G7 GDP growth is now expected to be weaker until the middle of 2003, before gaining strength thereafter.

[1] The UK forecast is consistent with national accounts and balance of payments statistics to the second quarter of 2002 released by the Office for National Statistics on 27 September, and output, income and expenditure data for the third quarter released on 27 November. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk), and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

[2] The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

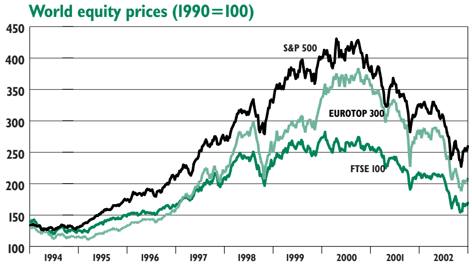
[3] The forecast does not build in any specific assumptions about the probabilities of alternative outcomes from prevailing geo-political tensions, beyond those already implicit in market expectations and other current economic indicators, and the contingency allocation set out in Chapter 6.

Box A1: Global equity market developments

2002 has been another turbulent year for equity markets. Following strong gains during the 1990s, most major stock markets peaked in 2000 and fell back during 2001. Having been relatively stable in the initial stages of this year, markets began a renewed bout of weakness in the spring. Both the S&P 500 and FTSE 100 indices fell by some 30 per cent between the middle of March and the beginning of October and the Eurotop 300 declined by 35 per cent. Post-September, equity prices have firmed around the world but are still no higher than levels seen in 1997 or 1998.

The most recent period of declining equity prices reflects a number of factors. Most obviously, a chain of high profile corporate accounting scandals and other financial malpractices in the United States sparked considerable nervousness over the financial health of US corporations. While these accounting scandals have so far remained confined to US shores, the aftershocks have stretched far beyond. Heightened concerns over the outcome of tensions with the Middle East have also compounded uncertainties surrounding the short-term outlook for the world economy, dampening profit expectations, and hence equity values, since the spring.

World equity prices (1990=100)



The experience of recent years has starkly illustrated how increased cross-border integration of financial and product markets amplifies the knock-on effects between exchanges in different parts of the world. International trading in shares has increased hugely over the past decade. In developed countries, households are increasingly investing in foreign as well as domestic equities, while many big firms are listed on more than one stock market and a growing slice of company profits come from abroad. Partly as a result, business confidence has become more globally correlated, which further increases the likelihood of share prices moving together. Global production patterns by multinational corporations may also mean a period of turbulence for one economy carries implications for overseas operations. Thus, even where economic and financial fundamentals may differ between countries, shocks originating in one financial centre now resonate to a greater extent and spread more quickly to other markets.

Nevertheless, since the spring the Eurotop 300 has seen sharper falls than Wall Street, and the positive gap between price-earnings ratios on US and European exchanges has widened. With scant evidence of corporate accounting malpractice in Europe, this may be at least partly attributable to a reassessment of fundamentals reflected in weaker European growth prospects.

G7 Activity

A5. Although G7 GDP is still expected to grow by around $1\frac{1}{2}$ per cent in 2002, in line with the Budget 2002 forecast, this masks weaker growth in the US and Europe offset by stronger than expected growth in Japan and Canada. With the global economy currently having less momentum than was anticipated at Budget time, G7 growth is now expected to be $2\frac{1}{4}$ per cent next year, compared with the Budget forecast of $2\frac{3}{4}$ per cent. Weaker growth in 2003 will, however, provide scope for stronger activity the year after, and growth in the G7 economies is now expected to reach 3 per cent in 2004.

A6. Latest GDP data now show that the US economy contracted during the first three quarters of 2001, and grew by just 0.3 per cent over the year as a whole. Last year's slowdown was therefore deeper and more protracted than previously reported. Decisive monetary policy action and strong government spending supported a return to growth in the final quarter of 2001. Continued strong household consumption and a more gradual rate of inventory liquidation accounted for stronger than expected growth in the first quarter of 2002.

A7. Over more recent months, however, a series of high-profile corporate accounting scandals and concern over political developments in the Middle East have prompted sharp falls in equity markets and rises in oil prices. Greater uncertainty has dented business confidence and led firms to defer investment decisions, with the consequence that the US recovery currently appears to have less momentum than was anticipated earlier in the year. Household consumption is nonetheless expected to continue to support growth, underpinned by low interest rates and housing market gains, and US GDP growth is expected to gather pace and to become more balanced during 2003 as a recovery in business confidence supports renewed investment growth.

A8. While GDP in the Euro-area has recovered after contracting in the final quarter of 2001, domestic demand remains weak, particularly in Germany. Household consumption has been affected by persistently high levels of unemployment and fears over job security. Business confidence has also fallen in recent months, as a result of the weaker than expected US recovery and recent equity price falls. However, a pick-up in overall Euro-area growth is expected during 2003, as stronger US growth and a more certain global outlook prompt renewed investment growth.

A9. Stronger external demand contributed to Japan's growth in the first half of 2002 but this has faded as uncertainty surrounding global prospects has increased. While the economy is expected to see a decline in GDP for 2002 as a whole, private consumption has proved surprisingly robust and has prevented a more severe contraction. A recovery in external demand is expected to support a return to modest growth in 2003. However, final domestic demand remains fragile with unemployment at historically high levels and continuing deflation.

Forecast issues and risks

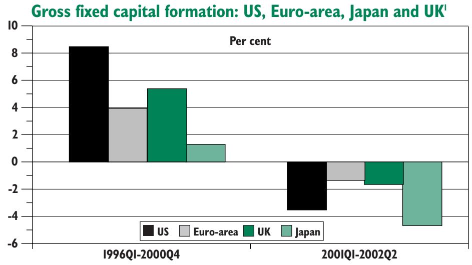
A10. Continued volatility in global equity markets and the possibility of renewed rises in oil prices pose a clear risk to the global economic outlook. Heightened investor uncertainty, as a result of any more high profile corporate failures or deterioration in the political situation in the Middle East, could delay the global investment recovery. Household consumption would be further negatively affected by the impact of any additional equity price falls on household wealth, by any continued weakening in the US or Euro-area labour markets, or by higher oil prices. A decisive resolution of the problem of non-performing loans in Japan, while positive for Japan's medium-term economic outlook, could depress activity there in the short-term. Moreover, any disorderly unwinding of the US current account deficit could lead to a sudden, sharp depreciation of the dollar, complicating macroeconomic policy around the world.

A11. Accommodating fiscal and monetary policy could yet, however, lead to a stronger than anticipated global recovery. In the US for example, low interest rates and further significant house price gains could stimulate faster than expected household consumption growth. Recent actions in the US to strengthen corporate governance, accounting and auditing have the potential to boost confidence, prompting a sharp rebound in equity markets and a more rapid pick-up in investment growth. A swift diminution of tensions in the Middle East could also bolster confidence. Over the medium-term, other major economies may emulate US

Box A2: Investment: global developments and prospects

A notable feature of last year's world slowdown was the reversal in investment across the world's major economies. G7 investment fell by 2 per cent during 2001 – the largest fall since 1982 – and the slowdown in the rate of investment growth was the sharpest since 1974. At Budget time, G7 investment was expected to recover during the first half of 2002, but the global investment outlook has been hampered by continued uncertainties. Compared with a year earlier, G7 investment was down 4½ per cent in the first quarter of this year and by 3½ per cent in the second quarter.

Gross fixed capital formation: US, Euro-area, Japan and UK[1]



[1] Average four quarter rate of change.

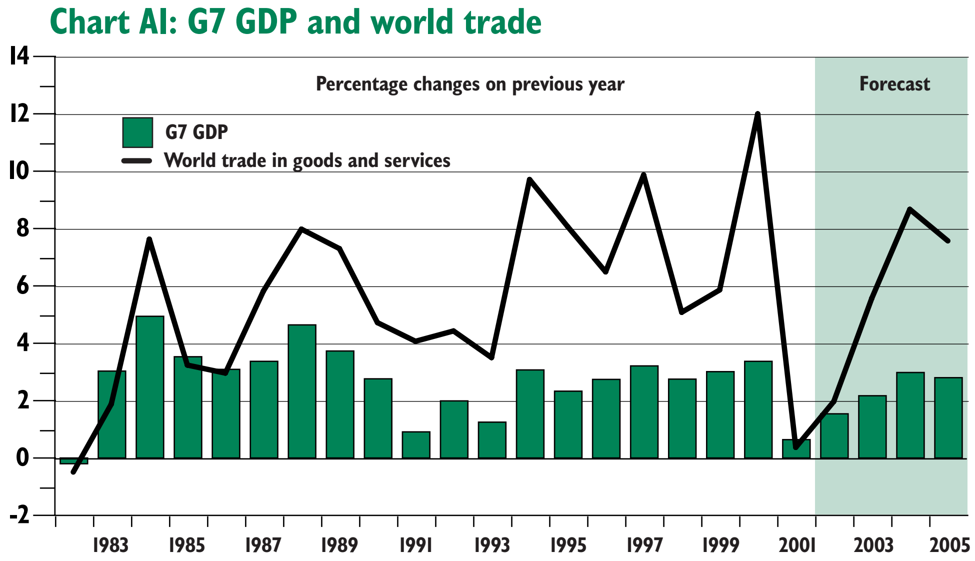
During the second half of the 1990s the US experienced particularly strong growth in investment, fuelled by a rising stock market and by expenditure on ICT and related technological advances. Over this period whole economy investment in the US grew by 8.5 per cent a year on average, while investment also accelerated in the UK and the Euro-area, growing respectively by 5.4 per cent and 3.9 per cent a year on average.

This strong growth was reversed during 2001 and 2002 in all the major economies. Unsurprisingly, this reversal was larger in the US than in the UK or Euro-area. There are a number of reasons why investment fell so sharply last year. In some cases firms simply over-stretched their ability to absorb new capital equipment. Moreover, the late 1990s investment boom saw some companies accumulating large amounts of debt to finance capital projects. Consequently, significant falls in world stock markets since the middle of 2000 and worsening corporate profitability are likely to have motivated a scaling back of plans last year. A number of factors explain Japan's weakness since 2001, including a fallback from particularly strong business investment in 2000 and significant falls in public sector investment.

Concerns over corporate accounting standards and events in the Middle East have led to further sharp falls in equity markets and rising oil prices during 2002, prompting further declines in confidence and renewed uncertainty about the strength of the global recovery. This increase in uncertainty appears to have encouraged firms across the major advanced economies to defer investment decisions. As a result, investment growth in the US and Europe is now expected to be weaker this year than was anticipated at Budget time.

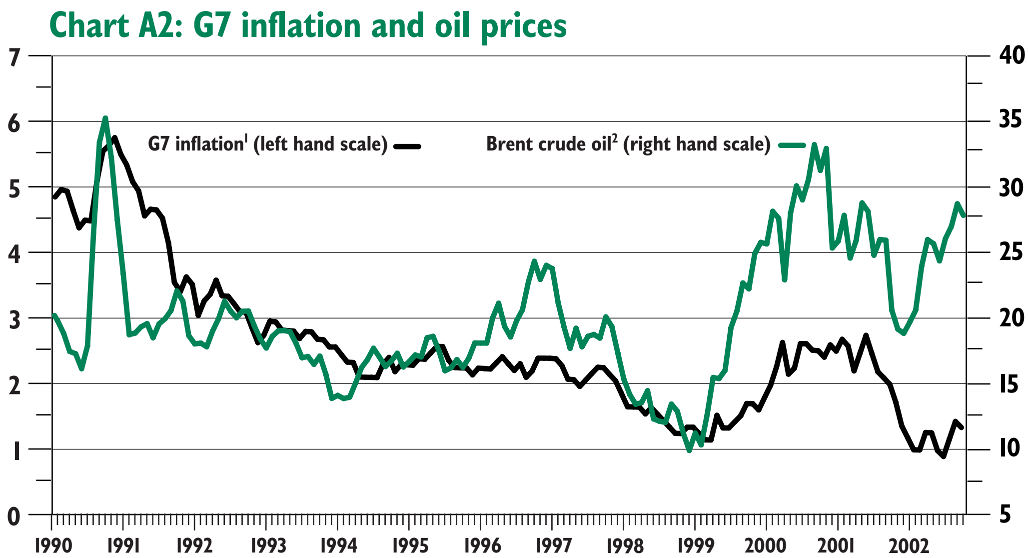
However, there have been encouraging signs from the US that suggest strong investment may yield substantial productivity gains. Looking ahead, investment should recover during 2003 as uncertainty recedes, deferred investment comes back on stream, renewal of shorter-life high-technology capital becomes more of a priority and economic slack gets taken up as the global recovery gathers pace.

productivity performance: evidence for recent quarters continues to suggest that the US may be benefiting from sustainable productivity growth improvements associated with widespread information and communications technology (ICT) investment. Further sustained progress on economic reform in the Euro-area, financial sector reform and corporate restructuring in Japan, would enhance the productive capacity of these economies and boost medium-term economic prospects.



World trade

A12. The recovery in world trade during the first half of 2002 was slightly stronger than anticipated at Budget time, underpinned by the pick-up in industrial production in a number of economies. Despite this, the weaker than expected global recovery in the second half of the year means that world trade is now expected to grow by just 2 per cent in 2002, compared to 12 per cent in 2000. As the global recovery gathers pace, world trade growth is now expected to rise to $5^1/_2$ per cent in 2003 and to $8^3/_4$ per cent in 2004. UK export market growth is expected to be a little lower than growth in world trade as a result of weaker than expected growth in the UK's major trading partners – the Euro-area and the US.



[1] Consumer price index, percentage change on a year earlier.
[2] US dollars per barrel.

Emerging markets and developing countries

A13. While favourable financing conditions during the first half of 2002 have been eroded in recent months, the limited financial contagion from events in Turkey, Argentina and Brazil suggests that investors are continuing to discriminate between emerging markets. Any increase in risk aversion among investors, and vulnerabilities surrounding the global recovery, pose the main threats to the outlook for emerging markets.

A14. Growth in the world's poorest economies has undoubtedly been affected by the recent global slowdown. However, surprisingly strong GDP growth in Africa during 2001 and the first half of 2002 suggests that debt relief provided under the Heavily Indebted Poor Countries (HIPC) initiative, and improved macroeconomic policies, are helping to sustain economic growth in those parts of the region where they have been implemented.

Oil and commodity prices

A15. Evidence that the global recovery was underway prompted a recovery in commodity prices during the first half of 2002. Oil prices also picked up sharply from the spring onwards as further OPEC production cuts began to bite, and as political uncertainty in the Middle East raised concerns about future supply. Prices have recently fallen back, largely due to ongoing developments in the Middle East. Non-oil commodity prices are expected to strengthen in line with the global recovery.

G7 inflation

A16. G7 inflation fell during the course of 2001, from around $2^1/_2$ per cent at the beginning of the year to just over 1 per cent by the start of 2002. While underlying inflationary pressures remain weak across the G7, the impact of weak oil prices in the final quarter of 2001 is expected to boost G7 inflation to around $1^3/_4$ per cent by the turn of the year. Inflation is forecast to fall back slightly during 2003, consistent with a small negative output gap, before settling at $1^1/_2$ per cent in 2004.

UK ECONOMY OVERVIEW

The economy in 2002

A17. Following the marked slowdown in the world economy during 2001, UK GDP has accelerated since the beginning of 2002. However, although world activity is judged to have troughed at the end of last year, 2002 has presented new global challenges and risks. Stock markets around the world have seen sharp falls since the spring. Corporate accounting malpractices in the United States were clearly one trigger for these developments, but equity market turbulence has rippled far beyond Wall Street and other US exchanges. Despite scant evidence of accounting irregularities in the UK or Europe, the FTSE 100 index fell by around 30 per cent between March and early October while the Eurotop 300 was down by 35 per cent over the same period. This, together with tensions in the Middle East and other ongoing risks, has compounded uncertainty over the current degree of momentum underpinning the world economic recovery and clearly hampered already fragile business confidence, including in the UK. As a result, mirroring developments in most major economies, the corporate sector has remained highly reluctant to step up investment spending, and the anticipated strengthening in UK activity has been weaker than forecast at the time of the Budget. UK GDP is estimated to have risen by 0.6 per cent in the second quarter and by 0.8 in the third quarter, to stand 1.8 per cent up on a year earlier.

Table A2: Summary of forecast[1]

		Forecast			
	2001	2002	2003	2004	2005
GDP growth (per cent)	2	$1\frac{1}{2}$	$2\frac{1}{2}$ to 3	3 to $3\frac{1}{2}$	$2\frac{3}{4}$ to $3\frac{1}{4}$
RPIX inflation (per cent, Q4)	2	$2\frac{1}{2}$	$2\frac{1}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$

[1] *See footnote 2 to Table A8 for explanation of forecast ranges.*

A18. The pattern of growth this year has also been distorted by a special public holiday in June to mark the Golden Jubilee. Output growth is widely perceived to have been depressed during the second quarter, as the additional public holiday and, in some cases, factory closures over the whole of that week, caused output to be lost. Growth, however, is judged to have received a corresponding boost in the third quarter as working patterns returned to normal. In contrast, the football World Cup, which was held over May and June, appears to have had virtually no overall impact on activity: anecdotal evidence suggests that working hours lost to allow employees to watch matches were fully made up at other times.

A19. The Government's reforms to the macroeconomic framework have created a platform of low inflation and fiscal discipline which has enabled the UK economy to face the recent challenges posed by the world environment from a position of underlying strength. As the world economy turned down in 2001, the independent Monetary Policy Committee (MPC) of the Bank of England was able to reduce interest rates on four occasions in the first eight months of the year. Further rate reductions after the terrorist atrocities of 11 September made a total of seven cuts and a cumulative reduction of 2 percentage points during 2001. This helped to restore business and consumer confidence to around the levels prevailing before the terrorist attacks, and to mitigate against any further drags on activity amidst already very difficult global conditions. With inflation remaining a little below target this year, interest rates have been kept at their lowest for almost 40 years, while fiscal policy has also been supportive of a pick-up in GDP growth.

A20. Last year the UK weathered the storm better than all other major economies, achieving the highest rate of GDP growth in the G7, at 2 per cent. This year, amid new uncertainties and risks, the UK economy has continued to grow more strongly than many other industrialised countries, despite having been equally exposed to global equity market turbulence. UK GDP growth has now been unbroken for 41 consecutive quarters, the longest sustained expansion since quarterly records began in 1955.

A21. RPIX inflation has remained below the Government's target since Budget time, although monthly movements have been unusually erratic of late: in October RPIX was back up to 2.3 per cent, as seen in March and April, following its June trough of 1.5 per cent. The divergence between goods and services price inflation has widened further this year, as services price inflation has picked up and weak and highly competitive global markets have continued to exert downward pricing pressures on more exposed tradeable sectors. Producer output prices have remained subdued in the face of ongoing global uncertainties inhibiting the degree of momentum underpinning demand: while manufacturing output has shown signs of having bottomed out following sharp falls in 2001, recovery is yet to get fully underway.

A22. The UK labour market remained resilient to the sharp slowdown in world growth in 2001. Continued global uncertainties this year have largely failed to undermine domestic employment, providing further evidence that the Government's macroeconomic and structural reforms have continued to yield substantive supply-side gains. Building on the impressive expansion of recent years, employment has continued to trend upwards during 2002, with the coming on stream of Government spending plans permitting public sector employment growth to take up the baton from preceding strong private sector employment growth. Employment has risen by 1.3 million since 1997 and has recently been at record levels. Unemployment has remained close to its lowest rate since the 1970s on both the International Labour Organisation (ILO) and claimant count measures. The resilience of the UK labour market has set the UK economy apart from most other industrialised countries, many of which have seen the rate of unemployment rise significantly over the past year or so.

A23. The strain of ongoing global uncertainty this year has continued to be felt in weak business investment (Box A2). Indeed, compared with the Budget forecast, the relative weakness of UK GDP growth in the first nine months of 2002 is entirely accounted for by lower than expected investment. Fragile confidence in the prospects for external demand, and heightened uncertainties and increases in the cost of capital following declines in global equity markets, are likely to have reduced corporate incentives to increase capital expenditure. Business investment has fallen in each of the past seven quarters.

A24. In recent years, strong labour market outcomes have continued to support growth in private consumption. As fragile confidence in global prospects has depressed private investment demand and inhibited underlying export growth, GDP growth has continued to be more than accounted for by household consumption. With close to record employment rates coinciding with buoyant gains in house prices, consumer confidence and spending have thus far held surprisingly firm against falling equity values and fragility in the world economy. While growth in consumer spending has moderated from its peaks in 2000, underlying growth has remained relatively strong. House prices have risen sharply, and may have been boosted by demand emanating from diversification out of equity markets.

A25. At the same time, government expenditure has also been helping to support growth in UK GDP. With the Government's spending plans continuing to come on stream, real government consumption in the first three quarters of 2002 is currently estimated to have been $4^{3}/_{4}$ per cent up on a year earlier.

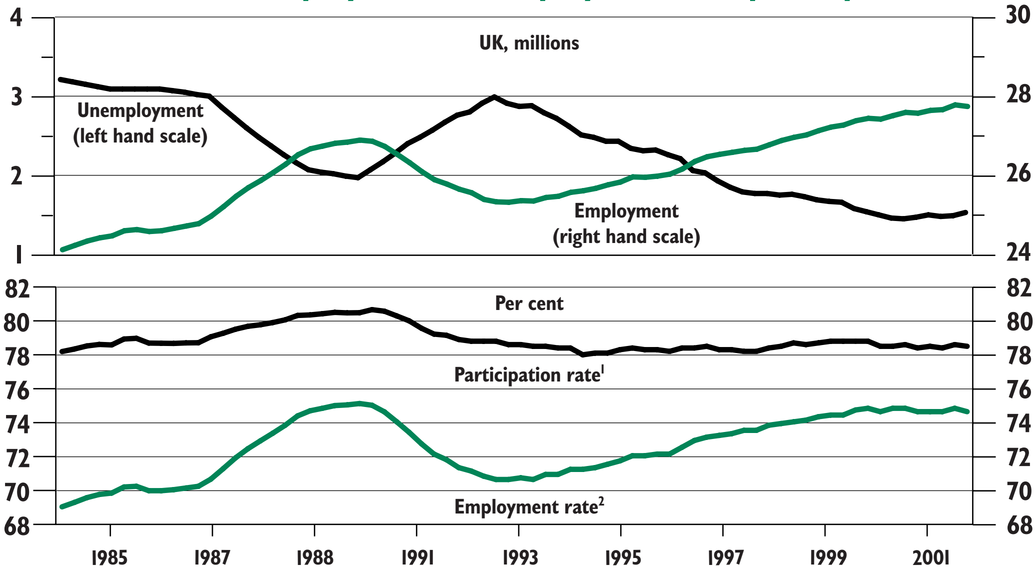
A26. The composition of aggregate demand growth, with relatively import-intensive investment and industrial activity weak, but consumer spending robust, has continued to restrain import growth. Thus, net trade made only a small negative contribution to growth in the first half of this year, as a resumption of export growth in the second quarter more than offset a modest increase in imports. However, faltering industrial production and demand in a number of the UK's key export markets appears to have been reflected in a significant contraction in exports in the third quarter, though imports fell too so net trade exerted less of a drag on GDP than exports.

The labour market

A27. The results from the 2001 Census showed the UK population of working age was about one million lower than previously estimated, mainly on account of fewer individuals in the 25 to 39 age cohort. Labour Force Survey (LFS) statistics have needed to be re-scaled to the new population estimates, but this does not change the conclusion that UK labour market performance has been robust in recent years. Employment rates are still shown to have risen close to record highs previously achieved only at the top of the cycle, while the results have hardly had any effect on estimated unemployment rates.

A28. The UK labour market has remained buoyant in 2002, outstripping most analysts' expectations by a significant margin. In the third quarter, the Labour Force Survey (LFS) measure of employment was 175,000 higher than a year earlier and, despite continued strong expansion in the population of working age, the working age employment rate has been stable over the past year or so, as has the inactivity rate. It would appear that, as Government spending plans continue to come on stream, the public sector has been contributing strongly

Chart A3: LFS employment, unemployment and participation



[1] Percentage of the working-age population who are economically active (i.e. employed or unemployed).
[2] Percentage of the working-age population in employment.

to overall employment growth. Increases in the number of workforce jobs in public administration, education and health sectors have averaged around 30,000 a quarter over the past year. This apparent expansion in public sector employment may help partly to explain the divergence between the resilience of the labour market indicated by official statistics, and the more moderate impression gained from private sector surveys.

A29. Part-time workers have more than accounted for the overall growth in employment over the past year. However, part-time working has increasingly become a matter of preference rather than inability to find a full-time position. At less than $8^1/_4$ per cent during the third quarter, the proportion of part-time workers who could not find a full-time job has recently been the lowest in the ten-year history of the series.

A30. ILO unemployment has been nudging up since spring last year, but by a lot less than the rise in the population of working age. Indeed, in the year to the third quarter of 2002, increased employment successfully absorbed over three quarters of the 185,000 increase in the population of working age. While the rate of ILO unemployment has increased a little, to 5.3 per cent in the third quarter, and is now judged to be above its sustainable rate, claimant count unemployment, at 3.1 per cent, remains at its lowest rate since August 1975. Claimant outflows have continued to increase modestly against broadly flat inflows. The Government's Welfare to Work policies have also ensured that long-term unemployment has continued to fall, with both youth and adult long-term unemployment now having fallen by more than three quarters since spring 1997[4].

[4] Claimant count. Long-term youth unemployment: aged 18-24, over 6 months duration. Long-term adult unemployment: aged 25 and over, over 18 months duration. Youth claimant unemployment over 12 months duration has been virtually eradicated; and over the past year New Deal 25+ has continued to make a substantial contribution to the fall in long-term adult unemployment.

A31. Although UK employment has held up extremely well to a challenging global environment, the slowdown in GDP growth in 2001 and early 2002 appears to have made itself felt in the labour market partly through a decline in average hours worked, which were down over $1^3/_4$ per cent in the year to the second quarter of 2002. This decline was not just the effect of rising part-time employment, as average hours worked by full-time workers also fell, consistent with companies expecting only a modest and short-lived period of below-trend growth. In the third quarter average hours worked picked up, though to some extent the second quarter figures are likely to have been depressed by the Jubilee holiday.

A32. Average earnings also appear to have responded to the cyclical path of output, giving further evidence of a flexible labour market. Whole economy average earnings growth has picked up since earlier in the year, following a period from the second half of 2001 when it fell sharply, but at about $3^3/_4$ per cent in the third quarter of 2002 it was still well down on a year earlier. This reflects a return to more normal bonus patterns after falling bonuses in late 2001 and early 2002 restrained earnings growth as the economy slowed. Excluding bonus effects, average earnings growth has fallen steadily since summer 2001. And whether bonuses are included or excluded, average earnings growth remains well within the range deemed by the MPC to be consistent with the Government's inflation target of $2^1/_2$ per cent in the medium-term. As growth in whole economy earnings excluding bonuses has moderated, growth in unit wage costs has declined, to its slowest rate for almost two years in the year to the second quarter of 2002.

A33. Despite strong growth in public sector employment, public sector average earnings growth has fallen back markedly since summer 2001, when growth reflected the exceptional pay rises linked to reforms in education and health. It was less than 4 per cent in the year to September 2002, not much above the rate of private sector earnings growth. Nevertheless, recently public sector earnings growth has been depressed by delayed settlement for 1.3 million local authority workers, which will feed through into earnings data from October. It is essential that public sector pay awards are designed, in conjunction with reforms, to be consistent with delivering the Government's plans for improved public services, and are affordable within the 2002 Spending Review expenditure limits. Excessive pay, not linked to improvements in productivity, puts upward pressure on inflation and threatens hard-won macroeconomic stability.

A34. The corollary of Census 2001 related downward revisions to employment and hours in recent years has been somewhat stronger productivity growth than previous estimates suggested. However, the broad pattern of productivity growth has remained largely unaffected. Whole economy productivity growth (output per worker) slowed in 2001 as employment growth proved resilient to the slowdown in global demand. Manufacturing productivity slowed particularly sharply last year, as the worldwide slump in ICT output took a heavy toll on production in the UK's high-technology industries. Despite also slowing last year, productivity growth measured on the basis of output per hour is estimated to have remained firmer than on a per worker basis as the number of hours worked eased back.

A35. Although productivity growth has remained below trend in the first half of this year, it does now appear to have strengthened following the cyclical easing seen in 2001. Manufacturing productivity growth has improved in line with the stabilisation in output and, partly as a result, in the second quarter of this year whole economy productivity on an output per job basis saw its fastest quarter-on-quarter rise since the end of 1999. Output per hour worked is also estimated to have risen significantly. In the longer term, Government policies designed to strengthen the drivers of productivity growth offer the potential to increase the economy's underlying productivity growth rate.

Trend output growth

A36. At the time of Budget 2002 the Treasury published a paper[5] setting out its latest assessment of the trend rate of output growth over the recent past and the neutral rate around which to anchor economic forecasts. Despite new and revised data released since the Budget, there are no reasons to change this assessment, although estimates of the *composition* of trend growth for both the recent past and going forward have been affected.

A37. There have been revisions since the Budget to GDP data for recent years, though these have had only a marginal effect on the average rate of growth between the first half of 1997 and the third quarter of 2001. Nothing has changed since Budget time to affect the judgement that the economy was on trend at these dates, and that mid-1999 was also an on-trend point. However, as explained in the Budget paper, the longer period since the first half of 1997 is preferred to the shorter period from mid-1999 as the basis for estimating the recent trend rate of growth. There is still some doubt about whether the economy was on trend in mid-1999 or just close to trend, so the judgement that the present cycle started in mid-1999 remains provisional. The data and methodology for estimating on-trend points and dating cycles are kept under review. But whether the current cycle started in 1997 or 1999 does not affect the judgement that the Government remains firmly on track to meet the fiscal rules over the cycle: the average current surplus since both 1997-98 and 1999-2000 is positive in every year of the projection period.

A38. The main data changes bearing on the assessment of trend growth derive from the 2001 Census of Population results, to which the Office for National Statistics and the Government Actuary's Department (GAD) have responded by revising related statistics on a timely interim basis. The Census results indicated that the population of working age in 2001 was one million lower than had previously been estimated, attributed mainly to under-recording of emigration in annual data. This prompted interim downward revisions to past estimates of population levels and growth, and subsequent downward revisions to the main LFS statistics for employment, hours worked, unemployment and inactivity. LFS data needed to be revised because the LFS is a household sample survey which is grossed to population. Employment, unemployment and inactivity rates by gender and age cohort were assumed to be unaffected, though this implied some revisions to aggregate rate series owing to compositional effects. Moreover, downward revisions to estimates of the levels and growth of employment and hours worked implied upward revision to the productivity growth component of trend output growth, more or less exactly offsetting the downward revision to the population growth component.

[5] *Trend growth: recent developments and prospects*, HM Treasury, April 2002.

A39. In view of the Census results, and taking into account latest data on net migration, GAD has released new population projections. These reduce the assumption for growth in the population of working age going forward, but by less than the downward revision to its growth in recent years implied by the Census. The offset derives mainly from taking account of recent information from the International Passenger Survey, which shows a larger increase in net inward migration than was previously assumed.

A40. In addition to the limited compositional effect of Census related revisions on the employment rate over the recent past, the estimated trend in the employment rate has also been affected by LFS data to the second quarter of 2002 that were not available at Budget time. The methodology set out in the Budget 2002 paper on trend growth assumes that employment lags output by three quarters. This meant that at Budget time estimation of the employment rate component of trend output growth for the period to the third quarter of 2001 had to be based on a projection of the employment rate to the second quarter of 2002 instead of actual data.

Table A3: Contributions to trend output growth[1]

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[2, 3]					
	Underlying (1)	Actual (2)	+ Trend average hours worked[3] (3)	+ Trends employment rate[3] (4)	+ Population of working age[4] (5)	= **Trend output** (6)
1986Q2 to 1997H1	*2.21*	2.01	–0.14	0.41	0.22	**2.51**
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	*2.14*	1.96	–0.37	0.36	0.66	**2.63**
PBR 2002	*2.35*	2.14	–0.47	0.43	0.50	**2.61**
Projection[5]						
2001Q4 to 2006Q4						
Budget 2002	*2.1*	2.0	–0.1	0.2	0.6	**2¾**
PBR 2002	*2.35*	2.25	–0.1	0.2	0.5	**2¾**

[1] *Treasury analysis based on the judgement that 1986Q2, 1997H1, and 2001Q3 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components going forward. Hours, employment and population data are consistent with Census related revisions to LFS data released on 30 October and 8 November 2002. Columns (2)+(3)+(4)+(5)=(6). Full data definitions and sources are set out in Annex A of 'Trend Growth: Recent Developments and Prospects', HM Treasury, April 2002.*

[2] *The underlying productivity rate is the actual productivity 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 rate and average hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that hours lag output by just one quarter, though this lag is hard to support by econometric evidence, not least because quarterly LFS data only extend as far back as 1992Q2. Hours worked and the employment rate are measured on a working age basis.*

[4] *UK household basis.*

[5] *Neutral case assumptions for trend from 2001Q3 and underlying the mid-points of the GDP forecast growth ranges from 2002Q4.*

A41. Table A3 summarises the overall effect of these changes on the decomposition of trend growth over the recent past and the projection going forward. The key points compared with the estimates reported at Budget time are that:

- over both the recent past and the projection period, trend output growth is now estimated to be more productivity rich, with a smaller contribution from population growth;

- over the recent past, the estimate of trend output growth is virtually unchanged. An upward revision to trend growth in output per hour of 0.2 percentage points nearly exactly offsets the downward revision to growth in the population of working age, and revisions to trend growth in average hours worked and trend employment rate growth also offset; and

- going forward, the upward revision to output per hour growth knocks through directly, but the downward revision to the population growth component (based on GAD projections) is less than over the past, reflecting the offsetting influence of latest migration data. So the net effect on projected trend output growth components tends if anything to be marginally upward.

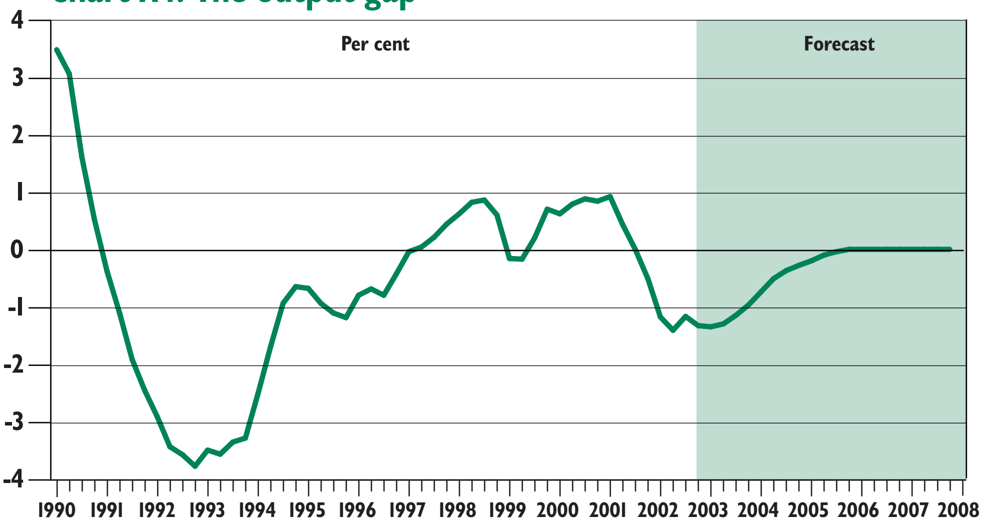
A42. Overall, the latest evidence implies that the $2^3/_4$ per cent forward-looking projection of trend output growth set out in the Budget 2002 paper remains a sound estimate.

Output and demand

A43. As a result of a modest downgrade to growth in late 2001 and weaker than projected growth so far this year, the latest national accounts data suggest the economy has built up a larger negative output gap than expected at Budget time, although its precise magnitude remains sensitive to potential data revisions in future.

A44. On the basis that the economy was last on-trend in the third quarter of 2001, as judged at Budget time, and with trend growth since then of $2^3/_4$ per cent, the implied size of the negative output gap in the third quarter of 2002 is just under $1^1/_4$ per cent. Measured output gaps of a similar magnitude also occurred at the end of 1995 and in mid-1991. However, the labour market appears tighter than on these previous occasions, probably reflecting confidence that the cyclical slowdown will not persist. The behaviour of average hours worked, which have fallen while employment has held up, tends to support this. The estimated output gap in the third quarter would diminish if recent GDP data were revised up, or if the fourth rather than third quarter of 2001 were judged to be the last on-trend point. But although some indicators do not clearly distinguish between these two quarters as on-trend points, there seems no convincing direct evidence to change the overall assessment that the economy was on trend in the third quarter of last year.

Chart A4: The output gap[1]



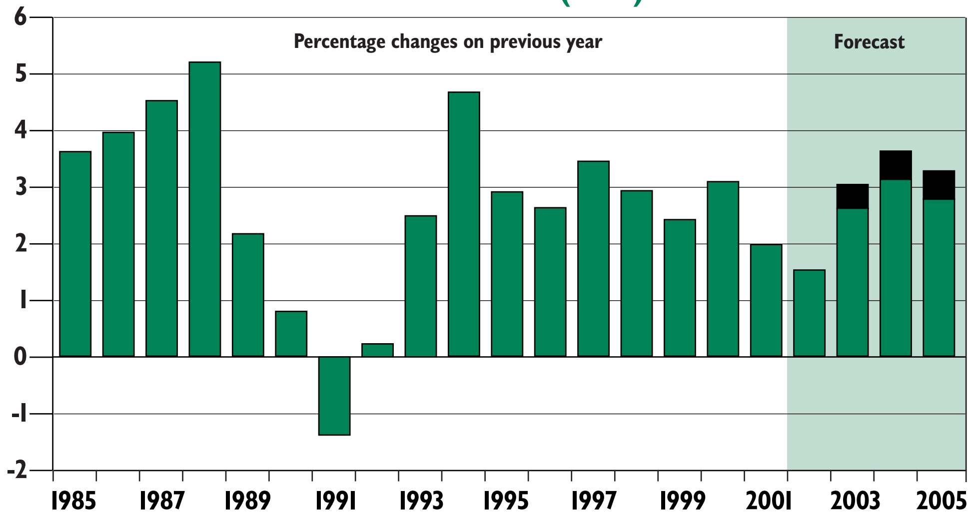
[1] *Actual output less trend output as a percentage of trend output (non-oil basis).*

A45. GDP is now expected to grow by 1.6 per cent in 2002, 0.4 percentage points below the lower end of the Budget forecast range. This shortfall is more than accounted for by much weaker than expected business investment, reflecting the set back to prospects for recovery in the world economy. The effects of global uncertainty and equity price falls this year are expected to restrain UK GDP growth at slightly below trend rates through to the middle of next year.

A46. Thereafter GDP is forecast to see a period of above trend growth, as recovery in the world economy becomes more firmly established and gathers pace, allowing slack in the UK economy to be taken up. The swift and decisive policy action taken by the MPC in 2001 is also likely to offer further impetus to activity, given the widely recognised lags between monetary policy and demand, although both monetary and fiscal policies must remain vigilant to respond to global risks. GDP is now forecast to grow by $2^1/_2$ to 3 per cent next year, around its estimated trend rate, accelerating from the second half of 2003 to reach 3 to $3^1/_2$ per cent in 2004. As the output gap closes, growth is expected to return to trend rates by the end of the forecast horizon.

A47. While growth has remained unbalanced this year, to some extent reflecting global developments, there have been preliminary signs that divergences may gradually be starting to unwind. In particular, growth in consumer spending has shown some signs of easing and manufacturing output has broadly stabilised. This pattern is expected to evolve further over the forecast horizon.

Chart A5: Gross Domestic Product (GDP)[1]



[1] *Shaded areas on bars represent forecast ranges.*

A48. Private consumption growth has averaged 0.9 per cent a quarter this year, with particularly strong growth in the second quarter falling back to 0.8 per cent in the third quarter. The declines in income growth and net financial wealth seen in 2002, together with the need to service higher levels of debt, are expected further to slow consumer spending through to next summer. Nonetheless, for 2002 as a whole, growth in private consumption is likely to be around the upper end of the Budget 2002 forecast range. In 2003, consumption growth is expected temporarily to slip slightly below its long-run average, though there is a risk that strong house price gains will discourage saving and further sustain momentum in consumer spending. Further ahead, household consumption is forecast to stabilise at around sustainable rates, as income growth settles around a more moderate pace than over recent years and the saving ratio tends to stabilise too.

A49. As evidence of improved world economic conditions mounts, so businesses should feel more confident about replacing existing assets, reviving postponed investment plans and expanding capacity. There are already some signs that corporate profitability may be turning the corner following a global profit squeeze in 2001, while marked improvements in company balance sheets and the relatively swift closure of the output gap over the forecast horizon should also support a climate for renewed private investment growth. Further increases in government investment are expected to work in tandem with private sector capital expenditure in contributing to a rebalancing of growth and activity in coming years.

A50. Flagging momentum in UK export markets appears to have undermined export growth in the third quarter of 2002, following a relatively strong first half of the year. Although the Jubilee holidays have complicated monthly patterns, goods export volumes have fallen back sharply in more recent months, with declines across nearly all product categories and to most key overseas markets. Faster external demand growth from the middle of next year should provide exports with renewed impetus, with export growth expected to be above its long-run average in both 2004 and 2005. At the same time stronger domestic demand is expected to spur renewed growth in import volumes, although additional government spending, which typically has a lower import intensity than private investment or consumption, is likely to keep import growth below rates seen in the late 1990s. Net trade is forecast to make a relatively modest negative contribution to GDP compared with the drag exerted over recent years.

A51. There is some evidence that UK manufacturing output has now bottomed out following the worldwide slump in industrial production last year. Although output fell sharply in the second quarter of 2002, this largely reflected the effect of Jubilee celebrations, during which a number of week-long factory closures compounded the impact of two June public holidays. The bulk of this output was made up in July and, although a sharp increase in car production has partially flattered outturns, the recent pattern of manufacturing output now appears close to flat.

A52. ICT output has been volatile this year, following sharp worldwide falls last year. In September, output was almost exactly at levels last seen at the turn of the year, suggesting that the pronounced downturn experienced in 2001 may have drawn to a close while, in the US, ICT industries saw a relatively strong bounce back in the first half of the year. However, around two thirds of UK ICT trade is with the EU, where the recovery in high-technology output has been much less convincing, and concerns over the degree of recovery in investment demand and continued over-supply in certain high-technology markets have also prevented UK ICT industries from making up lost ground. More generally, the continued weakness of investment spending worldwide is likely to have dampened the rate of recovery in manufacturing. With fragile global conditions generating continued uncertainty over the prospects for demand, manufacturers' sales have partly been serviced from further run-downs in inventories, following already significant de-stocking last year. Relatively high oil prices this year may also have hampered recovery in the manufacturing sector.

A53. Business survey indicators of manufacturing prospects have been mixed in recent months. The Chartered Institute of Purchasing and Supply Managers (CIPS) Report has generally pointed to an expansion in manufacturing activity since early this year, although the survey was temporarily affected by the Jubilee, and weak global sentiment has also coloured the results. The British Chambers of Commerce (BCC) Survey for the third quarter suggested that while domestic demand for manufactures was increasing, growth in external demand remained muted, with export balances below their long-run averages. The Confederation of British Industry (CBI) quarterly survey has been more downbeat, indicating continuing declines in manufacturing demand, albeit more modest than reported in 2001. While firms responding to both the BCC and CBI surveys expect to see an increase in demand in the coming months, survey expectations have not proved a reliable indicator to subsequent activity so far this year.

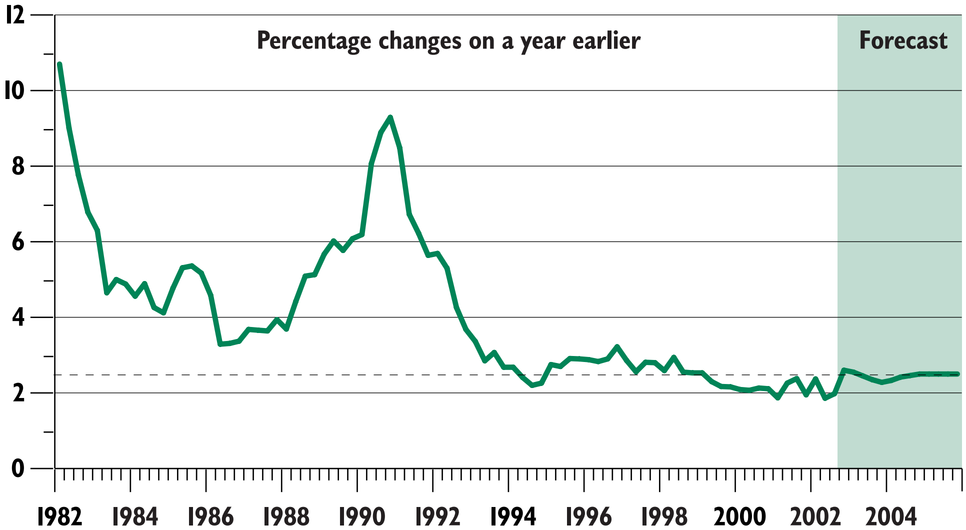
A54. Manufacturing output in 2002 is now expected to be down 4 per cent on 2001, although this at least partly reflects base effects as a result of the sharp declines in output during the course of 2001. Once adjustment is made for Jubilee distortions between the second and third quarters, manufacturing output appears to have been broadly flat since the beginning of this year. However, some parts of manufacturing have continued to expand with, for example, output in chemicals and related industries trending upwards this year, rising by almost 2 per cent between the first and third quarters. While a recovery in manufacturing output has been held back by weaker than expected global prospects, strengthening world conditions are expected to underpin an acceleration in output in 2003 and 2004 and to prompt a partial reversal in manufacturers' run-down of inventories. A resumption of business investment growth on the back of a stronger global outlook should also feed through to manufacturing activity. Manufacturing output is expected to increase by $1^3/_4$ to $2^1/_4$ per cent next year, accelerating further in 2004 to significantly above its long-run trend. Thereafter, output growth is forecast to slow slightly, although further increases in investment expenditure and export demand should help support underlying growth at around trend rates.

Inflation

A55. The UK economy continues to enjoy the longest period of sustained low inflation for four decades, with the targeted RPIX measure averaging 2.3 per since the inception of the MPC in May 1997. On the Harmonised Index of Consumer Prices (HICP) measure, targeted by the European Central Bank and designed to make cross-country comparisons, UK inflation is currently one of the lowest in the EU, having been the lowest for most of the past two and a half years.

A56. While monthly movements have been unusually volatile since Budget time, RPIX inflation has remained below the Government's $2^1/_2$ per cent target throughout. Falls in the

Chart A6: RPIX[1]



[1] *Outturns until 2002Q3; forecasts for every second quarter from 2002Q4 to 2005Q4.*

prices of seasonal food, petrol and a variety of other retail goods pushed RPIX inflation down to 1.5 per cent in June, its lowest rate since August 1967. It has since edged up, reaching 2.3 per cent in October, largely reflecting marked increases in housing costs. Higher contributions from erratic food and petrol prices compared with the same period in 2001 have also contributed to the pick-up in inflation.

A57. Aggregate inflation measures have continued to mask an increasing divergence between goods and services price inflation. In the year to October 2002, goods prices fell by 0.7 per cent – the sixth consecutive month of negative goods inflation, which is unprecedented since records began in 1988. Producer price pressures also remain highly subdued, with domestic manufactured output prices, excluding duties, rising by just 0.6 per cent in the year to October. Despite some pick-up in export and import prices since the end of 2001, and a fall back in sterling against the euro, competitive pressures from global markets have remained fierce with an uncertain outlook posing little risk of any supply shortages in the near term.

A58. In contrast, services price inflation was 4.8 per cent in September and October, the highest rate since May 1993. The continued strength of service sector inflation may appear at odds with a backdrop of moderate growth in unit wage costs, global uncertainty and subdued profitability. However, pricing behaviour within the service sector has diverged broadly in line with the contrasting patterns of household spending and corporate sector activity. Housing costs have increased firmly on the back of the strength in the housing market, while household services and foreign holidays have also made positive contributions to inflation in recent months. In contrast, utility and catering inflation has moderated. At the same time, the relative weakness of the corporate sector has been reflected in prices of business-to-business services, which have recently been rising at their lowest rate for six years according to the ONS's experimental index.

A59. Having remained somewhat below target for most of 2002, RPIX inflation is forecast to rise back to target in the final quarter as last autumn's falls in oil and housing costs drop out of the annual comparison. Inflation is expected to dip slightly below target again in 2003, as a negative output gap exerts modest downward pressure, but is projected to return to $2^1/_2$ per cent by the end of 2004. A pick-up in import price growth, arising from a gathering in the pace of the world economic recovery, is expected to feed through to higher UK inflation from around the second half of 2003. Moreover, although the currently estimated degree of slack in the economy offers ample scope to accommodate a period of above trend growth without jeopardising the inflation target, some modest upward inflationary pressure may emerge in 2004 as the economy accelerates back towards trend.

Independent forecasts

A60. Independent forecasts for UK GDP growth this year and next have come down since the time of the Budget. The latest independent average forecast for growth in 2002 is in line with the Pre-Budget Report projection. While the independent average for GDP growth next year is slightly below the Pre-Budget Report forecast range, this largely reflects the inclusion of one particularly marked outlier. Indeed, three quarters of the forecasters that comprise the independent average expect GDP growth next year to be either within or above the Pre-Budget Report forecast range.

A61. Consistent with the Pre-Budget Report forecast, independent forecasters on average expect RPIX inflation to be below target in 2003. The independent average forecast for the current account deficit next year is slightly smaller than projected in the Pre-Budget Report.

Table A4: Pre-Budget Report and independent forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2002			2003		
	Pre-Budget Report	Independent Average	Independent Range	Pre-Budget Report	Independent Average	Independent Range
Gross domestic product	$1\frac{1}{2}$	1.6	0.6 to 2.0	$2\frac{1}{2}$ to 3	2.4	–0.3 to 3.1
RPIX (Q4)	$2\frac{1}{2}$	2.2	1.5 to 2.6	$2\frac{1}{4}$	2.3	1.7 to 3.3
Current account (£ billion)	$-18\frac{3}{4}$	–18.7	–24.6 to –13.3	–24	–21.5	–36.4 to –13.8

Source: *Forecasts for the UK Economy: A Comparison of Independent Forecasts*, HM Treasury, November 2002.

UK FORECAST IN DETAIL

The household sector

A62. Against the background of underlying global weakness, robust growth in consumer spending in the UK has continued to provide substantial support to GDP growth, more than accounting for the increase in GDP in the first three quarters of 2002. Private consumption rose by 1.3 per cent in the second quarter and by 0.8 per cent in the third quarter. Over the six years to 2001 private consumption growth averaged more than 4 per cent a year, and reached a peak of $5\frac{1}{4}$ per cent in 2000.

A63. National accounts revisions now show that income growth in recent years has been somewhat stronger than previously estimated. As a result, movements in income now explain more of the strength in consumption over recent years. Between 1996 and 2001 real household disposable income grew on average by $3\frac{3}{4}$ per cent a year, but growth has moderated this year on the back of weaker earnings growth and falling dividend payments.

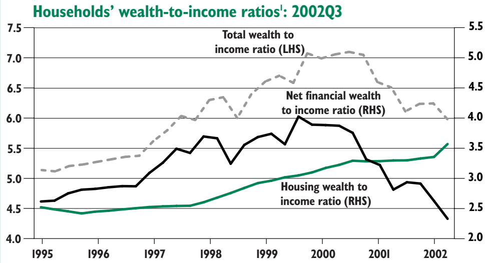
A64. Changes in household wealth are also likely to have had an important influence on consumer spending (Box A3). Sharp falls on global stock markets since 2000 and rising debt have dented households' net financial wealth. However, buoyant gains in house prices have partially cushioned households' wealth against falls in equity prices, though the ratio of total net wealth to income has recently returned to around its 1997 levels and growth in private consumption slowed from $5\frac{1}{4}$ per cent in 2000 to 4 per cent last year. Sharp house price rises may to some extent be a consequence of investors switching from equities into housing assets, a development perhaps most evident in the buy-to-let market. But house prices have also been supported by strong fundamentals, including a marked rise in the sustainable employment rate and low interest rates, which have underpinned high levels of consumer confidence. Consumer confidence in the general economic situation has remained well above its long-run average, while households' confidence in their own finances appears particularly robust, at around record highs. Households have become safer in the belief that the Government's monetary policy framework will continue to ensure low inflation and interest rates, so that debt servicing costs relative to income will not rise sharply. Structural housing supply constraints also support house prices, especially in the South East (Box A4).

A65. On the back of strong house price gains, the stock of personal borrowing rose by over 13 per cent in the year to September, and a steep rise in housing equity withdrawal is likely to have contributed to financing consumption. As a consequence, the saving ratio is expected to fall back in 2002 as a whole following a pick-up last year.

Box A3: Household wealth and consumption

Since the end of 1999 the FTSE all share index has lost around 40 per cent of its value. Households tend to offset falls in the value of their equity holdings by gradually saving more, implying a lagged negative effect on consumer spending. It has often been supposed that this link is weaker in the UK than in the US, because UK households hold a higher share of their equity wealth indirectly in life assurance and pension funds rather than through direct ownership. However, improved regulations on disclosure, for example through pension and endowment projections, and gravitation from defined benefit to defined contribution occupational pension schemes, will recently have made individuals more aware of the value of their indirect institutional asset holdings. These developments, and associated publicity, can therefore be expected to have strengthened the link between changes in indirect wealth holdings and consumer spending.

Households' wealth-to-income ratios[1]: 2002Q3



[1] HM Treasury estimates for 2002Q3.

In contrast to equities, house prices have continued to rise strongly, and are currently well above their long-run average relative to earnings. House price appreciation has given a significant lift to the ratio of housing equity to market valuation, which rose from around 68 per cent at the end of 1995 to almost 75 per cent in the fourth quarter of 2000. Although house prices have since risen sharply, households have chosen to withdraw these additional gains rather than let equity accrue further, supporting robust consumption growth. In the second quarter of 2002, the ratio of mortgage equity withdrawal to post-tax income was almost 6 per cent – the highest since its peak of just over 8 per cent in autumn 1988. But despite this, the housing equity ratio remains only just below its long-run average.

House price rises have been supported by strong fundamentals, but may also to some extent reflect falling equity prices, with funds flowing out of equities and into property in search of higher returns. Divergences between equity and property prices have been apparent in various other countries too. This *substitution* effect, at least to date, looks to have outweighed the *income* effect whereby falling equity prices reduce household wealth and curtail demand for housing as well as for all other goods and services. In any case, continued strong growth in consumption and high consumer confidence suggest that high capital gains on housing have dominated sharp falls in equity prices in terms of their impact on consumer spending.

The clearest evidence of diversification out of equities into property comes from the buy-to-let market, where the value of mortgages on buy-to-let purchases has increased over two and a half fold since end-1999. This is likely to have been further encouraged by structural easing of credit constraints, with landlords now able to use rents against mortgage applications. Rising investment demand for such properties led to very sharp capital gains, and although rental returns have fallen as the supply of rental properties has increased, total returns have remained much better than on equities.

Rising house prices have also encouraged households to borrow more generally in recent years, with their debt-to-income ratio reaching a record level in mid-2002. Thus, although house price gains have directly tended to shield households' total net wealth from falling equity prices, net wealth has nevertheless fallen since its peak in 2000. At the same time consumption growth has eased back, but remained strong.

A66. Nevertheless, there have been some signs that private consumption growth has gradually been losing a little of its momentum. In the third quarter of 2002, private consumption was up 0.8 per cent on the previous quarter and 3.8 per cent on a year earlier. While still robust, average quarterly growth appears to have eased back, falling from 1.2 per cent in 2000 to 1 per cent in 2001 and 0.9 per cent in the year to date. Retail sales growth up to September had also shown traces of slowing, after exceptionally strong growth in 2001, and consumer confidence has recently lost a little of its buoyancy. However, growth in retail sales in October was stronger than in preceding months and broadly based; and surveys by the British Retail Consortium and the CBI have also indicated a recent pick up in retail spending growth. So latest monthly indicators cast an element of doubt over the extent to which consumer spending may currently be slowing.

A67. For 2002 as a whole, private consumption is expected to grow by 3½ per cent. This would be a more moderate rate than in 2001, and indeed the slowest rate since 1995, although still unsustainably strong and at the upper end of the Budget 2002 forecast range.

Table A5: Household sector[1] expenditure and income

	Percentage changes on previous year unless otherwise stated				
		Forecast			
	2001	2002	2003	2004	2005
Household consumption[2]	4	3½	2¼ to 2½	2¾ to 3¼	2¼ to 2¾
Real household disposable income	6½	2	3 to 3½	2½ to 3	2 to 2½
Saving ratio (level, per cent)	6¼	4½	5¼	5	4¾

[1] *Including non-profit institutions serving households.*

[2] *At constant prices.*

A68. Growth in private consumption is expected to slow further in the early part of next year, as lagged effects from lower income growth and falls in equity prices feed through to spending patterns, and households' willingness to take on further debt recedes. Thereafter, consumption growth is expected to pick up temporarily, reaching 2¾ to 3¼ per cent in 2004, as GDP accelerates and income growth recovers from this year's lows. However, with income growth likely to remain subdued relative to rates seen between 1999 and 2001, and with historically high debt-to-income ratios continuing to limit households' appetite for further increases in borrowing, private consumption growth is expected to ease back over the remainder of the forecast horizon while the saving ratio tends to stabilise. With inflation and borrowing costs remaining low and employment around record highs, a gradual slackening in consumer spending growth is in prospect rather than an abrupt turnaround.

A69. Clear risks surround this outlook, but the Government's monetary policy framework, which has delivered inflation close to its symmetric target, means that the MPC can respond equally effectively to either negative or positive demand shocks. Any further falls in equity prices would pose a downside risk to this outlook, and the seemingly enhanced reliance of consumption on housing wealth raises a number of risks, leaving consumer spending exposed to any future adverse shift in valuations. While the Government's framework for macroeconomic stability and robust fundamentals mean debt servicing costs can be expected to remain low in relation to income, subdued inflation also means that the real value of debt is not eroded as quickly as in the past. Moreover, some regional and local markets may be more exposed than others. Parts of London and the South East have seen house price increases well in excess of the country as a whole (Box A4), and sustainability will depend on the extent to which this reflects fundamental demand and supply factors or inflated expectations.

A70. Nonetheless, recent developments do not foreshadow a repeat of the late 1980s and early 1990s and there may well be structural reasons why house prices have increased permanently. Economic fundamentals are far stronger today than they were in the late 1980s, when RPIX inflation reached $9^{1}/_{2}$ per cent and interest rates peaked at 15 per cent. Moreover, with financial markets expecting low inflation and only a modest rise in interest rates in the future, the risk of indebtedness leading to financial distress is much lower than in the late 1980s and early 1990s.

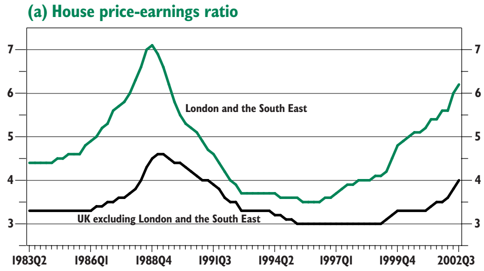
A71. However, there is as yet not much conclusive evidence of house price inflation and growth in consumer spending slowing to sustainable rates in the near term, and the momentum could prove stronger than forecast, especially if supported by global recovery coming through sooner than expected. Although a slowing must come at some point, the longer it is delayed the greater the risk of a sharp correction.

Box A4: Regional house price differentials

It is important to consider regional differences in house prices. Chart (a) shows movements in the house price-earnings ratio – a measure of housing affordability – over time for the South East (SE), including London (L), and the Rest of the UK. It illustrates that over time the house price-earnings ratio in the South East tends consistently to be higher, to lead the rest of the country and have a greater amplitude across its cycle. The relative levels and cyclical sensitivity of house prices in the South East to changes in demand appear to be consistent with relatively more binding constraints on housing supply.

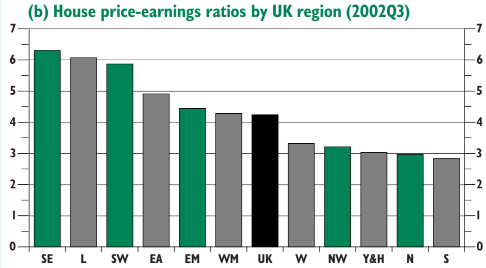
However, once South East prices have been bid up, households have greater incentives to demand housing in adjoining areas. These pressures tend to lead in due course to a partial equalisation of house price differentials. Nevertheless the ratio in the South East has always tended to be higher than elsewhere. Currently both the ratio and its gap with the rest of the country remain below their late 1980s peaks.

(a) House price-earnings ratio



Source: HBOS plc

(b) House price-earnings ratios by UK region (2002Q3)



Source: HBOS plc

Chart (b) shows in more detail the recent distribution of house prices in relation to income across the regions of Britain. This clearly illustrates that house prices are higher relative to earnings the nearer the region to the South East. However, the relatively high price of housing in the south is likely to moderate southern house price inflation and boost demand elsewhere. Furthermore, this also appears to be the case sub-regionally. Halifax report that recent house price gains in London have been focused on relatively inexpensive London boroughs. House prices are likely to stabilise in relatively high priced regions and areas, but the spill over of demand into less expensive areas could maintain strong national house price inflation in the near term.

Companies and investment

A72. At the time of the Budget, a global economic recovery had been expected to encourage firms to bring delayed investment projects back on stream from thereon. In the event, this outcome was undermined by heightened perceptions of downside risks to global prospects and a softening of profit expectations, reflected in lower equity prices and increases in the cost of capital. These factors have continued to deter investment through 2002. Mergers and acquisitions activity has also fallen casualty to lower equity prices.

A73. Indeed, as discussed in Box A2, weak private investment has been the main factor holding back growth worldwide this year. Historically, investment and global prospects have been closely intertwined and business investment has tended to amplify the global economic cycle, rising faster than GDP in upswings but slowing more markedly during downturns. The slowdown in the global economy during 2001 was no exception to this pattern, being characterised by sharp falls in investment in nearly all major industrialised economies, and ongoing uncertainties this year have continued to keep capital spending subdued. Thus, while G7 GDP grew by 1.2 per cent in the year to the second quarter of 2002, whole economy gross fixed capital formation fell by $3^1/_2$ per cent: it was down by $3^3/_4$ per cent in the US, $5^1/_2$ per cent in the UK, 6 per cent in Japan and $6^1/_2$ per cent in Germany.

A74. The slowdown in the global economy last year clearly had a marked impact on UK business investment: companies carrying significant levels of debt from the late 1990s investment boom were quick to curtail capital spending when faced with the prospect of temporarily weaker profit margins as the global environment deteriorated. By the fourth quarter of 2001 business investment was over 8 per cent down on its peak a year earlier, despite pre-emptive monetary policy action tending to limit the scale of decline. Although around 70 per cent of UK business investment is in the service sector, which has lower direct external exposure than manufacturing, a number of service-based industries may have suffered disproportionately from weak global confidence. Post and telecommunications and financial services, industries in which global difficulties have been particularly acute, together account for around 15 per cent of private sector investment in the UK, and investment by airline companies may have been adversely affected in the aftermath of 11 September. Moreover, the share of ICT services in business sector output is higher in the UK than in any other G7 economy, and the proportion of ICT services turnover accounted for by multinational corporations is also significantly higher than in most OECD countries. This suggests investment by ICT service businesses based in the UK may have been particularly exposed to global headwinds.

A75. Amidst heightened global uncertainties business investment has weakened further in 2002 and has now declined for seven consecutive quarters, with the CBI Industrial Trends Survey indicating that uncertainty about demand has remained the key factor holding back investment. Current price estimates of ICT investment also point to continued weakness in spending on high-technology assets following the sharp slowdown in 2001. Hardware spending was almost 25 per cent lower in the first three quarters of 2002 compared with a year earlier, while software expenditure was down by almost 10 per cent.

A76. While significant global downside risks remain, businesses are now better placed than they were last year to revive postponed investment plans once uncertainty recedes and the pace of recovery in the global economy strengthens. After a difficult 2001, company profitability, which is closely correlated with business investment, has strengthened this year. Moreover, debt accumulated as a result of fast investment growth in the late 1990s has been reined in – private non-financial corporations became net lenders in the first half of 2002, having run financial deficits in each of the past five years, and their capital gearing position has eased. This means that companies should have greater financial flexibility in funding increases in investment.

Table A6: Gross fixed capital formation

	Percentage changes on previous year				
		Forecast			
	2001	2002	2003	2004	2005
Whole economy[1]	$^1/_4$	$-4^1/_4$	$6^1/_2$ to 7	4 to $4^1/_2$	$4^1/_4$ to $4^3/_4$
of which:					
Business[2,3]	1	$-10^1/_2$	$2^3/_4$ to $3^1/_4$	$3^3/_4$ to $4^1/_2$	4 to $4^3/_4$
Private dwellings[3]	$-6^1/_2$	$10^1/_2$	$2^1/_2$ to $2^3/_4$	2 to $2^1/_2$	2 to $2^1/_2$
General government[3,4]	$5^1/_4$	$24^3/_4$	$36^1/_2$	$8^1/_2$	$7^1/_2$

[1] *Includes costs associated with the transfer of ownership of land and existing buildings.*

[2] *Private sector and public corporations' (except National Health Service Trusts) non-residential investment. Includes investment under the Private Finance Initiative.*

[3] *Excludes purchases less sales of land and existing buildings.*

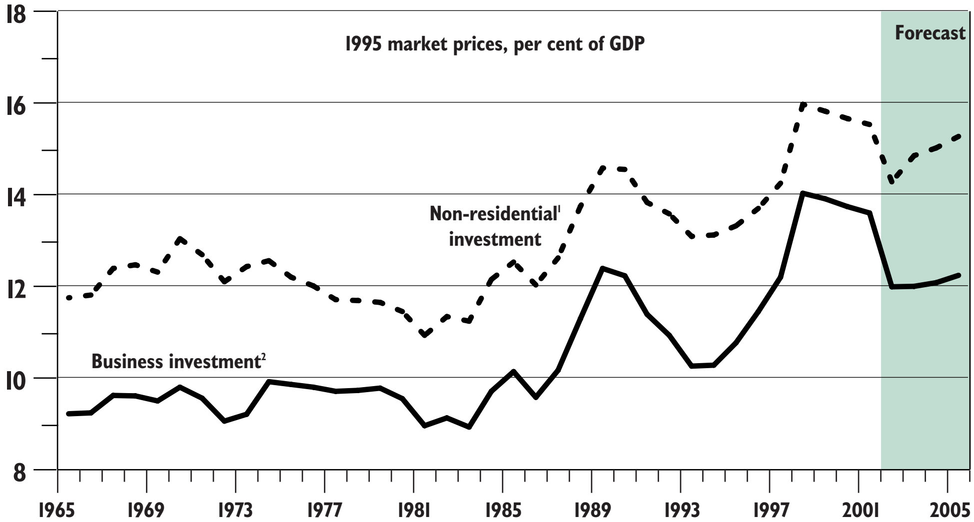
[4] *Includes National Health Service Trusts.*

A77. According to the BCC survey, service sector investment intentions have already strengthened since the end of last year, to around the survey's long-run average. Nevertheless business investment is forecast to be down by around 10 per cent in 2002 as a whole, although this partly reflects base effects from the steepness of the falls through 2001.

A78. Business investment is expected to return to growth during 2003. A strengthening in the pace of demand growth, coupled with a further rebalancing of activity, is expected to enhance corporate prospects and encourage renewed expansion in production capacity. The anticipated pick-up in both domestic and external demand in 2003 and 2004 should also encourage firms to pursue more aggressive investment strategies as spare capacity gets absorbed, and to bring postponed projects back on stream. Moreover, the replacement cycle in ICT should begin to have an effect in the near term as assets acquired in the late 1990s investment boom become obsolete. These factors are expected to allow business investment to grow temporarily above its long-run average rate and boost the capital-labour ratio. Government policies aimed at improving the UK's underlying investment record should further help support capital spending in the medium term.

A79. Thus business investment growth is forecast to pick up to between $2^3/_4$ to $3^1/_4$ per cent in 2003 as the world recovery finally gathers pace, and to reach 4 to $4^3/_4$ per cent in 2005. Whereas there are downside risks to this prospect, which would be revealed in resumed faltering on global equity markets, distinct upside risks are also readily conceivable, particularly from the latter half of next year. Business investment typically rebounds strongly following cyclical downturns. The current downturn in business investment has been globally, as opposed to domestically, induced unlike in the early 1990s, and has possibly led to an abnormal degree of deferred capital spending waiting to come back on stream as the cycle turns up. Moreover, strong investment spending in the late 1990s on ICT equipment with short asset lives may mean more pent up replacement demand than normal for the current stage of the cycle. A faster turnaround in global conditions, for example on the back of reduced tension and uncertainty over developments in the Middle East and a lower oil price premium, would also tend to call forth a sharper pick-up in private investment than envisaged.

Chart A7: Business and non-residential investment ratios



[1] *Whole economy less dwellings.*
[2] *Business investment by public corporations (except National Health Service Trusts) and investment under the Private Finance Initiative.*

A80. Government investment is forecast to show further strong expansion in 2003, as the Government's spending plans continue to deliver sustained spending increases on priority public services. Together with the anticipated pick up in business investment from next year, further growth in government investment should contribute to promoting a rebalancing of GDP growth over the forecast horizon: whole economy investment growth is projected to outstrip household consumption growth throughout.

Trade and the balance of payments

A81. Despite the global economic recovery currently having less momentum than expected at Budget time, net trade made its largest positive contribution to GDP growth for over 7 years in the second quarter of this year. Moreover, although net trade contributed negatively to growth in the third quarter, the deficit on trade in goods and services was still £1$^3/_4$ billion smaller than in the third quarter of 2001.

A82. Trade flows have been volatile in recent months. Goods export volumes rose at their sharpest rate for two years in the second quarter, more than offsetting a further decline in services exports. Taking the first half of the year as a whole, export volumes were up by 1$^1/_4$ per cent on the second half of 2001. Imports also picked up in the first half of 2002, but growth remained muted and almost entirely accounted for by consumer goods as global fragility, weak investment demand and a still delicate manufacturing recovery held back imports of capital and intermediate goods.

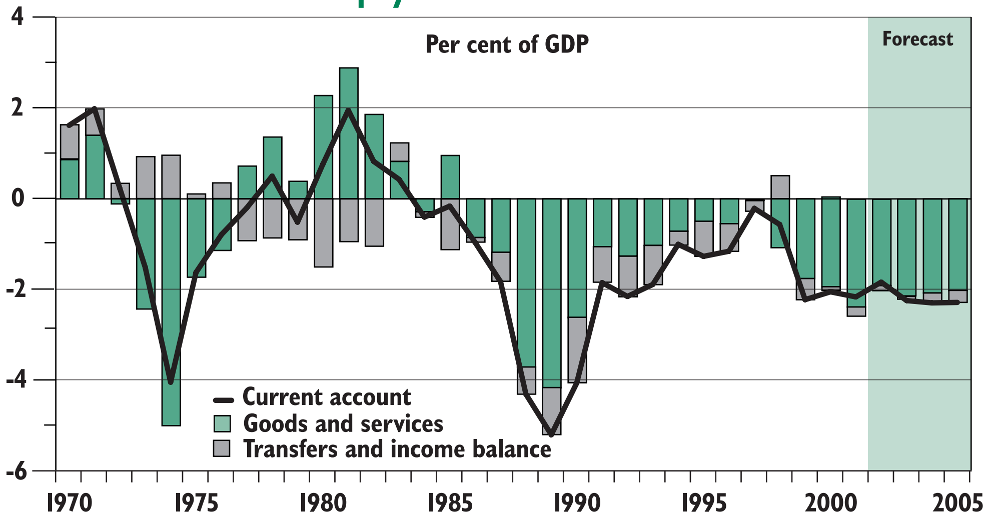
A83. However, following this broadly encouraging start to 2002, the third quarter saw growth in exports and imports of goods fall back, indicating that overall growth earlier in the year failed to gather any significant momentum amidst fragile worldwide business confidence.

A84. After having moved in tandem for much of 2001, goods exports to EU and non-EU markets have diverged since earlier this year. Goods exports to the EU faltered in the third quarter of 2002, declining to their lowest level since the start of 2000, in line with sluggish demand in Europe and the continued weakness of the euro. In contrast, goods exports to the non-EU were over 9 per cent above their first quarter trough, helped by the turnaround in world trade earlier this year. Exports to the EU have been held back by relatively weak consumption growth on the continent, with consumer goods exports, excluding cars, at their lowest level for seven years in the third quarter of 2002. But elsewhere, more robust household expenditure has seen consumer goods exports to non-EU markets increase in each of the past four quarters. To some extent, however, non-EU exports may have been boosted a number of temporary factors. In the US, a more gradual rate of inventory liquidation in the first quarter may have fed through to UK export demand. The relatively short-lived pick-up in world industrial production during the second quarter also appears to have fed through to UK exports of intermediate goods, once allowance is made for Jubilee effects; and exports of motor vehicles to the US are likely to have been boosted by the reintroduction of zero financing deals.

A85. While the Sterling Exchange Rate Index (ERI) has fallen modestly since the time of the Budget, this masks a modest fall in sterling against the euro which has been partly offset by a strengthening against the dollar.

A86. The deficit on trade in goods and services in 2002 is expected to be around £19 billion, or just over $1^3/_4$ per cent of GDP, significantly lower than forecast at Budget time. The deficit is forecast to widen slightly next year. Export volume growth is expected to pick up further in 2003 as the recovery in the world economy gains momentum. But import growth is also expected to increase from next year, as the recovery in manufacturing output moves onto a surer footing, boosting intermediate imports, and businesses again start to increase investment spending.

Chart A8: Balance of payments current account



A87. However, despite above trend growth in GDP between 2003 and 2005, import growth is not expected to return to the strong rates seen over the five years to 2000. This partly reflects the increasing importance of government spending in overall demand in the coming years, given its lower import content relative to private spending. As in the Budget forecast, export and import volume growth are expected broadly to keep in step over most of the forecast horizon, and the deficit on trade in goods and services is forecast to remain more or less stable as a percentage of GDP beyond next year.

Table A7: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices[1]			Goods and services balance
	Exports	Imports	Exports	Imports	Terms of trade[2]	
2001	$1^1/_4$	$2^3/_4$	$-^1/_4$	$-^1/_4$	0	–23
Forecast						
2002	$-1^3/_4$	$^1/_4$	$1^1/_4$	–2	$3^1/_4$	$-19^1/_4$
2003	$3^3/_4$ to $4^1/_4$	$4^3/_4$ to 5	$^1/_2$	$^1/_2$	0	$-22^3/_4$
2004	$7^3/_4$ to $8^1/_4$	7 to $7^1/_2$	$2^3/_4$	$2^3/_4$	0	$-23^1/_2$
2005	$6^3/_4$ to $7^1/_4$	$6^1/_4$ to $6^3/_4$	$2^1/_2$	$2^1/_2$	0	$-24^1/_4$

[1] *Average value indices.*
[2] *Ratio of export to import prices.*

A88. The current account deficit declined in the first half of 2002 and is expected to narrow markedly over 2002 as a whole, mainly due to a lower trade deficit. Over the next two years, the current account deficit is forecast to widen a little. The position on overseas income and transfers, taken together, is expected to weaken somewhat over coming years. Although a strengthening in the pace of world recovery should promote UK earnings overseas, faster UK growth is likely to boost foreign investors profits on UK operations. Moreover, the level of the UK's overseas income surplus in recent years has been unusually high, and the forecast assumes some convergence between the rates of return on overseas and UK assets. Nonetheless, relative to GDP, the current account deficit is expected to remain modest, levelling out at around $2^1/_4$ per cent from 2004.

Table A8: Summary of economic prospects[1, 2]

		Percentage changes on a year earlier unless otherwise stated				
		Forecast[2]				Average errors from past forecasts[4]
	2001	2002	2003	2004	2005	
Output at constant market prices						
Gross domestic product (GDP)	2	$1\frac{1}{2}$	$2\frac{1}{2}$ to 3	3 to $3\frac{1}{2}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	1
Manufacturing output	$-2\frac{1}{2}$	-4	$1\frac{3}{4}$ to $2\frac{1}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$1\frac{3}{4}$ to $2\frac{1}{4}$	$1\frac{3}{4}$
Expenditure components of GDP at constant market prices[5]						
Domestic demand	$2\frac{3}{4}$	$2\frac{1}{4}$	3 to $3\frac{1}{2}$	$3\frac{1}{4}$ to $3\frac{3}{4}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	1
Household consumption[6]	4	$3\frac{1}{2}$	$2\frac{1}{4}$ to $2\frac{1}{2}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$1\frac{1}{4}$
General government consumption	3	$4\frac{1}{4}$	$3\frac{3}{4}$	3	$3\frac{1}{2}$	1
Fixed investment	$\frac{1}{4}$	$-4\frac{1}{4}$	$6\frac{1}{2}$ to 7	4 to $4\frac{1}{2}$	$4\frac{1}{4}$ to $4\frac{3}{4}$	2
Change in inventories[7]	$-\frac{3}{4}$	$-\frac{1}{4}$	$-\frac{1}{4}$ to 0	$\frac{1}{4}$	0	$\frac{1}{4}$
Exports of goods and services	$1\frac{1}{4}$	$-1\frac{3}{4}$	$3\frac{3}{4}$ to $4\frac{1}{4}$	$7\frac{3}{4}$ to $8\frac{1}{4}$	$6\frac{3}{4}$ to $7\frac{1}{4}$	$2\frac{1}{2}$
Imports of goods and services	$2\frac{3}{4}$	$\frac{1}{2}$	$4\frac{3}{4}$ to 5	7 to $7\frac{1}{2}$	$6\frac{1}{4}$ to $6\frac{3}{4}$	$2\frac{1}{2}$
Balance of payments current account						
£ billion	-21	$-18\frac{3}{4}$	-24	-26	$-27\frac{1}{4}$	$6\frac{3}{4}$
per cent of GDP	$-2\frac{1}{4}$	$-1\frac{3}{4}$	$-2\frac{1}{4}$	$-2\frac{1}{4}$	$-2\frac{1}{4}$	$\frac{3}{4}$
Inflation						
RPIX (Q4)	2	$2\frac{1}{2}$	$2\frac{1}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$\frac{1}{2}$
Producer output prices (Q4)[8]	$-\frac{1}{4}$	$\frac{3}{4}$	$1\frac{3}{4}$	$2\frac{1}{4}$	2	1
GDP deflator at market prices	2	3	2	$2\frac{1}{2}$	$2\frac{1}{2}$	$\frac{3}{4}$
Money GDP at market prices						
£ billion	988	1033	1082 to 1087	1143 to 1153	1204 to 1220	13
percentage change	4	$4\frac{1}{2}$	$4\frac{3}{4}$ to $5\frac{1}{4}$	$5\frac{1}{2}$ to 6	$5\frac{1}{4}$ to $5\frac{3}{4}$	$1\frac{1}{4}$

[1] The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2002, released by the Office for National Statistics on 27 September 2002, and output, income and expenditure data for the third quarter released on 27 November.

[2] 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 $2\frac{3}{4}$ per cent assumption for the trend rate of output growth. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of $2\frac{1}{2}$ per cent a year trend growth used as the basis for projecting the public finances.

[3] 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.

[4] 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 2003.

[5] Further detail on the expenditure components of GDP is given in Table A9.

[6] Includes households and non-profit institutions serving households.

[7] Contribution to GDP growth, percentage points.

[8] Excluding excise duties.

Table A9: Gross domestic product and its components

		£ billion at 1995 prices, seasonally adjusted									
		Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
2001		588.4	157.2	152.4	0.4	898.8	288.6	1187.4	340.8	–0.8	845.8
2002		609.4	164.2	146.1	-1.4	918.2	283.3	1201.5	341.5	-1.0	859.1
2003		622.7 to 625.3	170.4	155.6 to 156.2	-2.7 to -2.0	945.9 to 950.0	293.8 to 295.1	1239.7 to 1245.0	357.3 to 358.8	-1.0	881.5 to 885.2
2004		639.3 to 645.1	175.6	161.9 to 163.4	-0.9 to 0.7	975.9 to 984.8	316.7 to 319.6	1292.6 to 1304.4	382.6 to 386.1	-1.0	909.0 to 917.3
2005		654.4 to 663.6	181.8	168.8 to 171.1	-1.3 to 1.2	1003.6 to 1017.8	338.1 to 342.9	1341.7 to 1360.6	406.4 to 412.2	-1.0	934.4 to 947.5
2001	1st half	291.3	77.5	77.3	0.7	446.9	148.0	594.8	172.9	–0.3	421.6
	2nd half	297.1	79.8	75.2	–0.4	451.9	140.6	592.6	167.9	–0.5	424.2
2002	1st half	302.2 to 302.2	81.7	72.8 to 72.8	–0.4 to –0.4	456.3 to 456.3	141.7 to 141.7	598.0 to 598.0	170.9 to 170.9	–0.5	426.6 to 426.6
	2nd half	307.1 to 307.3	82.5	73.3 to 73.3	-1.0 to -1.0	461.9 to 462.1	141.5 to 141.6	603.4 to 603.7	170.5 to 170.6	-0.5	432.4 to 432.6
2003	1st half	309.5 to 310.5	84.5	77.5 to 77.8	-2.0 to -1.7	469.6 to 471.0	144.3 to 144.7	613.9 to 615.8	175.9 to 176.4	-0.5	437.5 to 438.9
	2nd half	313.1 to 314.8	85.8	78.0 to 78.5	-0.7 to -0.2	476.3 to 478.9	149.5 to 150.3	625.8 to 629.2	181.4 to 182.4	-0.5	443.9 to 446.4
2004	1st half	317.5 to 320.0	87.1	80.0 to 80.7	-0.4 to 0.3	484.2 to 488.0	155.5 to 156.7	639.7 to 644.8	188.1 to 189.6	-0.5	451.1 to 454.7
	2nd half	321.8 to 325.1	88.5	81.9 to 82.7	-0.5 to 0.4	491.7 to 496.8	161.2 to 162.9	652.9 to 659.7	194.5 to 196.6	-0.5	457.9 to 462.6
2005	1st half	325.4 to 329.6	89.6	83.7 to 84.7	-0.2 to 0.9	498.5 to 504.9	166.5 to 168.6	665.0 to 673.5	200.4 to 203.0	-0.5	464.1 to 470.1
	2nd half	329.0 to 334.0	92.2	85.1 to 86.4	-1.1 to 0.3	505.1 to 512.9	171.6 to 174.2	676.8 to 687.1	206.0 to 209.2	-0.5	470.2 to 477.5
		Percentage changes on previous year[4,5]									
2001		4	3	1/4	–3/4	2 3/4	1 1/4	2 1/4	2 3/4	0	2
2002		3 1/2	4 1/2	–4 1/4	–1/4	2 1/4	–1 3/4	1 1/4	1/4	0	1 1/2
2003		2 1/4 to 2 1/2	3 3/4	6 1/2 to 7	–1/4 to 0	3 to 3 1/2	3 3/4 to 4 1/4	3 to 3 1/2	4 3/4 to 5	0	2 1/2 to 3
2004		2 3/4 to 3 1/4	3	4 to 4 1/2	1/4	3 1/4 to 3 3/4	7 3/4 to 8 1/4	4 1/4 to 4 3/4	7 to 7 1/2	0	3 to 3 1/2
2005		2 1/4 to 2 3/4	3 1/2	4 1/4 to 4 3/4	0	2 3/4 to 3 1/4	6 3/4 to 7 1/4	3 3/4 to 4 1/4	6 1/4 to 6 3/4	0	2 3/4 to 3 1/4

[1] *Includes households and non-profit institutions serving households.*

[2] *Also includes acquisitions less disposals of valuables.*

[3] *Expenditure adjustment.*

[4] *For change in inventories and the statistical discrepancy, changes are expressed as a per cent of GDP.*

[5] *Growth ranges for GDP components do not necessarily sum to the 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 Pre-Budget Report interim projections for the public finances show that the Government is firmly on track to meet its fiscal rules over the economic cycle, including in the cautious case:

- **the average current budget since the start of the present cycle in 1999-2000 is comfortably in surplus, ensuring that the Government is on track to meet the golden rule, using cautious assumptions and in the cautious case;**
- **this is confirmed by the cyclically-adjusted current budget, which allows for the impact of the economic cycle and is in surplus in every year throughout the projection period; and**
- **public sector net debt is projected to be low and stable throughout the next five years, comfortably meeting the sustainable investment rule and, at 31 to 33 per cent of GDP, the lowest in the G7.**

In a period of global economic weakness and uncertainty, the use of cautious assumptions and the 'stress test' against the cautious case help ensure that the public finances are sound and sustainable and that the Government is vigilant in the face of potential risks. In the short term, the automatic stabilisers are operating freely, as a cyclical shortfall in receipts this year and over the next two years – particularly in income tax and corporation tax – helps to support monetary policy in maintaining economic stability while the economy is below trend. In the medium term, the public finances return towards the Budget 2002 profile as the economy returns to trend.

INTRODUCTION

B1 Chapter 2 describes the Government's fiscal policy framework and shows how the projections of the public finances presented in this Pre-Budget Report are consistent with the fiscal rules. This annex explains the fiscal projections in more detail. It includes:

- six-year projections of the current budget and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule respectively;
- projections of public sector net borrowing, the fiscal aggregate relevant to assessing the impact of fiscal policy on the economy;
- projections of the cyclically-adjusted fiscal balances; and
- detailed analyses of the outlook for government receipts and expenditure.

B2 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 2000-01 and 2001-02, 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 and in the Financial Statement and Budget Report.

B3 The Pre-Budget Report updates the projections of the public finances contained in Budget 2002, 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.

B4 Table B1 compares the Pre-Budget Report projections for the current budget and net borrowing with those made in Budget 2002. As explained in Annex A, the short-term outlook for the world economy has weakened since Budget 2002. This has important implications for the UK economy and in turn for public sector receipts and expenditure. Table B1 shows that the current budget has been revised down from a surplus of £3.2 billion to a deficit of £5.7 billion in 2002-03, and from a surplus of £7 billion to a deficit of £5 billion in 2003-04. It also shows that net borrowing has been revised up from £11.2 billion to £20.1 billion in 2002-03 and from £13 to £24 billion in 2003-04. As discussed in Chapter 2, current estimates of the impact of changes in the output gap on the public finances over previous cycles suggest that automatic stabilisers account for £9 billion of the change in the current budget and net borrowing in 2003-04. As a result, the cyclically-adjusted fiscal balances are only slightly changed from their Budget 2002 levels, while the actual fiscal balances are projected to return to their Budget 2002 levels in the medium term.

Table B1: Fiscal balances compared with Budget 2002

	Outturn	Projections				
	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Surplus on current budget (£ billion)						
Budget 2002	10.6	3.2	7	9	7	9
PBR 2002	**7.7**	**–5.7**	**–5**	**3**	**5**	**8**
Net borrowing (£ billion)						
Budget 2002	1.3	11.2	13	13	17	18
PBR 2002	**1.2**	**20.1**	**24**	**19**	**19**	**19**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2002[1]	1.0	0.5	0.6	0.7	0.6	0.7
PBR 2002	**0.7**	**0.2**	**0.3**	**0.6**	**0.5**	**0.6**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2002[1]	0.2	0.9	1.2	1.2	1.4	1.4
PBR 2002	**0.2**	**1.2**	**1.5**	**1.3**	**1.5**	**1.5**

[1] *The 2001–02 figures were estimates in Budget 2002.*

MEETING THE FISCAL RULES

B5 Table B2 shows six-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 net worth, are also shown.

B6 As explained in Chapter 2, the Government's provisional view is that the current economic cycle started in 1999-2000. Based on the assumptions used in these projections, the economy will next return to trend levels, ending the current cycle, in 2005-06.

B7 The projections show that the Government is firmly on track to meet the golden rule. Over the period of this cycle, from 1999-2000 to 2005-06, the current budget is comfortably in surplus, with an accumulated surplus of £46 billion. Similarly, the average surplus on the current budget is positive since the start of the cycle and throughout the projection period.

The same is true were the cycle to start in 1997-98. The cyclically-adjusted surplus, which allows underlying or structural trends in the indicators to be seen more clearly by removing the estimated effects of the economic cycle, is also positive in every year of the forecast.

B8 Following a deficit of 3 per cent of GDP in 1996-97, current budget surpluses of more than 2 per cent were recorded in 1999-2000 and 2000-01 and of about $^3/_4$ per cent in 2001-02. Largely as a result of cyclical and other temporary factors, the current budget moves into a deficit of about $^1/_2$ per cent of GDP in 2002-03 and 2003-04, before returning to surplus in 2004-05 and recovering to a surplus of around $^3/_4$ per cent of GDP by 2007-08.

Table B2: Summary of public sector finances

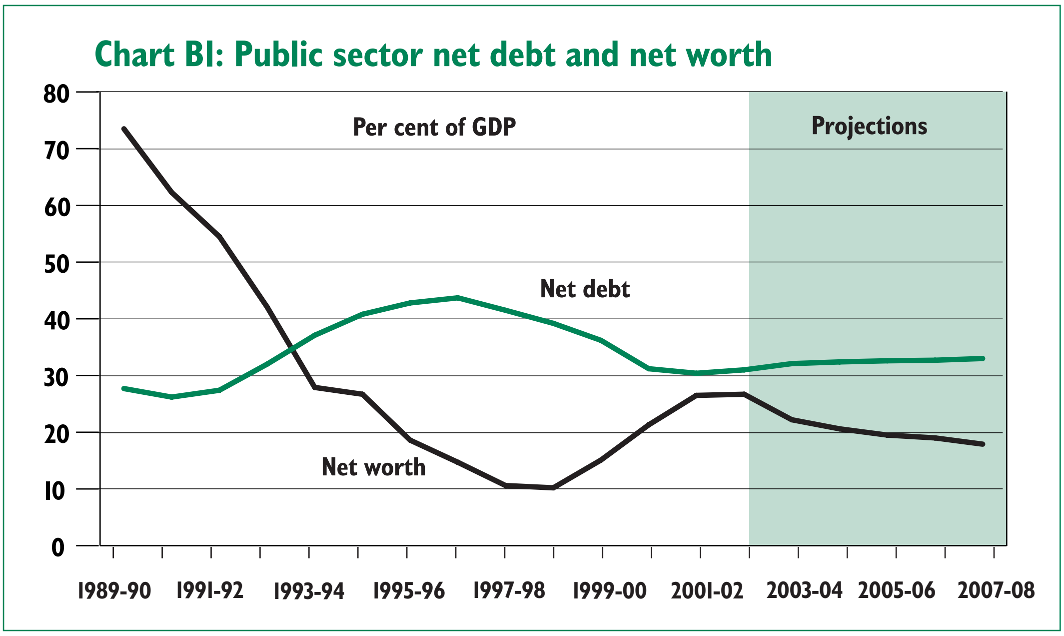
	Per cent of GDP							
	Outturns		Projections					
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Fairness and prudence								
Surplus on current budget	2.2	0.8	–0.5	–0.4	0.2	0.4	0.6	0.7
Average surplus since 1999-2000	2.2	1.7	1.2	0.8	0.7	0.7	0.7	0.7
Cyclically-adjusted surplus on current budget	1.7	0.7	0.2	0.3	0.6	0.5	0.6	0.7
Long-term sustainability								
Public sector net debt	31.2	30.4	31.0	32.1	32.4	32.6	32.7	33.0
Core debt	31.1	30.3	30.3	30.6	30.6	30.8	31.0	31.3
Net worth[1]	21.3	26.5	26.7	22.2	20.6	19.5	19.0	17.9
Primary balance	3.8	1.7	–0.3	–0.6	0.0	0.0	0.1	0.0
Economic impact								
Net investment	0.6	0.9	1.4	1.8	1.9	2.0	2.1	2.2
Public sector net borrowing (PSNB)	–1.7	0.1	1.9	2.2	1.6	1.6	1.5	1.5
Cyclically-adjusted PSNB	–1.2	0.2	1.2	1.5	1.3	1.5	1.5	1.5
Financing								
Central government net cash requirement	–3.7	0.3	1.8	2.8	1.9	1.7	1.9	1.6
European commitments								
Treaty deficit[2]	–1.7	0.2	1.8	2.2	1.7	1.6	1.6	1.6
Cyclically-adjusted Treaty deficit[2]	–1.2	0.2	1.1	1.4	1.3	1.5	1.6	1.6
Treaty debt ratio[3]	39.9	38.2	37.9	38.8	38.9	38.9	39.1	39.2
Memo: Output gap	0.9	-0.3	–1.3	–1.0	–0.3	0.0	0.0	0.0

[1] *At end-December; GDP centred on end-December.*

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

[3] *General government gross debt.*

B9 The sustainable investment rule is also met comfortably over the projection period. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and spending taken by the Government over the course of the last Parliament, including the decision to use the proceeds from the auction of spectrum licences to repay debt, reduced net debt to around 30 per cent of GDP by the end of 2001-02. It is now projected to grow slowly and stabilise at around 33 per cent of GDP by 2007-08, as the Government borrows modestly to fund increased investment in public services, consistent with the fiscal rules. The projections for core debt, which exclude the estimated impact of the economic cycle, increase more slowly to just over 31 per cent of GDP.



B10 Net worth is the approximate stock counterpart of the current budget balance. Current budget surpluses of over 2 per cent of GDP in recent years have increased net worth to 26.7 per cent of GDP in 2002-03. Modest declines are projected during the projection period. At present, net worth is not used as a key indicator of the public finances, mainly as a result of the difficulties involved in measuring accurately many government assets and liabilities.

B11 The primary balance is equal to net borrowing excluding net debt interest payments – thus subtracting the implications of past fiscal deficits. If real interest rates exceed trend output growth, a primary surplus is required to stabilise the net debt ratio. The primary balance is projected to show a modest deficit in 2002-03 and 2003-04, but then to return to balance for the remainder of the projection period.

B12 As a result of decisions taken in the 2002 Spending Review, public sector net investment is projected to rise steadily to $2^1/_4$ per cent of GDP in 2007-08. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being held at a stable and prudent level, well below 40 per cent of GDP. This increase in net investment, together with the new projections for the current budget, mean that public sector net borrowing is expected to increase from 0.1 per cent of GDP in 2001-02 to a maximum of $2^1/_4$ per cent in 2003-04, before falling back to about $1^1/_2$ per cent of GDP in later years. Cyclically-adjusted net borrowing is $1^1/_2$ per cent of GDP or lower in every year.

B13 The central government net cash requirement (CGNCR) was 0.3 per cent of GDP in 2001-02. The CGNCR is projected to increase in 2002-03 and subsequent years, mirroring the profile of public sector net borrowing.

B14 Table B2 also shows the Treaty measures of deficit and debt used in the Excessive Deficits Procedure. The reference levels of 3 per cent of GDP for the deficit and 60 per cent of GDP for gross debt are comfortably achieved throughout the projection period.

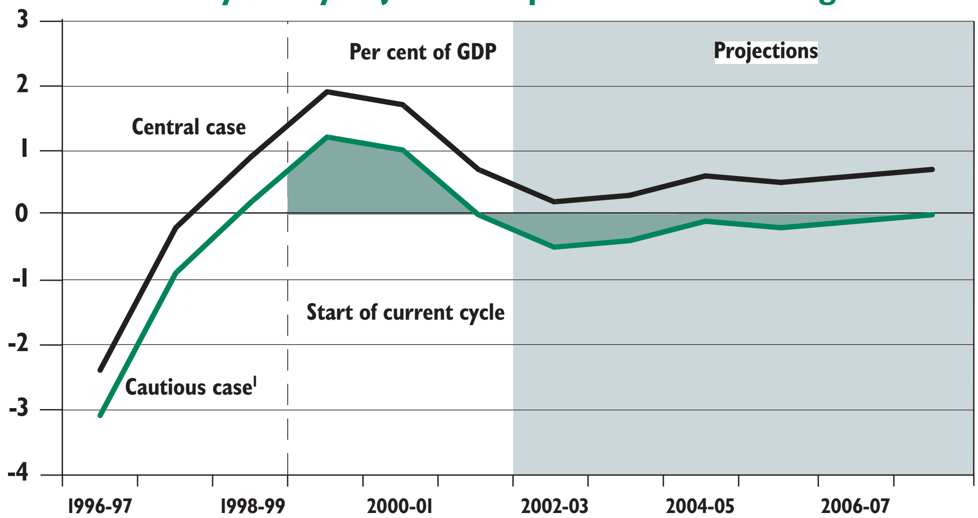
FORECAST DIFFERENCES AND RISKS

B15 The fiscal balances represent the difference between two large aggregates of spending and receipts, and forecasts are inevitably subject to wide margins of uncertainty. Over the past ten years, the average absolute difference between one-year ahead forecasts of net borrowing and subsequent outturns has been around 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 2000 and Budget 2001 and the subsequent outturns is provided in the *End of year fiscal report.*

B16 The uncertainties surrounding the current projections are both global and domestic. Global downside risks include continued volatility in equity prices, the recovery in business investment being delayed, the possibility of renewed rises in oil prices, and the possible disorderly unwinding of current account imbalances. Upside risks include faster productivity growth and quicker global recovery. Domestic risks include house prices continuing to grow steeply, increasing the possibility of a sharp correction, and the emergence of inflationary pressures in the labour market. For these reasons the public finance projections continue to be based on cautious assumptions, including equity prices and trend growth. This helps to ensure that the public finances are sound, that fiscal policy can support monetary policy over the economic cycle and that the Government is on track to meet its tough fiscal rules.

B17 Short-term forecasts of the public finances are critically dependent on the path of the economy, as most tax revenues and some public expenditure - notably social security - vary directly with the economic cycle. Earlier work[1] suggested that if GDP growth were one percentage point higher or lower than assumed over the coming year, net borrowing might be lower or higher by 0.4 per cent of GDP in the first year and by a further 0.3 per cent of GDP the following year. These figures are now closer to 0.5 and 0.2 per cent respectively, as the introduction of the corporation tax instalment system has reduced the lag between profits and tax receipts. However, not all cycles will conform exactly to these parameters, notably because the estimates are based on historical data (since which time both the state of the economy and the tax regime have changed) and because cycles differ in respects other than magnitude.

Chart B2: Cyclically-adjusted surplus on current budget



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

[1] *Fiscal policy: public finances and the cycle*, HM Treasury, March 1999.

B18 Forecast differences in short-term growth forecasts may have only a temporary effect on the public finances. For a given path of trend output, higher or lower growth in the short term will be followed by lower or higher growth later on, and the public finances may be little affected on average over the cycle.

B19 However, changes in the estimated cyclical position of the economy in relation to its trend - the output gap - will have a permanent effect on prospects. For this reason, the public finances projections are stress-tested against an alternative cautious case, in which the level of output is assumed to be 1 percentage point lower than the Government's central view. This scenario would imply that a greater proportion of any projected surplus on the current budget was due to the cyclical strength of the economy – a 1 per cent larger positive output gap reduces the structural surplus on the current budget by about $^{3}/_{4}$ per cent of GDP a year. This is illustrated in Chart B2. Even in this more cautious case, the cyclically-adjusted current budget is estimated to have been comfortably in surplus over the past four years. The impact of the temporary fall in receipts means that it is projected to move into a modest deficit over the short term, before returning broadly to balance towards the end of the projection period. However, since the start of the current cycle, the average surplus on the cyclically-adjusted current budget in the cautious case stays positive in each year, meaning that the golden rule is met, even in the cautious case. The same is true were the cycle to start in 1997-98.

ASSUMPTIONS

B20 The fiscal projections are based on the following assumptions:

- the economy follows the path described in Annex A. In the interests of caution, the fiscal projections continue to be based on the deliberately prudent and cautious assumption of trend output growth of $2^{1}/_{2}$ per cent a year up to 2006-07, $^{1}/_{4}$ percentage point lower than the Government's neutral view. Beyond 2006-07, projections by the Government Actuary imply a slowdown in the growth in the population of working age, due to demographic effects. As set out in the Budget 2002 paper, the Government's neutral view of trend output growth is reduced to $2^{1}/_{2}$ per cent in 2007-08, and so, to maintain a cautious approach, an assumption of $2^{1}/_{4}$ per cent is used in the public finance projections in that year, still $^{1}/_{4}$ percentage point lower than the Government's neutral view. The main economic assumptions are set out in Table B3;

- there are no tax changes beyond those announced since Budget 2002 or in this Pre-Budget Report (see Table B4), and the indexation of rates and allowances. Consistent with the *Code for fiscal stability,* the forecast does not take account of measures proposed in this Pre-Budget Report for consultation or other proposals where final decisions have yet to be taken;

- firm Departmental Expenditure Limits (DEL) as set out in the 2002 Spending Review up until 2005-06, but adjusted for the impact of policy decisions (see paragraph B64) and DEL/ AME reclassifications (see paragraph B69);

- total Annually Managed Expenditure (AME) is as set out in the 2002 Spending Review up until 2005-06, but adjusted for DEL/AME reclassifications and for the estimated costs of spending measures announced in this Pre-Budget Report or before (see Table B4). The forecast of individual components in AME has been updated with changes absorbed by the AME margin within set total AME;

- prior to spending plans being set in the 2004 Spending Review, real growth in DEL after 2005-06 in line with the economic growth assumption used for the public finances, supplemented by an addition to allow for the five-year health settlement of the difference between planned health growth and health's long term average growth of 3.6 per cent. Other current spending in AME is forecast to grow from 2005-06 onwards at $1^3/_4$ per cent in real terms in line with its recent trend; and

- within these aggregates, net investment is forecast to increase from 2 per cent of GDP in 2005-06 towards an assumption of $2^1/_4$ per cent in 2007-08, while remaining consistent with the sustainable investment rule.

Table B3: Economic assumptions for public finance projections

	Percentage changes on previous year						
	Outturn	Projections					
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Output (GDP)	$1^1/_2$	2	$2^3/_4$	3	$2^3/_4$	$2^1/_2$	$2^1/_4$
Prices							
RPIX	$2^1/_4$	$2^1/_4$	$2^1/_4$	$2^1/_2$	$2^1/_2$	$2^1/_2$	$2^1/_2$
GDP deflator	$2^1/_4$	$2^1/_2$	$2^1/_4$	$2^1/_2$	$2^1/_2$	$2^1/_2$	$2^1/_2$
RPI[1] (September)	$1^3/_4$	$1^1/_2$	$2^1/_2$	3	$2^3/_4$	$2^1/_2$	$2^1/_2$
Rossi[2] (September)	$1^3/_4$	1	$1^3/_4$	$2^1/_4$	2	2	2
Money GDP[3] (£ billion)	998	1044	1096	1158	1220	1281	1342

[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.*

B21 The key assumptions underlying the fiscal projections are audited by the National Audit Office (NAO) under the three-year rolling review process. Details of all the audited assumptions are given in Box B1. For this Pre-Budget Report, the Comptroller and Auditor General has audited the assumptions for oil prices under the three-year rolling review, and examined extensions to the assumptions covering VAT and tobacco smuggling measures. All three of the assumptions were deemed to be both reasonable and cautious[2]. Revisions to the VAT and tobacco assumptions are described in detail later in this annex, and the effects of changes on receipts projections are shown in Tables B7 and B8.

[2] *Audit of Assumptions for the 2002 Pre-Budget Report*, 27 November 2002

Box B1: Key assumptions audited by the NAO

• Privatisation proceeds[1,6]	Credit is taken only for proceeds from sales that have been announced.
• Trend GDP growth [1,6,9]	2½ per cent a year to 2006-07 and 2¼ per cent in 2007-08.
• UK claimant unemployment[1,4,7,9]	Rising slowly to 0.99 million in 2005-06, from recent levels of 0.94 million, consistent with average of independent forecasts.
• Interest rates[1,6,7]	3-month market rates change in line with market expectations (as of 15 November).
• Equity prices[2,7]	FTSE All-Share index rises from 1963 (close 15 November) in line with money GDP.
• VAT[2,7,10]	Ratio of underlying VAT to consumption falls by 0.05 percentage points a year.
• GDP deflator and RPI[2,7]	Projections of price indices used to plan public expenditure are consistent with RPIX.
• Composition of GDP[3,8]	Shares of labour income and profits in national income are broadly constant in the medium term.
• Funding[3,8]	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
• Oil prices[5,10]	$25.10 a barrel in 2003, the average of independent forecasts, and then constant in real terms.
• Tobacco[6,10]	Only the direct effects of the tobacco anti-smuggling strategy, including deterrent effects of fiscal marks, and any existing indirect effects are allowed for.

[1]Audit of Assumptions for the July 1997 Budget Projections, 19 June 1997 (HC3693).
[2]Audit of Assumptions for the Pre-Budget Report, 25 November 1997 (HC361).
[3]Audit of Assumptions for the Budget, 19 March 1998 (HC616).
[4]Audit of the Unemployment Assumption for the March 1999 Budget Projections, 9 March 1999 (HC294).
[5]Audit of the Oil Price Assumption for the Pre-Budget Report, November 1999 (HC873).
[6]Audit of Assumptions for the March 2000 Budget, 21 March 2000 (HC348).
[7]Audit of Assumptions for the Pre-Budget 2000 Report, 8 November 2000 (HC959).
[8]Audit of Assumptions for the March 2001 Budget, 7 March 2001 (HC304).
[9]Audit of Assumptions for the April 2002 Budget, 17 April 2002 (HC760).
[10]Audit of Assumptions for the 2002 Pre-Budget Report, 27 November 2002 (HC109)

PRE-BUDGET REPORT POLICY DECISIONS

B22 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all firm decisions announced in this Pre-Budget Report or since Budget 2002, including the abolition of North Sea Royalty payments and further measures to tackle tax avoidance and establish a modern and fair tax system. The fiscal impact of these measures is set out in Table B4.

B23 In line with the convention adopted in previous Pre-Budget Reports, expenditure measures in AME for future years have been added to total AME. DEL spending measures have only been added to total DEL where they are funded by increased revenue or are the direct result of a decision to increase public spending as a whole. The measures that affect DEL are:

- the decision to reform the Landfill Tax Credit Scheme from April 2003 will release funding to encourage sustainable waste management. The design of this programme will be determined following further work on the management of waste policy. In advance of allocation decisions on the programme, these funds have been added to total DEL and credited to the Reserve;
- as in previous years, the underspend from 2001-02 has been carried forward and added to total DEL in 2002-03; and
- in 2002-03 there is a special reserve addition.

B24 The projections do not take account of measures proposed in this Pre-Budget Report for consultation prior to Budget 2003 and other proposals where final decisions have yet to be taken, including medium to long-term increases in the standard rate of landfill tax.

Table B4: Estimated costs of Pre-Budget Report policy decisions and others announced since Budget 2002[1]

	(+ve is an Exchequer yield) £ million			
	2002–03	**2003–04**	**2004–05**	**2005–06**
Measures announced since Budget 2002				
Housing Benefit: standard rate pilot	0	–20	–20	–20
Anti-avoidance measures				
Derivative contracts: amendments to close loopholes in existing legislation	200	300	0	0
Controlled Foreign Companies: removing Ireland from excluded countries list	5	15	15	15
Total measures announced since Budget 2002	**205**	**295**	**–5**	**–5**
Measures announced in the Pre-Budget Report				
Share schemes – statutory corporation tax deduction	0	5	–45	–75
Transition to work: extending the Job Grant	0	0	–15	–15
Increases to the Social Fund budget	0	–25	–35	–45
Freeze of Class 2 NICs	0	–5	–5	–5
Extension of the Payroll Giving supplement for one year	0	–10	0	0
Abolition of North Sea Royalty from 1 January 2003	0	–170	–140	–120
Replacement of Landfill Tax Credit Scheme	0	100	110	110
Anti-avoidance measures				
Abuse of Employee Benefit Trusts	135	315	425	435
Claims for unfairly accelerated capital allowances	0	20	30	30
Controlled Foreign Companies: avoidance of UK tax on profits from extended warranties	0	0	50	170
Avoidance of VAT on sales of freehold buildings	60	165	165	165
Total Pre-Budget Report measures	**195**	**395**	**540**	**650**
Additonal Pre-Budget Report policy decisions				
Additional waste spending in DEL	0	–100	–110	–110
Special reserve addition to DEL	–1000	0	0	0
Carry forward from 2001-02	–435	0	0	0
TOTAL POLICY DECISIONS	**–1035**	**590**	**425**	**535**

[1] *All costings shown relative to an indexed base.*

FISCAL AGGREGATES

B25 Tables B5 and B6 provide more detail on the projections for the current and capital budgets. The tables show the current budget and net borrowing both including and excluding Windfall Tax and associated spending (WTAS). WTAS now has much less impact and, unless otherwise stated, all projections now cover all public expenditure. Latest estimates of associated spending are given in Table 4.1.

Table B5: Current and capital budgets

	£ billion						
	Outturn			**Projections**			
	2001–02	**2002–03**	**2003–04**	**2004–05**	**2005–06**	**2006–07**	**2007–08**
Current budget							
Current receipts	390.7	399.7	430	463	493	521	548
Current expenditure	369.6	391.4	420	444	471	496	520
Depreciation	13.4	14.1	15	15	16	17	18
Surplus on current budget (excluding WTAS[1])	8.4	–4.8	–5	3	5	8	10
Surplus on current budget	**7.7**	**–5.7**	**–5**	**3**	**5**	**8**	**10**
Capital budget							
Gross investment	26.5	32.2	38	41	44	48	52
less asset sales	–4.3	–3.8	–4	–4	–4	–4	–4
less depreciation	–13.4	–14.1	–15	–15	–16	–17	–18
Net investment	8.8	14.3	20	22	24	27	30
Net borrowing (excluding WTAS[1])	0.0	19.1	24	19	19	19	20
Net borrowing	**1.2**	**20.1**	**24**	**19**	**19**	**19**	**20**
Public sector net debt – end year	**310.9**	**332.0**	**362**	**385**	**407**	**430**	**454**
Memos:							
Treaty deficit[2]	1.7	18.7	24	19	19	21	21
Treaty debt[3]	380.7	396.0	426	450	475	500	527

[1] *Windfall Tax receipts and associated spending.*
[2] *General government net borrowing on a Maastricht basis.*
[3] *General government gross debt.*

B26 The current budget surplus is equal to public sector receipts minus public sector current expenditure and depreciation. The current budget is projected to show a modest deficit in 2002-03 and 2003-04, before moving back into surplus throughout the rest of the projection period. These temporary deficits are consistent with allowing the automatic stabilisers to operate fully over the economic cycle, while continuing to meet the golden rule.

B27 The cumulative total surplus on the current budget between 1999-2000, the beginning of the current economic cycle, and 2001-02 is £49 billion. If the cycle were to start in 1997-98, the accumulated surplus would be £58 billion. Even after the modest cyclical deficits expected in 2002-03 and 2003-04, the current budget will therefore be comfortably in surplus over this cycle.

B28 Underlying the projections of the current budget are steady increases in the ratios of public sector receipts and current expenditure to GDP, shown in Table B6, largely reflecting measures announced in Budget 2002 and the 2002 Spending Review. By 2005-06, when the current cycle ends under the assumptions used in these projections, the accumulated total surplus over this economic cycle will be £46 billion.

B29 Table B5 also shows that net investment is projected to more than double from £14¼ billion in 2002-03 to £30 billion in 2007-08, as the Government seeks to rectify historical under-investment in public infrastructure. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, as debt is being held at 33 per cent of GDP or below throughout the projection period, well within the 40 per cent limit set by the sustainable investment rule, as shown in Table B6.

Table B6: Current and capital budgets

	Per cent of GDP						
	Outturn	Projections					
	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Current budget							
Current receipts	39.2	38.3	39.3	39.9	40.4	40.6	40.8
Current expenditure	37.0	37.5	38.4	38.4	38.6	38.7	38.8
Depreciation	1.3	1.4	1.3	1.3	1.3	1.3	1.3
Surplus on current budget (excluding WTAS[1])	0.8	–0.5	–0.4	0.3	0.4	0.6	0.7
Surplus on current budget	**0.8**	**–0.5**	**–0.4**	**0.2**	**0.4**	**0.6**	**0.7**
Capital budget							
Gross investment	2.7	3.1	3.5	3.5	3.6	3.7	3.9
less asset sales	–0.4	–0.4	–0.3	–0.3	–0.3	–0.3	–0.3
less depreciation	–1.3	–1.4	–1.3	–1.3	–1.3	–1.3	–1.3
Net investment	0.9	1.4	1.8	1.9	2.0	2.1	2.2
Net borrowing (excluding WTAS[1])	0.0	1.8	2.2	1.6	1.6	1.5	1.5
Net borrowing	**0.1**	**1.9**	**2.2**	**1.6**	**1.6**	**1.5**	**1.5**
Public sector net debt – end year	**30.4**	**31.0**	**32.1**	**32.4**	**32.6**	**32.7**	**33.0**
Memos:							
Treaty deficit[2]	0.2	1.8	2.2	1.7	1.6	1.6	1.6
Treaty debt ratio[3]	38.2	37.9	38.8	38.9	38.9	39.1	39.2

[1] *Windfall Tax receipts and associated spending.*
[2] *General government net borrowing on a Maastricht basis.*
[3] *General government gross debt.*

B30 Table B7 sets out the effects of revisions and forecasting changes, including the effect of the changes to the VAT and tobacco audited assumptions, Pre-Budget Report policy decisions and other discretionary changes since Budget 2002 on the main fiscal aggregates.

Table B7: Fiscal balances compared with Budget 2002

	£ billion					
	Outturn		Projections			
	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Surplus on current budget						
Budget 2002	**10.6**	**3.2**	**7**	**9**	**7**	**9**
Effect on receipts of:						
Revisions and forecasting changes	–0.1	–7.8	–12	–6	–2	0
of which:						
Indirect tax fraud and avoidance changes	*0.0*	*0.0*	*1*	*1*	*2*	*2*
Policy decisions since Budget 2002	—	0.4	1	1	1	1
Effects on spending of:						
Revisions and forecasting changes	–2.8	–0.1	0	0	–1	–1
Policy decisions since Budget 2002	—	–1.4	0	0	0	0
PBR 2002	**7.7**	**–5.7**	**–5**	**3**	**5**	**8**
Net borrowing						
Budget 2002	**1.3**	**11.2**	**13**	**13**	**17**	**18**
Effects of changes in the current surplus	3.0	8.9	12	6	2	1
Effects of changes in net investment	–3.1	–0.1	0	0	0	0
PBR 2002	**1.2**	**20.1**	**24**	**19**	**19**	**19**

Note: Figures may not sum due to rounding.

B31 The latest available outturn information for 2001-02 shows current receipts only £0.1 billion lower than estimated in Budget 2002, but current expenditure, including depreciation, £2.8 billion higher. As a result, the current budget surplus was around £3 billion lower than expected at Budget 2002. However, net borrowing was only around £0.1 billion lower, as net investment was around £3 billion lower than estimated in Budget 2002. Further explanation of the differences between outturns and earlier forecasts is given in the *End of year fiscal report*.

B32 The current surplus for 2002-03 onwards is lower than in Budget 2002, mainly because of lower tax receipts, especially income tax and corporation tax. Further details of these changes are given in the next section. Net borrowing is also increased by the forecasting changes to receipts.

B33 There are only minor forecasting changes to total expenditure in 2002-03 and during the 2002 Spending Review period. However, changes to the composition of expenditure announced in the Spending Review, coupled with the assumptions used to project spending after the end of the Spending Review period, lead to small increases in spending in 2006-07.

RECEIPTS

B34 This section looks in detail at the Pre-Budget Report projections for public sector tax receipts. Table B8 provides a detailed breakdown of the main factors that have led to changes in the overall projections since Budget 2002, while Table B9 shows the changes to the individual taxes. Table B10 sets out projections of the overall tax-GDP ratio and Table B11 shows projections of receipts from major taxes as a per cent of GDP. Tables B12 and B13 give more information on the level of tax receipts in 2001-02, 2002-03 and 2003-04.

Total receipts

B35 As shown in Table B8, relative to Budget 2002, current receipts are projected to be around £7½ billion lower in 2002-03 and around £11½ billion lower in 2003-04. Most of these falls are explained by cyclical or other temporary factors. As a result, overall levels of receipts are expected to return to their Budget 2002 levels over the medium term.

B36 Changes to the assumptions audited by the NAO explain only a small proportion of the fall in receipts in 2002-03. However, they have a much larger impact in subsequent years, mainly because of changes in equity prices. The audited assumption underpinning the current projections is that equity prices increase in line with money GDP from the existing level of the FTSE All-Share Index, 1963 in these projections, compared with the Budget 2002 starting point of 2542. As a result, equity prices are 23 per cent lower than the Budget forecast for 2002-03 and 25 per cent lower for 2003-04. Equity price levels are important determinants of capital taxes, stamp duty and, because of their impact on the capital gains of life insurance companies, corporation tax, though the timing of the impact varies from tax to tax, and the size of the impact increases after the first year. Lower equity prices reduce receipts by around £1 billion in 2002-03, by £3½ billion in 2003-04, and by around £4 billion a year from 2004-05 onwards.

Table B8: Changes in current receipts since Budget 2002

	£ billion				
			Projections		
	2002–03	2003–04	2004–05	2005–06	2006–07
Effect on receipts of changes in:					
Assumptions audited by the NAO	**0**	**–3½**	**–3**	**–2½**	**–1½**
of which: Equity prices	*–1*	*–3½*	*–4*	*–4*	*–4*
Revised tobacco and VAT assumptions	*0*	*½*	*1½*	*2*	*2*
Financial company profits	**–5**	**–5**	**–3½**	**–1½**	**–1**
Other economic and forecasting effects[1]	**–2½**	**–3½**	**½**	**2**	**2½**
Total before policy changes	**–8**	**–12**	**–6**	**–2**	**0**
Policy decisions since Budget 2002 affecting receipts	½	½	½	½	1
Total change	**–7½**	**–11½**	**–5½**	**–1½**	**½**

[1] *Excluding assumptions audited by the NAO.*

Table B9: Changes in current receipts by tax since Budget 2002

		£ billion	
	2001–02	2002–03	2003–04
Income tax (gross of tax credits)	0.1	–3.4	–3.0
Non-North Sea corporation tax[1]	0.0	–3.7	–5.7
Less tax credits[2]	0.3	0.5	–2.1
North Sea revenues	0.0	–0.5	–1.2
Capital taxes[3]	0.0	0.2	–0.2
Stamp duty	0.0	0.0	0.0
Value added tax	0.0	0.6	0.6
Excise duties[4]	0.0	–0.3	–0.9
Social security contributions	0.0	0.5	0.7
Other taxes and royalties[5]	–0.9	0.1	0.9
Net taxes and social security contributions	**–0.5**	**–6.0**	**–11.0**
Other receipts and accounting adjustments	0.4	–1.4	–0.3
Current receipts	**–0.1**	**–7.4**	**–11.3**

[1] *National Accounts measure: gross of enhanced and payable tax credits.*
[2] *Includes company tax credits.*
[3] *Capital gains tax and inheritance tax.*
[4] *Fuel, alcohol and tobacco duties.*
[5] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*

B37 Changes to the audited assumptions for VAT and tobacco add about £½ billion to receipts in 2003-04 and increasing amounts thereafter, reaching almost £2 billion in 2007-08. These effects are also shown in the audited assumptions section of Table B8. The Government aims to reduce VAT fraud by more than £2 billion a year by 2005-06, but in line with its audited, cautious approach to forecasting a lower figure of £1.4 billion a year is used here.

B38 A large proportion of the temporary shortfall in receipts relative to the Budget 2002 forecast is explained by temporarily lower levels of financial companies' profits resulting from the impact of global events, especially further downturns in international capital markets. This impacts most significantly on the corporation tax paid by financial companies (other than life insurance companies – see paragraph B36) and on income tax, through their impact on the level of salaries, especially bonuses, paid by financial companies to their employees.

B39 The other economic and forecasting effects line in Table B8 is driven by a large number of different, but interrelated, factors working in different directions at different times. Some of these effects are temporary but others persist throughout the projection period. They include changes to other economic determinants such as GDP components and price effects and fiscal forecasting changes, which reflect recent tax receipts data that cannot be explained by changes in economic determinants, and changes arising from the models used to forecast receipts relating to, for example, average tax rates. The more important changes are described in the following tax-by-tax analysis section. The figures for 2003-04 onwards include a fall of about £2 billion a year in respect of the revision to the split of tax credits between their negative tax and expenditure components. This has no overall impact on the current budget or net borrowing, and is explained in more detail in paragraph B47.

Tax-GDP ratio

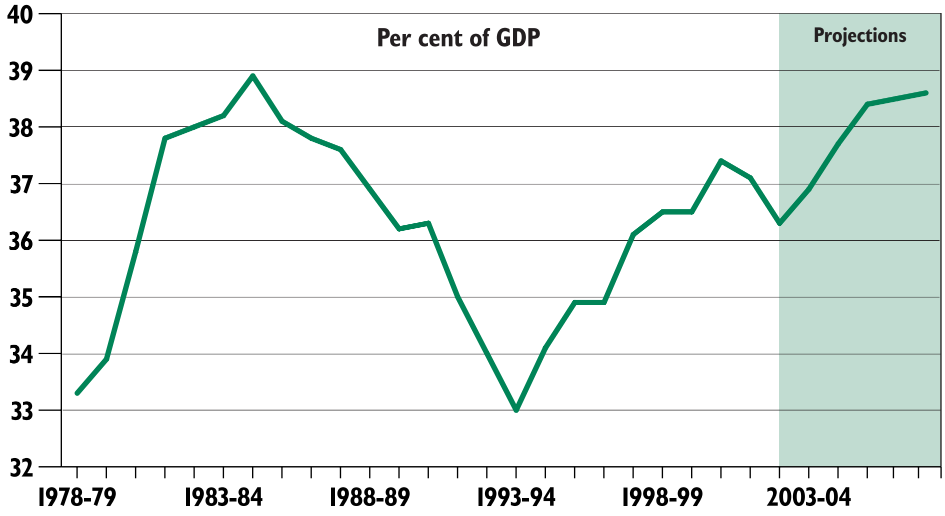
B40 Table B10 shows the impact of changes to tax projections on the tax-GDP ratio, which is now expected to fall to 36.3 per cent of GDP in 2002-03, compared with a Budget 2002 projection of 36.7 per cent. Similarly, the tax-GDP ratio in 2003-04 is now projected to be 37.0 per cent, compared with a Budget 2002 projection of 37.6 per cent. Thereafter, the recovery of financial company profits and other cyclical and temporary factors mean that the tax-GDP ratio moves back towards Budget 2002 levels. The additional VAT and tobacco duty receipts resulting from changes to the audited assumptions also increase the ratio, by up to 0.2 percentage points in the medium term. Chart B3 shows the tax-GDP ratio from 1978-79 to 2007-08.

Table B10: Net taxes and social security contributions[1]

	Per cent of GDP						
	Outturn[2]	Projections					
	2001-02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Budget 2002	37.0	36.7	37.6	38.1	38.3	38.3	
PBR 2002	**37.1**	**36.3**	**37.0**	**37.7**	**38.2**	**38.4**	**38.6**

[1] *Cash basis. Uses OECD definition of negative tax personal tax credits. Net of company tax credits.*
[2] *The 2001–02 figures were estimates in Budget 2002.*

Chart B3: Tax-GDP ratio[1]



[1] *Net taxes and social security contributions as defined in Table B10.*

B41 Table B11 provides a more detailed breakdown of the projections of the tax-GDP ratio, which is derived from 'net taxes and social security contributions' (NTSSC). This is a measure of net cash payments made to UK government and differs in several respects from the accruals measures used in the National Accounts. The lower half of Table B11 sets out the adjustments needed to reconcile NTSSC with total current receipts, as defined in the National Accounts. Similar information is given, in £ billion, in Table B12. The main adjustments are:

- accruals adjustments, mainly on income tax, national insurance contributions and VAT, are added to change the basis of figures from cash to National Accounts accruals;
- some tax payments that are collected by the government, but then paid to the EC, are subtracted as they do not score as government receipts in the National Accounts;
- tax paid by public corporations is also subtracted, as it has no impact on overall public sector receipts;
- an adjustment is made for tax credits. In NTSSC, all tax credits are scored as negative tax to the extent that they are less than or equal to the tax liability of the household, and as public expenditure where they exceed the liability, in line with OECD Revenue Statistics guidelines. Although the Office for National Statistics will adopt this treatment in the National Accounts for the Working Tax Credit and Child Tax Credit, due to be introduced in April 2003, they have continued to treat the Working Families' Tax Credit (WFTC), the Disabled Person's Tax Credit (DPTC) and enhanced and payable company tax credits entirely as public expenditure in the National Accounts. Those parts of WFTC, DPTC and company tax credits that offset tax liability in NTSSC are added back into current receipts in Table B11; and
- interest and other non-tax receipts, which are excluded from NTSSC, are added. However, NTSSC includes payments of oil royalties, prior to their abolition from 1 January 2003, which are not scored as tax in the National Accounts.

Table B11: Current receipts as a proportion of GDP

	Per cent of GDP						
	Outturn			Projections			
	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Income tax (gross of tax credits)	11.1	10.9	11.2	11.4	11.6	11.8	11.9
Non-North Sea corporation tax[1]	2.9	2.5	2.5	2.9	3.2	3.3	3.3
Tax credits[2]	–0.2	–0.3	–0.4	–0.4	–0.4	–0.4	–0.4
North Sea revenues[3]	0.5	0.5	0.4	0.4	0.4	0.4	0.3
Value added tax	6.1	6.2	6.1	6.1	6.1	6.1	6.1
Excise duties[4]	3.7	3.6	3.5	3.4	3.3	3.3	3.2
Social security contributions	6.3	6.3	6.9	7.0	7.0	7.0	7.1
Other taxes and royalties[5]	6.7	6.7	6.7	6.8	6.9	7.0	7.1
Net taxes and social security contributions[6]	37.1	36.3	37.0	37.7	38.2	38.4	38.6
Accruals adjustments on taxes	0.1	–0.1	0.3	0.2	0.2	0.2	0.2
less EC transfers	–0.4	–0.3	–0.2	–0.2	–0.1	–0.1	–0.1
Tax credits[7]	0.1	0.1	0.1	0.0	0.0	0.1	0.1
Other receipts[8]	2.2	2.2	2.2	2.2	2.1	2.1	2.1
Current receipts	39.2	38.3	39.3	39.9	40.4	40.6	40.8
Memo:							
Current receipts (£ billion)	390.7	399.7	430	463	493	521	548

[1] *National Accounts measure: gross of enhanced and payable tax credits.*
[2] *Tax credits scored as negative tax in net taxes and social security contributions.*
[3] *Includes oil royalities, petroleum revenue tax and North Sea corporation tax.*
[4] *Fuel, alcohol and tobacco duties.*
[5] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*
[6] *Includes VAT and 'own resources' contributions to EC budget. Cash basis.*
[7] *Tax credits scored as negative tax in net taxes and social security contributions, but as expenditure in the National Accounts.*
[8] *Mainly gross operating surplus and rent, excluding oil royalties.*

Tax-by-tax analysis

B42 This section looks in detail at the projections for individual taxes and receipts. Table B12 contains updated projections for the main components of public sector receipts up to 2003-04, while Table B13 looks in more detail at changes in receipts between 2001-02 and 2002-03.

Income tax

B43 As shown in Table B13, total income tax receipts for April to October 2002 have increased very little relative to the same period in 2001-02. Receipts are expected to grow a little more strongly over the rest of the year, mainly because of self assessment receipts, which are due at the end of January, but income tax receipts in 2002-03 are now expected to be £114 billion, around £3½ billion lower than forecast in Budget 2002. This reflects a reduction in the Pay as You Earn (PAYE) projection of just under £4 billion, offset by a £½ billion increase in other types of income tax. As explained in Box 3.2 of the *End of year fiscal report*, PAYE is projected by applying appropriate tax rates to the changes in the tax base. Estimates of wages and salaries, the most important component of the tax base, are only slightly lower than in Budget 2002, and most of the fall in PAYE is due to a fall in the average tax rate. The falls in financial companies' profits this year also seem likely to impact on bonuses at the end of 2002-03, and the forecast prudently makes an allowance for this.

Table B12: Current receipts

	£ billion		
	Outturn	Projections	
	2001–02	2002–03	2003–04
Inland Revenue			
Income tax (gross of tax credits)	110.4	114.1	123.0
Corporation tax[1]	32.4	29.3	30.8
Tax credits[2]	–2.3	–3.5	–4.9
Petroleum revenue tax	1.3	1.1	1.3
Capital gains tax	3.0	2.0	1.4
Inheritance tax	2.4	2.4	2.6
Stamp duties	7.1	8.2	8.6
Social security contributions	63.2	65.5	75.4
Total Inland Revenue (net of tax credits)	**217.4**	**219.1**	**238.3**
Customs and Excise			
Value added tax	61.0	64.5	67.3
Fuel duties	21.9	22.4	23.1
Tobacco duties	7.8	8.2	7.8
Spirits duties	1.9	2.2	2.4
Wine duties	2.0	1.9	1.9
Beer and cider duties	3.1	3.1	3.1
Betting and gaming duties	1.4	1.3	1.3
Air passenger duty	0.8	0.8	0.8
Insurance premium tax	1.9	2.1	2.2
Landfill tax	0.5	0.5	0.7
Climate change levy	0.6	0.9	0.9
Aggregates levy	0.0	0.2	0.4
Customs duties and levies	2.0	2.0	1.9
Total Customs and Excise	**104.9**	**110.1**	**113.8**
Vehicle excise duties	4.2	4.4	4.8
Oil royalties	0.5	0.5	0.0
Business rates[3]	17.5	18.0	18.2
Council tax	15.3	16.6	17.8
Other taxes and royalties[4]	10.1	10.9	12.3
Net taxes and social security contributions[5]	**369.8**	**379.6**	**405.1**
Accruals adjustments on taxes	1.3	–0.6	3.4
less own resources contribution to EC budget	–3.6	–3.0	–2.4
less PC corporation tax payments	–0.1	–0.2	–0.2
Tax credits[6]	0.8	1.2	0.6
Interest and dividends	4.7	4.1	4.1
Other receipts[7]	17.7	18.6	19.7
Current receipts	**390.7**	**399.7**	**430.3**
Memo:			
North sea revenues[8]	5.2	4.9	4.5

[1] National Accounts measure: gross of enhanced and payable tax credits.
[2] Includes enhanced and payable company tax credits.
[3] Includes district council rates in Northern Ireland paid by business.
[4] Includes money paid into the National Lottery Distribution Fund.
[5] Includes VAT and 'traditional own resources' contributions to EC budget. Cash basis.
[6] Excludes Children's Tax Credit and other tax credits which score as a tax repayment in the National Accounts.
[7] Includes gross operating surplus and rent; net of oil royalties.
[8] Consists of North Sea corporation tax, petroleum revenue tax and royalties.

Table B13: Net taxes and social security contributions 2002-03

	£ billion			Percentage change on 2001–02		
	Outturn[1] Apr–Oct	Estimate Nov–Mar	2002–03	Outturn[1] Apr–Oct	Nov–Mar	Full year
Inland Revenue						
Income tax and capital gains tax[2]	60.6	52.3	112.9	0.9	2.6	1.7
Corporation tax[3]	20.0	9.0	29.0	–14.0	–1.0	–10.3
Petroleum revenue tax	0.6	0.6	1.1	–35.0	30.8	–13.5
Inheritance tax	1.4	1.0	2.4	–0.1	6.5	2.5
Stamp duties	4.7	3.5	8.2	5.9	30.1	15.1
Social security contributions	37.4	28.2	65.5	1.7	6.5	3.7
Total Inland Revenue (net of tax credits)	**124.6**	**94.5**	**219.1**	**–1.7**	**4.4**	**0.8**
Customs and Excise						
Value added tax	37.8	26.7	64.5	5.1	6.3	5.6
Fuel duties	13.0	9.4	22.4	0.9	4.0	2.1
Tobacco duties	4.9	3.2	8.2	7.2	2.1	5.1
Alcohol duties	4.2	3.1	7.3	5.4	3.4	4.5
Other Customs duties and levies	4.5	3.3	7.8	8.5	8.4	8.5
Total Customs and Excise	**64.3**	**45.8**	**110.1**	**4.6**	**5.5**	**5.0**
Vehicle excise duties	2.5	1.9	4.4	–2.8	16.9	4.7
Oil royalties	0.2	0.3	0.5	–38.4	9.3	–15.9
Business rates	13.8	4.3	18.0	9.4	–13.2	3.1
Council tax	11.1	5.5	16.6	9.4	6.6	8.5
Other taxes and royalties[4]	6.6	4.3	10.9	15.5	–2.2	7.9
Net taxes and social security contributions[5]	**223.1**	**156.5**	**379.6**	**1.6**	**4.1**	**2.6**

[1] *Provisional.*
[2] *Net of personal tax credits.*
[3] *Net of company tax credits.*
[4] *Includes money paid into the National Lottery Distribution Fund.*
[5] *Includes VAT and 'traditional own resources' contributions to EC budget. Cash basis.*

B44 After 2002-03, the projected growth in wages and salaries is marginally higher than assumed in Budget 2002. Slightly less of this growth is assumed to derive from employment growth and slightly more from growth in average earnings, mainly reflecting the results of the 2001 Census and new population projections. This increases the effective tax rate on wages and salaries, while the lower indexation factors used to uprate personal allowances and tax bands have a similar effect in 2004-05. The average tax rate is also assumed to recover slowly from the fall in 2002-03, as financial companies' profits recover from their current low levels. Mainly as a result of these effects, receipts at the end of the period are only about £$^3/_4$ billion a year lower than in Budget 2002.

Non-North Sea corporation tax

B45 Non-North Sea corporation tax receipts in 2002-03 are expected to be £26 billion, almost £4 billion lower than projected in Budget 2002. This downward revision is largely based on instalment payments received in July and October – the first and second instalments paid in respect of 2002 for companies with calendar year accounting periods, together with the first instalments in respect of 2002-03 for companies with fiscal year accounting periods. Much of the observed shortfall relates to financial companies as their instalment payments suggest that the companies' own estimates of their profitability in 2002 are around 20 per cent lower than assumed in Budget 2002. Most financial companies have calendar year accounting periods and the impact of transitional provisions associated with the Budget 1998 reforms, coupled with falling profits, means that receipts were particularly low in October 2002, and much lower than in October 2001. Receipts over the remainder of 2002-03 are likely to be only slightly lower than in the corresponding period in 2001-02.

B46 After 2002-03, non-financial company profits are assumed to recover to a slightly higher level than assumed in Budget 2002. Coupled with lower than previously projected interest payments and investment levels, this would result in slightly higher projected receipts. However, these effects are broadly offset by other fiscal forecasting changes reflecting new data, notably on the stock of capital allowances available to companies. Financial companies' profits are also projected to be much lower in 2003-04 than expected at the time of the Budget, but to recover over the projection period to slightly lower levels than assumed earlier in the year. As discussed in paragraph B36, lower equity prices will have adverse effects on life insurers' profits which derive largely from capital gains. Receipts from life insurers are therefore projected to be between £1 and £1½ billion a year lower than expected in Budget 2002. In total, non-oil corporation tax receipts are expected to be lower than in Budget 2002, by around £5¾ billion in 2003-04, and by declining amounts in later years.

Tax credits

B47 The tables in this section show the amounts of tax credits classified as negative tax in line with OECD Revenue Statistics guidelines (see paragraph B41). The public expenditure amounts are included in Table B17. Since Budget 2002, the estimated split of total tax credits between that scored as tax and that scored as public expenditure has been revised, with the negative tax element now about £2 billion a year higher from 2003-04 onwards. These revisions are balanced by changes in the public expenditure element of tax credits. Similar changes, though smaller and acting in the opposite direction, have been made to earlier years to reflect revisions to the negative tax - public expenditure split of WFTC. This has no overall impact on the current balance or net borrowing.

North Sea revenues

B48 North Sea revenues in 2002-03 are expected to be just under £5 billion, around £½ billion lower than forecast in Budget 2002, of which around half is North Sea corporation tax. Much of this reflects lower than expected production. The very different growth rates shown for petroleum revenue tax in Table B13 reflect the interactions between oil price changes and the payment regime. Oil prices were much lower in the second half of 2001 than in the first half, but the pattern reversed in 2002.

B49 The production forecast underlying the projection in future years is around 5 per cent lower than that underpinning the Budget projections, largely reflecting outturns this year. This accounts for much of the downward revision in projected revenues after this year. While the projections are based on a starting oil price of $25.10 – almost 15 per cent higher than in Budget 2002 – the projections for sterling have strengthened against the dollar by almost as much, leaving the sterling oil price little changed. As a result, the impact of oil price changes on receipts has been small.

Capital taxes

B50 Receipts of capital taxes are expected to be £4½ billion in 2002-03, marginally higher than projected in Budget 2002. Capital gains tax receipts in 2002-03 are based on gains realised in 2001-02, and are therefore unaffected by recent movements in asset prices. The upward revision largely reflects new information on tax receipts and also the mix of assets upon which chargeable gains are realised. Inheritance tax receipts respond to asset prices with a lag, so that recent changes in asset prices have little effect on receipts in 2002-03.

B51 In later years, capital tax receipts are about £¼ billion a year lower than in the Budget 2002 forecast. The impact of lower equity prices on inheritance tax is offset almost entirely by the effect of higher house prices, leaving projected receipts little changed since Budget 2002. However, the equity price changes have a bigger impact on capital gains tax than house price changes, because gains arising from the sale of main residences are exempt from tax. The full impact does not take effect until 2004-05, partly because the largest falls in share prices occurred part of the way through 2002-03, and partly because of the time lag before tax is paid.

Stamp duty

B52 Receipts of stamp duty are expected to be £8 billion in 2002-03, unchanged from Budget 2002. Around two-thirds of stamp duty receipts relate to land and property transactions; the remainder is derived from shares. The unchanged projection for 2002-03 partly reflects the offsetting nature of the changes in the assumptions for house prices and equity prices. The growth rate relative to 2001-02 is expected to increase in the latter part of 2002-03 because of the quarterly pattern of house price increases. Outturns for the year to date suggest that stamp duty on land has responded less strongly than would have been expected given the strength of house prices and transactions in the housing market. Commercial property accounts for about one third of the yield from land and property and prices in this sector have not risen nearly as fast as house prices. There is also some evidence that the prices of cheaper houses have risen more rapidly than more expensive ones, which, given the differing rates charged, has reduced the average tax rate. On the equity side, the volume of equity transactions observed so far in 2002-03 has been higher than expected, partly offsetting the effect of lower prices.

B53 Stamp duty receipts are also expected to be unchanged from Budget 2002 projections in 2003-04 and about £$^{1}/_{4}$ billion lower in 2004-05. The larger reduction relative to 2002-03 reflects the impact of a full year of lower equity prices, together with an assumption that housing and equity market transactions revert to more normal levels.

Social security contributions

B54 Receipts from social security contributions are expected to be just over £65 billion in 2002-03, around £$^{1}/_{2}$ billion higher than projected in Budget 2002. The bonus changes and other distributional effects described in paragraph B43 have less effect on national insurance contributions than on income tax collected under PAYE, and changes in the timing of personal pension repayments suggest that growth will be higher in the remaining months of 2002-03 than observed for April to October. In later years, the upward revision to the accrual in 2002-03 increases the projection slightly, as do the small increases in projected wages and salary growth compared with Budget 2002.

VAT receipts

B55 VAT receipts in 2002-03 are expected to be about £0.5 billion higher than projected in Budget 2002, largely reflecting stronger than expected receipts in the first half of the year. The forecast of VAT revenues from 2003-04 onwards continues to be governed by an NAO audited assumption, which stipulates that the ratio of VAT receipts to consumers' expenditure should decline gradually, by 0.05 percentage points a year, after the effects of VAT policy decisions are taken into account. This assumption, together with downward revisions to consumers' expenditure in 2003-04 and the upward revisions to receipts in 2002-03, has a broadly neutral effect on receipts in 2003-04 compared with Budget 2002. However, the combined effect increases VAT receipts in all other forecast years.

B56 The VAT forecast also takes into account additional VAT receipts resulting from the introduction of a new strategy for tackling VAT fraud and avoidance, which is expected to produce more than £2 billion a year in additional revenues by 2005-06. This is the Government's aim, but in line with the audited, cautious approach underlying the public finances, a lower figure of £1.4 billion a year by 2005-06 has been included in the public finance forecast. Scoring of any extra revenue in future forecasts will be subject to further evidence that the strategy is working. The strategy itself is described in Chapter 5, and in *Protecting indirect tax revenues*, published alongside this Pre-Budget Report.

Excise duties **B57** Excise duties in 2002-03 are expected to be around £0.3 billion lower than forecast in Budget 2002, and £0.9 billion lower than forecast in 2003-04. This is mainly due to a downward revision in the forecast for fuel duties of around £0.7 billion for 2002-03 and of about £0.9 billion for 2003-04. This partly reflects higher oil prices, lower GDP and lower forecasts for the RPI, which is used to uprate duty rates. Table B13 shows that although fuel duty receipts were only marginally higher in the first half of 2002-03 than in 2001-02, they are expected to be around 2 per cent higher for the year as a whole. This is because the current forecast for 2002-03 assumes that duty rates will be increased in line with inflation in March 2003, and that there will be corresponding forestalling by oil companies that will result in a surge in receipts in March 2003. There was no such behaviour in March 2002 because of the late Budget in 2002, and therefore receipts in the second half of 2002-03 are expected to be higher than in the second half of 2001-02.

B58 The impact of the revision to fuel duty receipts is partly offset by higher tobacco duties, which have been revised up in 2002-03 by around £0.4 billion, mainly on account of stronger than expected receipts in the first half of the year.

B59 The tobacco forecast is determined in part by an NAO audited assumption governing the proportion of additional revenue that should be included in the fiscal forecast resulting from HM Customs and Excise's tobacco anti-smuggling strategy. This assumption has been revised and now specifies that the forecast should take account of existing indirect effects, as well as direct effects. The revised assumption, combined with downward revisions to RPI figures and the impact of new indicative levels for bringing cigarettes and tobacco into the UK from the EU, results in projections that are close to Budget 2002 levels in 2003-04, and about £0.2 billion higher in later years. Alcohol duties are broadly as forecast in Budget 2002.

Other receipts **B60** Receipts from business rates in all years are expected to be around £0.5 billion lower than in Budget 2002, largely reflecting lower than expected net increases to rateable property values and lower indexation. The impact on total receipts is more than offset by higher than expected VAT refunds to central government and local authorities, although these refunds are balanced by offsetting changes in current expenditure.

PUBLIC EXPENDITURE

B61 Table B14 shows projections for public expenditure through to 2005-06, the last year covered by the 2002 Spending Review. The projections cover the whole of the public sector, using the National Accounts aggregate Total Managed Expenditure (TME). TME is split into Departmental Expenditure Limits (DEL) – firm three year limits for departments' programme spending – and Annually Managed Expenditure (AME) – spending that is not easily subject to firm multi-year limits.

B62 The 2002 Spending Review was the first to be conducted on a full resource basis. Resource accounting and budgeting (RAB) replaces the previous approach of planning and controlling public expenditure on a cash basis and applies the best financial and disclosure practices of commercial accounting to central government finances. Resource budgeting was introduced in two stages, and prior to the 2002 Spending Review budgets were set on a 'near cash' basis – a hybrid of resource budgeting and the previous cash management system. Table B14 tracks changes to DEL, AME and TME from Budget 2002 through the 2002 Spending Review to the projections set out in this Pre-Budget Report. As the table shows, the move to full resource budgeting does not affect TME, but does lead to changes within DEL and AME.

B63 The Pre-Budget Report is an interim report on the public finances. For this purpose, and in line with the usual convention, TME has been increased to accommodate the impact of policy decisions set out in Table B4 but otherwise remains unchanged.

Table B14: Public expenditure aggregates

	£ billion				
	Outturn	Projections			
	2001–02	2002–03	2003–04	2004–05	2005–06
Departmental Expenditure Limits (DEL)					
Budget 2002 – near cash basis[1]	211.8	229.5	249.1	—	—
2002 Spending Review – near cash basis	212.4	229.8	252.9	269.1	289.7
2002 Spending Review – resource based allocation	221.8	239.7	263.4	279.8	301.0
Changes since 2002 Spending Review	–0.2	1.6	3.1	3.4	3.6
PBR 2002	**221.5**	**241.3**	**266.5**	**283.2**	**304.6**
Annually Managed Expenditure (AME)					
Budget 2002 – near cash basis[1]	180.3	188.9	205.5	—	—
2002 Spending Review – near cash basis	177.7	188.6	201.7	212.4	221.7
2002 Spending Review – resource based allocation	168.3	178.7	191.2	201.7	210.4
Changes since 2002 Spending Review	2.0	–0.2	–3.0	–3.2	–3.4
PBR 2002	**170.3**	**178.5**	**188.2**	**198.5**	**207.0**
Total Managed Expenditure (TME)					
Budget 2002	392.1	418.4	454.6	481	511
2002 Spending Review	390.1	418.4	454.6	481.5	511.4
Changes since 2002 Spending Review	1.7	1.4	0.1	0.2	0.2
PBR 2002	**391.8**	**419.8**	**454.8**	**481.7**	**511.6**
Memo: PBR 2002 TME (per cent of money GDP)	*39.3*	*40.2*	*41.5*	*41.6*	*41.9*

[1] Figures for DEL and AME beyond 2003-04 were not published in Budget 2002.

B64 Departmental Expenditure Limits from 2003-04 to 2005-06 were set in the 2002 Spending Review. DEL for 2002-03 was set in the 2000 Spending Review. These plans have been adjusted to take account of changes to certain public sector pension schemes and other minor classification changes that have no impact on overall public spending. The only other changes to DEL are certain policy changes, as shown in Table B4, which are:

- the decision to reform the Landfill Tax Credit Scheme from April 2003;
- as in previous years, the underspend from 2001-02 has been carried forward and added to total DEL in 2002-03; and
- in 2002-03, the £1 billion special reserve addition.

B65 From 2003-04, departmental budgets will be controlled on a full resource budgeting basis, which means that the full economic cost of departmental activity will be recognised in budgets. Table B15 shows the Departmental Expenditure Limits for resource and capital budgets on this basis for the next three years, and restates budgets for 2001-02 and 2002-03 on the same basis. For 2001-02 and 2002-03, departmental expenditure is controlled on a near cash basis, and Table B16 shows outturn and plans on this basis. Both tables have been updated since the 2002 Spending Review to reflect transfers between departments and programmes.

B66 It is assumed in this Pre-Budget Report that the outturn for 2002-03 will equal total DEL plans. As in previous years it is assumed that, over the course of the year, underspends will offset the drawdown of end-year flexibility.

Table B15: Departmental Expenditure Limits – resource and capital budgets

	£ billion				
	Outturn		Plans		
	2001–02	2002–03	2003–04	2004–05	2005–06
Resource Budget					
Education and Skills	16.9	21.0	22.5	24.2	27.0
Health	50.8	56.7	63.0	68.5	74.7
of which: NHS	*49.5*	*54.1*	*60.9*	*66.7*	*72.9*
Transport	4.6	4.9	7.4	7.5	8.4
Office of the Deputy Prime Minister	2.8	4.6	4.7	5.1	5.3
Local Government	36.9	37.4	41.0	43.7	46.8
Home Office	10.4	10.4	11.7	12.0	12.7
Lord Chancellor's Departments	3.1	2.9	3.2	3.4	3.5
Attorney General's Departments	0.4	0.4	0.5	0.5	0.5
Defence	31.7	31.9	33.0	33.8	34.7
Foreign and Commonwealth Office	1.4	1.5	1.4	1.5	1.6
International Development	3.1	3.4	3.7	3.8	4.6
Trade and Industry	4.0	4.7	4.8	5.1	5.6
Environment, Food and Rural Affairs	2.4	2.7	2.7	2.7	2.8
Culture, Media and Sport	1.2	1.4	1.5	1.5	1.6
Work and Pensions[1]	6.5	7.6	7.9	8.0	8.1
Scotland[2]	16.0	17.1	18.4	19.4	20.7
Wales[2]	8.3	9.0	9.8	10.4	11.2
Northern Ireland Executive[2]	5.9	6.2	6.5	6.8	7.2
Northern Ireland Office	1.0	1.2	1.1	1.1	1.2
Chancellor's Departments	4.1	4.5	4.5	4.6	4.8
Cabinet Office	1.6	1.7	1.9	1.9	1.9
Invest to Save Budget	0.0	0.0	0.0	0.0	0.0
Capital Modernisation Fund	0.0	0.0	0.1	0.1	0.1
Policy Innovation Fund	0.0	0.0	0.0	0.0	0.0
Reserve	0.0	0.1	1.0	1.3	1.7
Special reserve addition	0.0	1.0	0.0	0.0	0.0
Allowance for shortfall[3]	0.0	–2.1	0.0	0.0	0.0
Total Resource Budget DEL	**213.0**	**230.2**	**252.4**	**267.1**	**286.7**
Capital Budget					
Education and Skills	2.1	2.5	3.3	3.8	4.4
Health	1.8	2.4	2.9	3.5	4.5
of which: NHS	*1.7*	*2.3*	*2.8*	*3.4*	*4.4*
Transport	2.4	3.6	3.4	3.7	3.4
Office of the Deputy Prime Minister	1.8	1.6	2.0	2.2	2.3
Local Government	0.1	0.3	0.3	0.3	0.3
Home Office	0.6	0.8	0.8	0.9	1.1
Lord Chancellor's Departments	0.1	0.1	0.1	0.1	0.1
Attorney General's Departments	0.0	0.0	0.0	0.0	0.0
Defence	5.5	5.9	6.0	6.3	6.9
Foreign and Commonwealth Office	0.1	0.1	0.1	0.1	0.1
International Development	0.0	0.0	0.0	0.0	0.0
Trade and Industry	0.2	0.5	0.4	0.2	0.1
Environment, Food and Rural Affairs	0.2	0.4	0.3	0.3	0.4
Culture, Media and Sport	0.0	0.1	0.1	0.1	0.1
Work and Pensions[1]	0.2	0.2	0.0	0.2	0.1
Scotland[2]	1.6	1.9	2.0	2.1	2.3
Wales[2]	0.5	0.7	0.8	0.9	1.0
Northern Ireland Executive[2]	0.4	0.3	0.4	0.5	0.5
Northern Ireland Office	0.0	0.1	0.1	0.1	0.1
Chancellor's Departments	0.2	0.3	0.2	0.3	0.3
Cabinet Office	0.2	0.2	0.2	0.2	0.2
Invest to Save Budget	0.0	0.0	0.0	0.0	0.0
Capital Modernisation fund	0.0	0.2	1.1	0.8	0.9
Policy Innovation Fund	0.0	0.0	0.0	0.0	0.0
Reserve	0.0	0.0	0.6	0.8	1.0
Allowance for shortfall[3]	0.0	–0.8	0.0	0.0	0.0
Total Capital Budget DEL	**18.1**	**21.3**	**25.2**	**27.6**	**30.1**
Depreciation	**–9.6**	**–10.1**	**–11.1**	**–11.5**	**–12.2**
Total Departmental Expenditure Limits	**221.5**	**241.3**	**266.5**	**283.2**	**304.6**
Total education spending	50.6	53.7	58.6	62.9	68.4

[1] Includes Welfare to Work expenditure financed by the Windfall Tax.

[2] For Scotland and Wales and Northern Ireland, the split between current and capital budgets is decided by the respective executives.

[3] It is assumed that over the year underspends in total will offset the drawdown of end-year flexibility.

Table B16: Departmental Expenditure Limits on a near cash basis – resource and capital budgets

	£ billion	
	Outturn 2001–02	Plan 2002–03
Resource Budget		
Education and Skills	16.5	20.2
Health	48.7	54.1
of which: NHS	*47.4*	*51.5*
Transport	2.8	2.9
Office of the Deputy Prime Minister	1.3	2.2
Local Government	36.9	37.4
Home Office	9.6	9.7
Lord Chancellor's Departments	2.9	2.7
Attorney General's Departments	0.4	0.4
Defence	18.9	19.0
Foreign and Commonwealth Office	1.2	1.3
International Development	3.1	3.4
Trade and Industry	3.6	3.8
Environment, Food and Rural Affairs	2.4	2.1
Culture, Media and Sport	1.0	1.2
Work and Pensions[1]	6.5	7.5
Scotland[2]	14.3	15.9
Wales[2]	7.5	8.3
Northern Ireland Executive[2]	4.9	5.3
Northern Ireland Office	1.0	1.1
Chancellor's Departments	3.9	4.2
Cabinet Office	1.3	1.4
Invest to Save Budget	0.0	0.0
Capital Modernisation Fund	0.0	0.0
Policy Innovation Fund	0.0	0.0
Reserve	0.0	0.1
Special reserve addition	0.0	1.0
Allowance for shortfall[3]	0.0	–1.9
Total Resource Budget DEL	**188.7**	**203.5**
Capital Budget		
Education and Skills	2.5	3.2
Health	1.9	2.5
of which: NHS	*1.8*	*2.4*
Transport	4.3	5.5
Office of the Deputy Prime Minister	2.6	3.4
Local Government	0.1	0.3
Home Office	0.8	0.9
Lord Chancellor's Departments	0.1	0.1
Attorney General's Departments	0.0	0.0
Defence	5.6	6.0
Foreign and Commonwealth Office	0.1	0.1
International Development	0.0	0.0
Trade and Industry	0.7	1.0
Environment, Food and Rural Affairs	0.5	0.6
Culture, Media and Sport	0.1	0.2
Work and Pensions[1]	0.2	0.2
Scotland[2]	2.2	2.6
Wales[2]	0.9	1.0
Northern Ireland Executive[2]	0.6	0.6
Northern Ireland Office	0.0	0.1
Chancellor's Departments	0.2	0.3
Cabinet Office	0.2	0.2
Invest to Save Budget	0.0	0.0
Capital Modernisation fund	0.0	0.2
Policy Innovation Fund	0.0	0.0
Reserve	0.0	0.0
Allowance for shortfall[3]	0.0	–1.0
Total Capital Budget DEL	**23.7**	**27.9**
Total Departmental Expenditure Limits	**212.3**	**231.4**
Total education spending	50.6	53.7

[1] Includes Welfare to Work expenditure financed by the Windfall Tax.

[2] For Scotland and Wales and Northern Ireland, the split between current and capital budgets is decided by the respective executives.

[3] It is assumed that over the year underspend in total will offset the drawdown of end-year flexibility.

Table B17: Total Managed Expenditure 2001-02 to 2005-06

	£ billion				
	Outturn		Projections		
	2001–02	2002–03	2003–04	2004–05	2005–06
Departmental Expenditure Limits					
Resource Budget	213.0	230.2	252.4	267.1	286.7
Capital Budget	18.1	21.3	25.2	27.6	30.1
less depreciation	–9.6	–10.1	–11.1	–11.5	–12.2
Total Departmental Expenditure Limits	**221.5**	**241.3**	**266.5**	**283.2**	**304.6**
Annually Managed Expenditure					
Social security benefits[1]	101.4	104.9	110.1	115.6	121.1
Tax credits[1]	8.6	10.0	11.7	12.3	12.7
Housing Revenue Account subsidies	4.5	4.3	4.2	4.2	4.1
Common Agricultural Policy	3.8	2.3	2.3	2.4	2.5
Net public service pensions	4.9	5.1	2.5	2.3	2.6
National Lottery	1.7	2.0	2.2	1.9	1.5
Non-cash items in AME	4.6	4.8	5.1	5.4	5.5
Other departmental expenditure	0.7	1.5	0.6	1.1	0.9
Net payments to EC institutions[2]	0.8	1.6	2.2	3.0	3.3
Locally financed expenditure	20.3	21.0	22.3	23.4	24.7
Central government gross debt interest	22.2	20.8	21.6	23.8	23.9
Public corporations' own-financed capital expenditure	1.9	2.5	2.8	2.6	2.7
Total AME before margin and accounting adjustments	**175.4**	**180.8**	**187.5**	**198.1**	**205.4**
AME margin	0.0	0.1	1.8	0.5	0.5
Accounting adjustments[3]	–5.1	–2.3	–1.1	–0.1	1.2
Annually Managed Expenditure	**170.3**	**178.5**	**188.2**	**198.5**	**207.0**
Total Managed Expenditure	**391.8**	**419.8**	**454.8**	**481.7**	**511.6**
of which:					
Public sector current expenditure	369.6	391.4	420.5	444.3	471.3
Public sector net investment	8.8	14.3	19.6	21.9	24.1
Public sector depreciation	13.4	14.1	14.7	15.4	16.2

[1] For 2001-02 to 2004-05, child allowances in Income Support and Jobseekers' Allowance, which, from 2003-04, are paid as part of the Child Tax Credit, have been included in the tax credits line and excluded from the social security benefits line. This is in order to give figures for both of these lines on a consistent definition over the forecast period.

[2] Net payments to EC Institutions exclude the UK's contribution to the cost of EC aid to non-Member States (which is attributed to the aid programme).

Net payments therefore differ from the UK's net contribution to the EC Budget, latest estimates for which are (in £ billion):

2001-02	2002-03	2003-04	2004-05	2005-06
1.5	2.4	3.1	3.6	3.9

The trended forecast for 2002-03 is £2.9 billion.

[3] Excludes depreciation.

B67 Table B17 shows Total Managed Expenditure from 2001-02 to 2005-06 and new projections for individual AME programmes. Excluding additional spending on measures from 2003-04 onwards and reclassifications between DEL and AME, total AME is unchanged from the Spending Review. In line with the convention adopted in previous Pre-Budget Reports, changes to AME programmes have been offset in the AME margin.

B68 The main economic assumptions underpinning projections of AME are set out in Table B3. In particular, it is assumed that UK claimant unemployment will increase slightly from its recent level of 0.94 million (the average of the three months ending in October) to 0.99 million in 2005-06, in line with the average of independent forecasts.

B69 Table B18 shows changes to DEL and AME since the 2002 Spending Review. Of these changes, £3.0 billion, £3.3 billion and £3.5 billion in 2003-04 to 2005-06 respectively are accounted for by switches of expenditure from AME to DEL, which have no net effect on TME. The major part of this switch reflects a change in the way employers in the teachers and NHS pension schemes are charged superannuation contributions. In future these charges will be based on the full cost of pensions (including price indexation) not just the basic pension as in the past. DEL has been increased to cover these higher charges, though these are offset by higher pension scheme receipts in AME. The remaining changes to DEL and AME reflect increases to TME as a result of the measures set out in Table B4.

Table B18: Changes in Total Managed Expenditure since the 2002 Spending Review

	£ billion				
	Outturn		Projections		
	2001–02	2002–03	2003–04	2004–05	2005–06
Departmental Expenditure Limits					
Resource Budget	–0.1	1.6	3.1	3.4	3.6
Capital Budget	–0.2	0.0	0.0	0.0	0.0
less depreciation	0.1	0.0	0.0	0.0	0.0
Total Departmental Expenditure Limits	**–0.2**	**1.6**	**3.1**	**3.4**	**3.6**
Annually Managed Expenditure					
Social security benefits	–0.4	–0.4	–0.5	–0.6	–0.1
Tax credits	0.3	0.6	–1.7	–1.8	–2.0
Housing Revenue Account subsidies	0.0	–0.3	–0.2	0.0	0.1
Common Agricultural Policy	–0.8	0.0	–0.1	0.0	0.0
Net public service pensions	0.4	0.0	–2.9	–3.4	–3.6
National Lottery	0.0	–0.3	–0.1	0.1	0.0
Non-cash items in AME	0.0	0.0	0.0	0.0	0.0
Other departmental expenditure	0.1	1.0	0.3	0.4	–0.1
Net payments to EC institutions	0.0	–0.6	–0.1	0.2	0.2
Locally financed expenditure	–0.2	0.2	0.3	0.2	0.2
Central government gross debt interest	0.0	–0.1	–1.4	0.9	1.1
Public corporations' own-financed capital expenditure	–0.1	0.2	0.5	0.6	0.8
Total AME before margin and accounting adjustments	**–0.8**	**0.3**	**–5.9**	**–3.5**	**–3.3**
AME margin	0.0	–1.2	0.8	–1.5	–2.5
Accounting adjustments[1]	2.8	0.7	2.2	1.8	2.5
Annually Managed Expenditure	**2.0**	**–0.2**	**–3.0**	**–3.2**	**–3.4**
Total Managed Expenditure	**1.7**	**1.4**	**0.1**	**0.2**	**0.2**

[1] *Excludes depreciation.*

B70 In 2001-02, TME was £1.7 billion higher than expected at the time of the 2002 Spending Review, with DEL £0.2 billion lower, and AME £2.0 billion higher. The total underspend on DEL in 2001-02 was £0.4 billion, taking into account reclassifications between DEL and AME.

B71 Changes to AME programmes reflect a combination of factors discussed below. With the exception of 2003-04, forecasts for AME programmes are higher than those published in the 2002 Spending Review. As total AME – excluding DEL/AME reclassifications and policy decisions – is unchanged, this results in a lower margin in each year than at the 2002 Spending Review. In 2003-04 expenditure on AME programmes is lower, resulting in an AME margin £0.8 billion higher than at the 2002 Spending Review.

B72 The social security expenditure forecast is lower than in the 2002 Spending Review. This reflects lower forecasts for inflation, which affect the uprating of benefits in 2003-04 and, in particular 2004-05, than at the Budget. Falling numbers of lone parents on benefits also contributes to the reduced forecast. However, these factors are increasingly offset over the forecast period by higher expenditure on the Minimum Income Guarantee/Pension Credit and Disability Living Allowance.

B73 Revisions to the breakdown of tax credits between negative tax and public expenditure, described in paragraph B47, mean that projected tax credit expenditure in AME is approximately £2 billion a year lower from 2003-04 to 2005-06 than expected at the time of the 2002 Spending Review.

B74 Compared with the Spending Review, central government gross debt interest payments are lower in 2002-03 and 2003-04 but higher in 2004-05 and 2005-06. The reduced forecast this year and next is mainly the result of lower market interest rate expectations and, in 2003-04, the impact of a lower accrued uplift on index-linked gilts due to a lower forecast for inflation. In the latter two years, the effect of lower interest rate expectations is offset by the effect of higher borrowing than forecast in Budget 2002.

B75 Public corporations' own-financed capital expenditure is higher than forecast at the time of the 2002 Spending Review. This is primarily because the London Underground Public Private Partnership is now expected to be included on London Underground's balance sheet and hence that projected investment under this project will count towards public sector net investment. Forecasts for other departmental expenditure are also higher, from 2002-03 to 2004-05, than in the 2002 Spending Review, due to increased projections of payments to former British Coal miners under the coal health compensation scheme.

B76 Increases to the accounting adjustments are mainly the result of higher forecasts for VAT refunded on general government expenditure, due to higher than expected outturn data for last year and for the year to date. Increased VAT refunds are offset by equivalent changes in receipts. The main accounting adjustments, which comprise those items within TME but outside DEL and AME main programmes, are shown in Table B19.

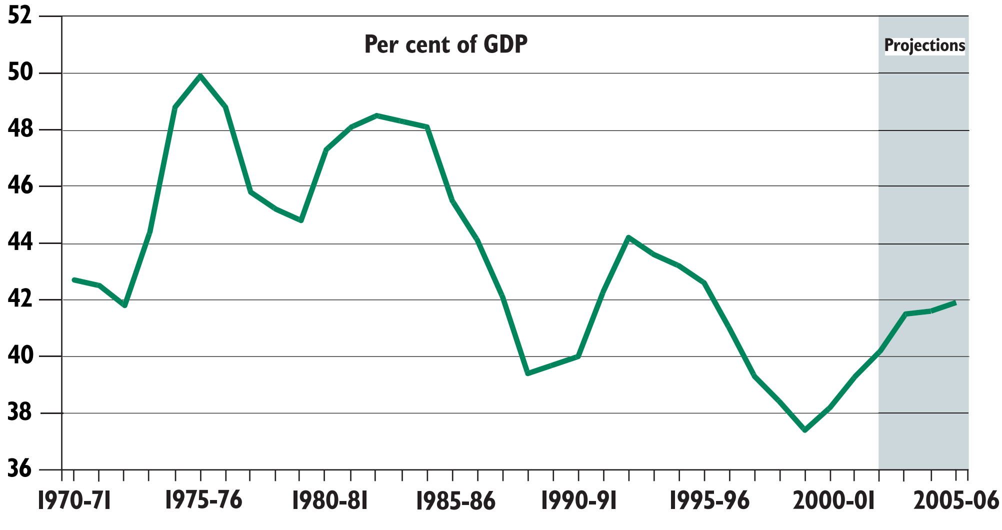
Table B19: Accounting adjustments

	£ billion				
	Outturn	Projections			
	2001–02	2002–03	2003–04	2004–05	2005-06
Removal of non-cash spending in DEL[1]	–11.2	–9.6	–10.3	–10.5	–11.1
Financial transactions in DEL	–1.7	–1.4	–1.7	–1.3	–1.4
Removal of non-cash spending in AME	–4.6	–4.8	–5.1	–5.4	–5.5
Financial transactions in AME	0.0	–0.5	0.3	0.3	0.7
Adjustments for public corporations	3.5	2.9	3.3	3.3	3.5
Central government non-trading capital consumption	8.3	8.7	9.1	9.5	10.0
VAT refunded on general government expenditure	7.8	9.0	10.0	10.7	11.6
EC contributions	–6.1	–4.7	–4.6	–4.3	–4.2
Tax credits	0.8	1.3	0.8	0.8	0.8
Intra-general government debt interest	–3.0	–3.4	–2.6	–2.9	–2.9
Other accounting adjustments	1.2	0.2	–0.2	–0.1	–0.3
Total accounting adjustments	**–5.1**	**–2.3**	**–1.1**	**–0.1**	**1.2**

[1] *Excluding depreciation in resource DEL.*

B77 Chart B4 shows TME as a per cent of GDP from 1970-71 to 2005-06.

Chart B4: Total Managed Expenditure



B78 Table B20 gives a breakdown of public sector capital expenditure.

Table B20: Public sector capital expenditure

	£ billion				
	Outturn		Projections		
	2001–02	2002–03	2003–04	2004–05	2005–06
Capital Budget DEL	18.1	21.3	25.2	27.6	30.1
Locally financed expenditure	1.7	1.8	1.7	1.7	1.6
National Lottery	0.9	1.0	1.1	1.0	0.6
Public corporations' own-financed capital expenditure	1.9	2.5	2.8	2.6	2.7
Other capital spending in AME	–0.4	1.9	3.3	4.4	5.3
AME margin	0.0	0.0	0.2	0.0	0.1
Public sector gross investment[1]	**22.2**	**28.4**	**34.3**	**37.3**	**40.3**
Less depreciation	13.4	14.1	14.7	15.4	16.2
Public sector net investment	**8.8**	**14.3**	**19.6**	**21.9**	**24.1**
Proceeds from the sale of fixed assets[2]	4.3	3.8	3.8	3.8	3.8

[1] *This and previous lines are all net of sales of fixed assets.*

[2] *Projections of total receipts from the sale of fixed assets by public sector.*

B79 Table B21 shows estimated receipts from loans and sales of assets from 2001-02 to 2005-06. The Government's existing credit facility for British Energy (BE) of £650 million will expire on 29 November 2002. The Secretary of State for Trade and Industry will therefore make an announcement about the outcome of the Government's discussions with the company shortly. The Government expects the loan facility to be managed within the planned totals for Departmental Expenditure Limits and the financial implications of any restructuring to be consistent with the forecast of the public finances and performance against the fiscal rules published in this Pre-Budget Report.

Table B21: Loans and sales of assets

	£ billion				
	Outturn		Projections		
	2001–02	2002–03	2003–04	2004–05	2005–06
Sales of fixed assets					
Central government	0.7	1.0	1.0	1.0	1.0
Local authorities	3.6	2.8	2.8	2.8	2.8
Total sales of fixed assets	**4.3**	**3.8**	**3.8**	**3.8**	**3.8**
Total loans and sales of financial assets	**–1.9**	**–2.8**	**–2.1**	**–1.8**	**–1.3**
Total loans and sales of assets	**2.4**	**0.9**	**1.6**	**1.9**	**2.4**

FINANCING REQUIREMENT

B80 Table B22 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 B22: Public sector net cash requirement

£ billion

	2001–02				2002–03			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing	**1.2**	**0.5**	**–0.5**	**1.2**	**17.0**	**1.8**	**1.3**	**20.1**
Financial transactions								
Net lending to private sector and abroad	2.5	0.2	–0.5	2.2	3.0	–0.1	0.0	2.9
Cash expenditure on company securities	–0.4	–0.3	0.1	–0.7	–0.1	0.0	0.0	–0.1
Accounts receivable/payable	0.5	–0.4	0.7	0.8	0.5	0.0	0.0	0.5
Adjustment for interest on gilts	–0.4	0.0	0.0	–0.4	–1.5	0.0	0.0	–1.5
Miscellaneous financial transactions	0.5	–0.3	0.3	0.5	–0.9	0.0	–0.3	–1.2
Own account net cash requirement	3.9	–0.4	0.1	3.6	17.9	1.7	1.1	20.7
Net lending within the public sector	–1.0	0.1	0.8	0.0	0.8	1.5	–2.3	0.0
Net cash requirement[1]	2.9	–0.3	0.9	3.6	18.7	3.2	–1.2	20.7

[1] *Market and overseas borrowing for local government and public corporation sectors.*

B81 Table B23 updates the financing arithmetic for 2002-03 to allow for the latest forecast of the central government net cash requirement. The Debt and Reserves Management Report 2002-03 (DRMR), published on 14 March 2002, outlined how the Government planned to finance its net financing requirement in 2002-03.

B82 The forecast for the central government net cash requirement for the financial year 2002-03 has now been revised up from £13.5 billion to £18.7 billion. In addition, National Savings and Investments have increased their forecast for their net contribution by £0.5 billion to minus £1.0 billion. This means that the net financing requirement for 2002-03 is now £37.1 billion, an increase of £5.0 billion from the forecast published in Budget 2002.

B83 In order to meet this increased financing requirement, the Debt Management Office's gilt remit has been revised and they are now instructed to:

- increase gross gilts issuance by £3.8 billion to £26.2 billion; and
- increase the planned rundown of their net cash position by a further £1.2 billion to £6.6 billion.

B84 Full details of these measures and a complete financing table for 2002-03 can be found on the Debt Management Office's website (www.dmo.gov.uk).

Table B23: Financing requirement forecast

	2002–03		
£ billion	Original remit[1] March 2002	Revised remit April 2002	Pre-Budget Report
Central government net cash requirement	**13.6**	**13.5**	**18.7**
Expected gilt redemptions	17.2	17.0	17.0
Debt buy-backs	0.0	0.0	0.3
Gross financing requirement	**30.8**	**30.5**	**36.0**
Less assumed net National Savings and Investments' contribution	–1.5	–1.5	–1.0
Less change in DMO balance at the Bank of England	0.0	–0.1	–0.1
Net financing requirement	**32.3**	**32.1**	**37.1**
Contingencies			
Less change in Ways and Means facility	0.0	0.0	0.0
Less increase in planned Treasury bill stock	4.3	4.3	4.3
Less change in other net short-term debt[2]	5.0	5.4	6.6
Planned gross gilt sales	**23.0**	**22.4**	**26.2**
Gilt sales to date (April-October 2002)			14.2
of which:			
Short conventionals (1-7 years)			3.0
Medium conventionals (7-15 years)			5.5
Long conventionals (>15 years)			2.2
Index-linked			3.5
Further planned gilt sales			
Short conventionals (1-7 years)			5.5
Medium conventionals (7-15 years)			0.0
Long conventionals (>15 years)			5.5
Index-linked			1.0

Note: Figures may not sum due to rounding.

[1] *The Debt and Reserves Management Report 2002-03 was published on 14 March 2002 in advance of Budget 2002 to comply with the Code for fiscal stability.*

[2] *Excluding DMO cash deposit at the Bank of England.*

ANALYSIS BY SUBSECTOR AND ECONOMIC CATEGORY

B85 Table B24 shows a breakdown of general government transactions by economic category for 2001-02 to 2005-06. Table B25 shows a more detailed breakdown for public sector transactions by sub-sector and economic category for 2001-02 to 2003-04.

Table B24: General government transactions by economic category

	£ billion				
	Outturn		Projections		
	2001–02	2002–03	2003–04	2004–05	2005–06
Current receipts					
Taxes on income and wealth	145.1	144.4	153.5	170.1	184.2
Taxes on production and imports	136.4	143.9	150.3	158.4	166.9
Other current taxes	18.3	19.7	21.1	22.6	24.3
Taxes on capital	2.4	2.4	2.6	2.9	3.1
Social contributions	63.5	64.5	77.0	81.4	85.8
Gross operating surplus	8.3	8.7	9.1	9.5	10.0
Rent and other current transfers	1.9	2.0	1.6	1.5	1.5
Interest and dividends from private sector and abroad	4.2	3.5	3.4	4.1	4.2
Interest and dividends from public sector	7.0	7.2	7.5	7.9	8.1
Total current receipts	**387.2**	**396.5**	**426.0**	**458.5**	**488.1**
Current expenditure					
Current expenditure on goods and services	197.8	211.5	227.7	241.4	259.6
Subsidies	6.0	6.1	6.9	6.9	7.6
Net social benefits	125.1	130.2	136.6	142.9	149.2
Net current grants abroad	–1.9	–0.4	–0.7	–0.8	–0.5
Other current grants	19.9	22.7	26.4	29.2	30.7
Interest and dividends paid	22.5	21.1	21.9	24.1	24.2
AME margin	0.0	0.1	1.6	0.4	0.3
Total current expenditure	**369.5**	**391.3**	**420.3**	**444.2**	**471.0**
Depreciation	8.3	8.7	9.1	9.5	10.0
Surplus on current budget	**9.4**	**–3.5**	**–3.4**	**4.8**	**7.0**
Capital expenditure					
Gross domestic fixed capital formation	11.6	16.1	20.4	23.5	25.3
Less depreciation	–8.3	–8.7	–9.1	–9.5	–10.0
Increase in inventories	0.0	0.7	0.6	0.4	0.6
Capital grants (net) within public sector	1.8	0.6	0.5	0.4	0.4
Capital grants to private sector	6.9	7.0	9.0	9.8	10.6
Capital grants from private sector	–0.9	–0.5	–0.7	–0.6	–0.6
AME margin	0.0	0.0	0.2	0.0	0.1
Net investment	**11.1**	**15.2**	**21.0**	**24.0**	**26.4**
Net borrowing[1]	**1.7**	**18.7**	**24.4**	**19.2**	**19.4**
of which:					
Central government net borrowing	1.2	17.0	22.7	17.5	18.1
Local authority net borrowing	0.5	1.8	1.6	1.7	1.3

[1] *Although this is based on the ESA95 definition of general government net borrowing (GGNB), the forecasts are identical to GGNB calculated on a Maastricht definition.*

Table B25: Public sector transactions by sub-sector and economic category

	£ billion			
	2001–02			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	145.1	0.0	–0.1	145.1
Taxes on production and imports	136.3	0.2	0.0	136.4
Other current taxes	3.0	15.3	0.0	18.3
Taxes on capital	2.4	0.0	0.0	2.4
Social contributions	63.5	0.0	0.0	63.5
Gross operating surplus	4.6	3.7	9.4	17.7
Rent and other current transfers	1.9	0.0	0.6	2.5
Interest and dividends from private sector and abroad	3.4	0.7	0.5	4.7
Interest and dividends from public sector	5.7	1.3	–7.0	0.0
Total current receipts	**366.0**	**21.2**	**3.5**	**390.7**
Current expenditure				
Current expenditure on goods and services	120.5	77.2	0.0	197.8
Subsidies	5.1	0.9	0.0	6.0
Net social benefits	113.2	11.9	0.0	125.1
Net current grants abroad	–1.9	0.0	0.0	–1.9
Current grants (net) within public sector	72.4	–72.4	0.0	0.0
Other current grants	19.9	0.0	0.0	19.9
Interest and dividends paid	22.2	0.3	0.1	22.6
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**351.5**	**18.0**	**0.1**	**369.6**
Depreciation	4.6	3.7	5.1	13.4
Surplus on current budget	**9.8**	**–0.4**	**–1.7**	**7.7**
Capital expenditure				
Gross domestic fixed capital formation	4.6	7.0	4.3	15.9
Less depreciation	–4.6	–3.7	–5.1	–13.4
Increase in inventories	0.0	0.0	0.1	0.0
Capital grants (net) within public sector	5.7	–3.9	–1.8	0.0
Capital grants to private sector	5.8	1.1	0.3	7.2
Capital grants from private sector	–0.4	–0.5	0.0	–0.9
AME margin	0.0	0.0	0.0	0.0
Net investment	**11.0**	**0.1**	**–2.3**	**8.8**
Net borrowing	**1.2**	**0.5**	**–0.5**	**1.2**

Table B25: Public sector transactions by sub-sector and economic category

£ billion 2002–03 General government Central government	Local authorities	Public corporations	Public sector	
				Current receipts
144.4	0.0	–0.2	144.3	Taxes on income and wealth
143.7	0.2	0.0	143.9	Taxes on production and imports
3.1	16.6	0.0	19.7	Other current taxes
2.4	0.0	0.0	2.4	Taxes on capital
64.5	0.0	0.0	64.5	Social contributions
4.9	3.8	9.4	18.1	Gross operating surplus
2.0	0.0	0.7	2.7	Rent and other current transfers
2.9	0.6	0.6	4.1	Interest and dividends from private sector and abroad
6.0	1.3	–7.2	0.0	Interest and dividends from public sector
374.0	**22.5**	**3.2**	**399.7**	**Total current receipts**
				Current expenditure
128.9	82.6	0.0	211.5	Current expenditure on goods and services
5.2	0.9	0.0	6.1	Subsidies
118.0	12.2	0.0	130.2	Net social benefits
–0.4	0.0	0.0	–0.4	Net current grants abroad
77.4	–77.4	0.0	0.0	Current grants (net) within public sector
22.7	0.0	0.0	22.7	Other current grants
20.8	0.3	0.1	21.2	Interest and dividends paid
0.1	0.0	0.0	0.1	AME margin
372.6	**18.6**	**0.1**	**391.4**	**Total current expenditure**
4.9	3.8	5.4	14.1	Depreciation
–3.5	**0.0**	**–2.2**	**–5.7**	**Surplus on current budget**
				Capital expenditure
5.7	10.3	5.1	21.2	Gross domestic fixed capital formation
–4.9	–3.8	–5.4	–14.1	*Less* depreciation
0.7	0.0	0.0	0.7	Increase in inventories
6.1	–5.5	–0.6	0.0	Capital grants (net) within public sector
5.8	1.2	0.0	7.0	Capital grants to private sector
0.0	–0.5	0.0	–0.5	Capital grants from private sector
0.0	0.0	0.0	0.0	AME margin
13.5	**1.7**	**–0.9**	**14.3**	**Net investment**
17.0	**1.8**	**1.3**	**20.1**	**Net borrowing**

Table B25: Public sector transactions by sub-sector and economic category

	£ billion			
	2003–04			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	153.5	0.0	–0.2	153.3
Taxes on production and imports	150.1	0.2	0.0	150.3
Other current taxes	3.4	17.8	0.0	21.1
Taxes on capital	2.6	0.0	0.0	2.6
Social contributions	77.0	0.0	0.0	77.0
Gross operating surplus	5.1	4.0	10.5	19.6
Rent and other current transfers	1.6	0.0	0.7	2.3
Interest and dividends from private sector and abroad	2.8	0.6	0.7	4.1
Interest and dividends from public sector	5.1	2.4	–7.5	0.0
Total current receipts	**401.1**	**24.9**	**4.3**	**430.3**
Current expenditure				
Current expenditure on goods and services	138.3	89.4	0.0	227.7
Subsidies	5.9	1.0	0.0	6.9
Net social benefits	123.7	12.9	0.0	136.6
Net current grants abroad	–0.7	0.0	0.0	–0.7
Current grants (net) within public sector	83.5	–83.5	0.0	0.0
Other current grants	26.4	0.0	0.0	26.4
Interest and dividends paid	21.6	0.3	0.1	22.0
AME margin	1.6	0.0	0.0	1.6
Total current expenditure	**400.2**	**20.2**	**0.1**	**420.5**
Depreciation	5.1	4.0	5.6	14.7
Surplus on current budget	**–4.1**	**0.7**	**–1.5**	**–4.9**
Capital expenditure				
Gross domestic fixed capital formation	8.2	12.2	4.7	25.2
Less depreciation	–5.1	–4.0	–5.6	–14.7
Increase in inventories	0.6	0.0	0.0	0.6
Capital grants (net) within public sector	7.0	–6.5	–0.5	0.0
Capital grants to private sector	7.7	1.3	0.0	9.0
Capital grants from private sector	0.0	–0.7	0.0	–0.7
AME margin	0.2	0.0	0.0	0.2
Net investment	**18.6**	**2.4**	**–1.4**	**19.6**
Net borrowing	**22.7**	**1.6**	**0.1**	**24.5**

Table B26: Historical series of public sector balances, receipts and debt

	Per cent of GDP									
	Public sector current budget	Public sector net borrowing	Cyclically adjusted public sector net borrowing	Public sector net cash requirement	General government net borrowing[1]	Net taxes and social security contributions	Public sector current receipts	Public sector net debt[2]	General government gross debt[3]	Public sector net worth[4]
1970–71	6.7	–0.6	–0.8	1.2	–2.1		43.3			
1971–72	4.2	1.1	0.5	1.4	–0.7		41.4			
1972–73	2.0	2.8	2.7	3.6	2.2		39.0			
1973–74	0.3	4.9	5.7	5.9	4.4		39.5			
1974–75	–1.1	6.6	7.2	9.0	4.1		42.3	52.1	60.4	
1975–76	–1.6	7.0	6.5	9.3	4.8		42.9	53.9	58.7	
1976–77	–1.2	5.5	4.8	6.4	4.1		43.3	52.4	59.1	
1977–78	–1.4	4.3	3.8	3.7	3.6		41.5	49.0	57.1	
1978–79	–2.6	5.0	4.8	5.2	4.3	33.3	40.2	47.1	56.2	
1979–80	–1.9	4.1	4.0	4.7	3.0	33.9	40.7	43.9	51.8	
1980–81	–3.0	4.9	2.9	5.2	3.8	35.8	42.4	46.1	52.9	
1981–82	–1.4	2.3	–1.7	3.3	3.3	37.8	45.8	46.1	51.7	
1982–83	–1.5	3.0	–1.1	3.2	3.1	38.0	45.5	44.8	50.4	
1983–84	–2.0	3.8	0.6	3.2	3.8	38.2	44.5	45.3	50.4	
1984–85	–2.2	3.7	1.0	3.1	3.3	38.9	44.4	45.2	50.3	
1985–86	–1.2	2.4	0.9	1.6	2.6	38.1	43.1	43.4	49.5	
1986–87	–1.4	2.1	1.9	0.9	2.3	37.8	42.0	41.1	48.9	
1987–88	–0.3	1.0	2.1	–0.7	1.3	37.6	41.1	36.8	46.5	75.8
1988–89	1.7	–1.3	1.2	–3.0	–0.9	36.9	40.7	30.6	40.6	81.8
1989–90	1.4	–0.2	2.5	–1.3	0.3	36.2	39.9	27.7	35.5	73.5
1990–91	0.4	1.0	2.6	–0.1	1.4	36.3	39.0	26.2	33.3	62.3
1991–92	–1.9	3.8	3.3	2.3	3.7	35.0	38.6	27.4	34.4	54.5
1992–93	–5.6	7.6	5.5	5.9	7.4	34.0	36.6	32.0	40.6	42.1
1993–94	–6.2	7.8	5.5	7.1	7.8	33.0	35.8	37.1	45.9	27.9
1994–95	–4.8	6.3	4.9	5.3	6.5	34.1	36.9	40.8	49.4	26.7
1995–96	–3.4	4.8	4.1	4.3	5.0	34.9	37.8	42.8	51.9	18.6
1996–97	–3.0	3.7	3.2	2.9	3.9	34.9	37.4	43.7	52.1	14.7
1997–98	–0.2	0.8	0.8	0.1	0.9	36.1	38.5	41.5	49.1	10.6
1998–99	1.2	–0.5	–0.2	–0.8	–0.5	36.5	38.8	39.2	46.3	10.2
1999–00	2.2	–1.7	–1.4	–0.9	–1.7	36.5	39.1	36.2	43.2	15.1
2000–01	2.2	–1.7	–1.2	–3.9	–1.7	37.4	39.8	31.2	39.9	21.3
2001–02	0.8	0.1	0.2	0.4	0.2	37.1	39.2	30.4	38.2	26.5

[1] *UK National Accounts definition.*
[2] *At end-March; GDP centred on end-March.*
[3] *Maastricht measure from 1993.*
[4] *At end-December; GDP centred on end-December.*

Table B27: Historical series of government expenditure

	£ billion (2001-02 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	161.2	30.3	49.5	210.8	32.6	6.1	10.0	42.7
1971-72	168.6	26.7	46.4	215.0	33.3	5.3	9.2	42.5
1972-73	176.3	25.7	46.4	222.7	33.1	4.8	8.7	41.8
1973-74	193.8	28.9	52.1	245.9	35.0	5.2	9.4	44.4
1974-75	214.2	30.5	55.4	269.6	38.8	5.5	10.0	48.8
1975-76	219.0	29.9	55.0	274.0	39.9	5.5	10.0	49.9
1976-77	225.0	24.4	50.4	275.4	39.9	4.3	8.9	48.8
1977-78	221.6	16.6	42.5	264.2	38.4	2.9	7.4	45.8
1978-79	228.3	14.4	41.0	269.3	38.4	2.4	6.9	45.2
1979-80	234.0	13.4	40.3	274.3	38.2	2.2	6.6	44.8
1980-81	240.8	10.7	38.0	278.8	40.8	1.8	6.4	47.3
1981-82	251.7	5.5	32.6	284.3	42.6	0.9	5.5	48.1
1982-83	257.5	9.0	35.3	292.8	42.7	1.5	5.9	48.5
1983-84	265.7	11.2	37.3	303.1	42.3	1.8	5.9	48.3
1984-85	273.1	9.8	34.7	307.9	42.6	1.5	5.4	48.1
1985-86	273.1	8.3	30.4	303.5	41.0	1.2	4.6	45.5
1986-87	277.0	4.9	27.4	304.5	40.1	0.7	4.0	44.1
1987-88	280.7	4.8	25.6	306.3	38.6	0.7	3.5	42.1
1988-89	274.4	2.7	24.2	298.5	36.2	0.4	3.2	39.4
1989-90	276.2	9.2	30.8	307.0	35.7	1.2	4.0	39.7
1990-91	277.9	11.1	30.0	307.9	36.1	1.4	3.9	40.0
1991-92	294.6	14.1	30.1	324.7	38.4	1.8	3.9	42.3
1992-93	309.3	15.4	30.3	339.6	40.3	2.0	3.9	44.2
1993-94	319.6	12.6	27.2	346.8	40.1	1.6	3.4	43.6
1994-95	330.8	12.5	27.5	358.3	39.9	1.5	3.3	43.2
1995-96	335.9	12.0	27.2	363.0	39.4	1.4	3.2	42.6
1996-97	339.2	6.0	20.1	359.3	38.7	0.7	2.3	41.0
1997-98	336.6	5.4	19.0	355.6	37.2	0.6	2.1	39.3
1998-99	336.5	6.4	19.9	356.4	36.2	0.7	2.1	38.4
1999-00	341.0	4.6	17.8	358.8	35.6	0.5	1.9	37.4
2000-01	356.1	5.5	18.8	375.0	36.3	0.6	1.9	38.2
2001-02	369.6	8.8	22.2	391.8	37.0	0.9	2.2	39.3

[1] *Net of sales of fixed assets.*

LIST OF ABBREVIATIONS

ABI	Association of British Insurers
ALSF	Aggregates Levy Sustainability Fund
AME	Annually Managed Expenditure
APD	Air passenger duty
BCC	British Chambers of Commerce
BID	Business Improvement District
BPZ	Business Planning Zone
BRC	British Retail Consortium
CABE	Commission for Architecture and the Built Environment
CBI	Confederation of British Industry
CCL	Climate change levy
CEML	Council for Excellence in Management and Leadership
CEO	Chief Executive Officer
CGAA	Coordinating Group on Audit and Accounting Issues
CGNCR	Central government net cash requirement
CGT	Capital gains tax
CNG	Compressed Natural Gas
CHAI	Commission for Healthcare Audit and Inspection
CITC	Community Investment Tax Credit
CPA	Comprehensive Performance Assessment
CTF	Child Trust Fund
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
DIS	Departmental Investment Strategy
DPTC	Disabled Person's Tax Credit
DTI	Department of Trade and Industry
DTLR	Department for Transport, Local Government and the Regions
DVLA	Driver and Vehicle Licensing Agency
ECA	Enhanced capital allowance
EEF	Engineering Employers' Federation
ELCI	Employers' Liability Compulsory Insurance
EMA	Education Maintenance Allowance
EMU	Economic and Monetary Union
ETS	Emissions Trading Scheme
EU	European Union
EYF	End-year flexibility

FSA	Financial Services Authority
G7	Group of Seven. A group of seven major industrial countries (comprising: Canada, France, Germany, Italy, Japan, UK and US).
GAD	Government Actuary's Department
GCSE	General Certificate of Secondary Education
GDP	Gross domestic product
HEIF	Higher Education Innovation Fund
HICP	Harmonised index of consumer prices
HIPC	Heavily Indebted Poor Countries
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome
ICT	Information and communications technologies
IFF	International Financing Facility
ILO	International Labour Organisation
IMF	International Monetary Fund
ISA	Individual Savings Account
JRRP	Job Retention and Rehabilitation Pilot
LCD	Lord Chancellor's Department
LEA	Local Education Authority
LFE	Locally-financed expenditure
LIG	Leadership Investment Grant
LFS	Labour Force Survey
LPG	Liquefied petroleum gas
LSC	Learning and Skills Council
LSP	Local Strategic Partnership
LTCS	Landfill Tax Credit Scheme
MA	Modern Apprenticeship
MDGs	Millennium Development Goals
MIG	Minimum Income Guarantee
MPC	Monetary Policy Committee
MtC	Million tonnes of carbon
NAO	National Audit Office
NDDP	New Deal for disabled people
NDLP	New Deal for lone parents
NDYP	New Deal for young people
ND25+	New Deal for those aged 25 and over
ND50+	New Deal for the over 50s
NHS	National Health Service
NICs	National insurance contributions

NIESR	National Institute of Economic and Social Research
NVQ	National Vocational Qualification
ODPM	Office of the Deputy Prime Minister
OECD	Organisation for Economic Cooperation and Development
OFSTED	Office for Standards in Education
OFT	Office of Fair Trading
OGC	Office of Government Commerce
ONS	Office for National Statistics
OPEC	Organisation of Petroleum Exporting Countries
PAYE	Pay as You Earn
PBR	Pre-Budget Report
PCT	Primary Care Trust
PFI	Private Finance Initiative
PPP	Public Private Partnership
PSA	Public Service Agreement
PSNB	Public sector net borrowing
PSNI	Public sector net investment
RAB	Resource accounting and budgeting
R&D	Research and development
RDA	Regional Development Agency
RPIX	Retail Price Index excluding mortgage interest payments
SBS	Small Business Service
SCI	Street Crime Initiative
SME	Small and medium-sized enterprise
SMP	Statutory Maternity Pay
SRO	Scientific research organisation
SSG	School Standards Grant
TME	Total Managed Expenditure
TUC	Trades Union Congress
ULSD	Ultra-low sulphur diesel
ULSP	Ultra-low sulphur petrol
UN	United Nations
URC	Urban Regeneration Company
VAT	Value added tax
VED	Vehicle excise duty
WFTC	Working Families' Tax Credit
WTAS	Windfall Tax and associated spending

LIST OF CHARTS

B1	Public sector net debt and net worth
B2	Cyclically-adjusted surplus on current budget
B3	Tax-GDP ratio
B4	Total Managed Expenditure

LIST OF TABLES

Printed in the UK by The Stationery Office Limited
On behalf of the Controller of Her Majesty's Stationery Office
ID 122601 786386 19585