HM TREASURY

Opportunity for all:

The strength to take the long-term decisions for Britain

Pre-Budget Report

December 2004

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

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

CONTENTS

1 OVERVIEW

The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. Ensuring opportunity for all in the global economy requires taking long-term decisions to promote flexibility, enterprise and fairness in the economy, including through Government investing for the long term.

The 2004 Pre-Budget Report, *Opportunity for all: The strength to take the long-term decisions for Britain*, presents updated assessments and forecasts of the economy and public finances, reports on how the Government's policies are helping to deliver its long-term goals and describes the reforms the Government is considering ahead of Budget 2005 and on which it will be consulting in the months ahead. The Pre-Budget Report:

- **shows that the economy is growing strongly and that the Government is meeting its strict fiscal rules for the public finances;**
- **announces a ten-year strategy for childcare, setting out the Government's vision of affordable, flexible, high-quality childcare for all parents who need it; an extension of paid maternity leave to nine months from April 2007; and improvements to the childcare element of the Working Tax Credit;**
- **gives employers the opportunity to access free and flexibly delivered training for their low skilled employees through a National Employer Training Programme, and new measures under the New Deal for skills;**
- **introduces reforms to reduce the regulatory burden on enterprise and welcomes the publication of the interim report of the Hampton Review consulting on improvements to the current system of regulatory inspection and enforcement;**
- **announces a payment of £50 to households with someone aged over 70, to help with council tax and other living expenses;**
- **takes further steps to extend employment opportunity for all, by introducing measures to help people on incapacity benefits who want to return to work, including a major expansion of the successful Pathways to Work Pilots;**
- **allocates a further £520 million to the special reserve for 2004-05 for military operations in Iraq and the UK's other international obligations, and additional resources for counter-terrorism and resilience;**
- **promotes fairness in the tax system through a range of measures to tackle avoidance; and**
- **announces the continuation of the freeze on main road fuel duties, in response to the sustained volatility in the oil market.**

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

1.2 The long-term decisions the Government has taken – giving independence to the Bank of England, new fiscal rules and a reduction in debt – have created a strong platform of economic stability. Over the past four years, many industrialised countries have suffered economic downturns, including the US and much of the euro area. More recently, the international economy has been affected by geopolitical uncertainty, rising oil prices and large current account imbalances and shifting exchange rates between Europe, Asia and the US. The UK has grown continuously throughout this period of global economic uncertainty and continues its longest unbroken expansion since quarterly national accounts data began 50 years ago, with GDP now having grown for 49 consecutive quarters.

1.3 To continue to prosper in the coming decades the UK must meet the long-term challenges of the rapidly evolving global economy. As described in Box 1.1 and in *Long-term global economic challenges and opportunities for the UK*, published today alongside the Pre-Budget Report, the international economy is becoming increasingly integrated through greater cross-border trade and investment, driven in part by rapid advances in technology. Emerging market economies are growing strongly, particularly China and India, and are developing skilled workforces. Within the next twenty years, half the world's manufactured exports could come from developing countries.

Meeting the challenges of the global economy

1.4 The Government is committed to taking the long-term decisions that will ensure the UK will meet these challenges, by entrenching macroeconomic stability and by building a flexible, enterprising economy with a highly-skilled, high-productivity workforce and a strong science and innovation sector. This requires investment by Government in the country's long-term future, and the public and private sectors working together to meet the challenges facing the UK economy. Fairness must go alongside flexibility, providing security and support for those that need it and ensuring that everyone has the opportunity to fulfil their potential. The Pre-Budget Report describes the action the Government is taking to address the key policy challenges identified in *Long-term global economic challenges and opportunities for the UK*, which will ensure the UK can prosper in the changing global economy, through:

- **maintaining macroeconomic stability** in a more integrated global economy where shocks in one part of the world can be rapidly transmitted to other regions, and ensuring fiscal sustainability in the face of the long-term demographic changes facing all developed economies. Stability allows business and individuals to plan for the long term and ensures the UK will remain an attractive destination for foreign investment;
- **promoting enterprise and competition** to create a business environment that is the best in the world, from which firms are able to succeed in the more open and competitive global economy;
- **enhancing science and innovation** through the public and private sectors working together to make the UK one of the leading countries in the world for turning science into business innovation. Countries at the forefront of research and innovation will be best placed to move into high value-added, technology driven areas, which can provide new sources of growth;
- **improving workforce skills** by investing in the education that individuals and the country need to prosper and by enabling all adults to update and enhance their skills. Higher level skills will increase the UK's ability to benefit from technological advances and become more productive. It will also increase the ability of both employers and employees to adapt to the changing demands of the UK economy;
- **ensuring fairness** by providing security for people when they need it and support to return to the labour market. In the global economy, the pace of economic change will be ever quicker and more intense. This has great potential benefits but also means that there may be transitional impacts for individuals and firms, as labour and capital are redeployed; and
- **addressing global environmental challenges, such as climate change**, by increasing the energy and resource efficiency of the economy and by speeding up the commercialisation of low-carbon energy sources. Tackling global environmental issues, notably climate change, requires engagement with international partners to secure effective multilateral action.

Box 1.1: Meeting the challenges of the global economy

Long-term global economic challenges and opportunities for the UK, published alongside this Pre-Budget Report, examines the economic challenges facing the global economy and policy priorities for the UK over the next ten years. The global economy is experiencing a period of rapid and far-reaching change. Many emerging markets are growing strongly and their workforces are developing higher skills levels and becoming more productive. International trade and investment is growing and production is becoming increasingly fragmented, as companies locate different parts of the production process where costs are lowest. This is facilitated in part by the rapid rate of technological advance. These trends mean that the next ten years and beyond will be ones of fundamental change in the global economy:

- the balance of global economic activity will probably shift significantly. By 2015, China is likely to have become the world's third largest economy after the US and Japan; and if current growth rates are sustained, the Indian economy will have doubled in size. These two countries between them account for almost one-third of the world's population;
- cross-border trade and investment flows are likely to continue to grow as markets are liberalised and technological advance allows the production of ever more goods and services to be located away from final markets. Emerging markets are likely to become increasingly important destinations and sources of foreign direct investment;
- as communication and technology continue to improve, so production processes are becoming increasingly flexible, dispersed across continents and with an increasing level of specialisation. More services such as accountancy, banking and IT servicing will be processed remotely in offshore centres;
- rapid advances in technology mean there will be increasing rewards from innovation. Countries at the forefront of research and innovation will be best placed to move into high value-added, technology driven areas, which can provide new sources of growth;
- workforce skills in emerging economies are likely to rise – China and India already each produce around 2 million graduates a year, compared to around 250,000 in the UK. By 2015, this will translate into huge increases in the stock of skilled human capital in these countries; and
- the growing global economy will put increasing pressure on the world's resources, such as energy, commodities, water and the environment. By 2015, the share of energy demand from developing countries is expected to rise to around half of total international demand.

These developments are both a great opportunity and a great challenge for the UK and the global economy. The emergence of India and China has the potential to lift hundreds of millions of people out of poverty. Alongside increasing international competition and technological advance it will also provide new opportunities for developed economies. Countries that are flexible, skilled and innovative will prosper in this changing global economy. The challenge for the UK is to seize these opportunities by drawing on its strengths and confronting historical weaknesses. This Pre-Budget Report sets out the action the Government is taking now to ensure the UK will meet these long-term challenges.

MAINTAINING MACROECONOMIC STABILITY

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

The policy framework

1.6 The Government's macroeconomic framework is based on the principles of transparency, responsibility and accountability, and is designed to ensure lasting stability so that businesses, individuals and the Government may plan effectively for the long term. The Bank of England has operational independence to meet the Government's symmetrical inflation target. Fiscal policy is underpinned by clear objectives and two strict rules which ensure sound public finances over the medium term. The fiscal rules underpin the Government's public spending framework which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes.

Economic prospects

1.7 Over the past four years, many industrialised countries have suffered economic downturns, including the US and much of the euro area. More recently, the international economy has been affected by geopolitical uncertainty, rising oil prices and large current account imbalances and shifting exchange rates between Europe, Asia and the US. The UK has grown continuously throughout this period of global economic uncertainty and it continues its longest unbroken expansion since quarterly national accounts data began 50 years ago, with GDP now having grown for 49 consecutive quarters.

1.8 Sound macroeconomic fundamentals, recent strong growth rates and continued growth in the world economy point to a further period of relatively strong growth in demand for UK output. UK GDP is expected to grow by $3^1/_4$ per cent in 2004, in line with the Budget 2004 forecast and up from 2.2 per cent last year. Growth is forecast to remain within the 3 to $3^1/_2$ per cent range for 2005 as a whole. By early 2006, the output gap is forecast to have closed and GDP growth is expected to be back to trend rates.

The public finances

1.9 The Pre-Budget Report provides updated projections for the public finances. These represent an interim forecast update and are based on a series of cautious audited assumptions that help to build a margin against unexpected events. The projections for the public finances take into account all firm decisions announced in this Pre-Budget Report, consistent with the requirements of the *Code for fiscal stability*. Table 1.2 lists the key Pre-Budget Report policy decisions and their impact on the public finances. Further details are set out in Annex B .

The fiscal rules

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

- the current budget since the start of the current economic cycle in 1999-2000 shows an average annual surplus up to 2005-06 of 0.1 per cent of GDP and the Government is therefore meeting the golden rule on the basis of cautious assumptions. There is a margin against the golden rule of £8 billion in this cycle, including the Annually Managed Expenditure (AME) margin. The current budget returns to balance by 2006-07, and the cyclically-adjusted current budget in the cautious case moves into surplus by the end of the projection period; and

- public sector net debt is projected to remain low and stable over the forecast period, stabilising at around 37 per cent of GDP in 2009-10, well below the 40 per cent ceiling set in the sustainable investment rule.

Table 1.1: Meeting the fiscal rules

	Per cent of GDP						
	Outturn[1]	Estimate	Projections				
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009-10
Golden rule							
Surplus on current budget	–1.9	–1.1	–0.6	0.0	0.3	0.6	0.8
Average surplus since 1999-2000	0.4	0.2	0.1	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–1.0	–0.4	–0.4	0.1	0.3	0.6	0.8
Sustainable investment rule							
Public sector net debt	32.9	34.3	35.4	36.2	36.8	37.0	37.1

[1] *The 2003–04 figures were estimates in Budget 2004.*

1.11 An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2004 *Long-term public finance report*. Using a range of sustainability indicators, the report shows that the public finances are sustainable in the longer term. In addition, the UK is in a strong position relative to many other countries to meet the challenges of an ageing population.

MEETING THE PRODUCTIVITY CHALLENGE

1.12 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance. In the increasingly knowledge-driven global economy, a strong science and innovation sector is an important driver of productivity growth, backed up by a highly-skilled workforce and a competitive and enterprising economy. As a result of macroeconomic instability and market failures, the UK has historically experienced low rates of productivity growth compared to other major economies. However, in recent years, UK performance has improved in relation to other major economies. The Government's long-term goal is for the UK to continue to close the productivity gap by achieving a faster rate of growth than its main competitors.

Action so far

1.13 The Government's strategy focuses on five key drivers of productivity performance:

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

Next steps **1.14** Building on the reforms and initiatives already introduced, the Pre-Budget Report sets out the next steps the Government is taking to strengthen the drivers of productivity growth and meet the long-term challenges of the global economy, including:

- giving employers the opportunity to access free and flexibly delivered training for their low-skilled employees through **a National Employer Training Programme**;
- **establishing an independent review to examine the future skills needs of the UK economy, to be led by Sandy Leitch**, (Chairman of the National Employment Panel and formerly a Chief Executive of Zurich Financial Services);
- **reforms to reduce the regulatory burden on business**, including the extension of Common Commencement Dates to other areas of legislation, and progress on the Panel for Regulatory Accountability;
- **publication of the interim report of the Hampton Review** consulting on improvements to the current system of regulatory inspection and enforcement to reduce the administrative burden on business;
- **setting out the vision of how significant reductions in compliance burdens for small businesses** will be delivered through the integration of HM Customs and Excise and the Inland Revenue;
- **implementation of the changes recommended by the Graham Review** of the Small Firms Loan Guarantee by end 2005; and
- **implementation of the ten-year Science and Innovation Investment Framework**, through strengthening the partnership with business on raising investment in UK R&D, and taking forward the recommendations of the Lambert Review on business-university collaboration including through the Northern Science and Industry Initiative.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.15 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. To achieve this, each individual who wants and is able to work should be provided with the support to enable them to find work and develop skills. The Government recognises that each person will face different barriers to work. Delivering full employment requires a personalised approach, with services tailored to the needs of the individual and local circumstances.

1.16 The Government is also determined to build a flexible labour market which allows the economy to respond quickly and efficiently to economic change, driven for example by shifting patterns of international production and trade. Without a flexible labour market, firms may be unable to respond quickly enough to grasp market opportunities and workers may find that they face prolonged periods of unemployment.

Action so far **1.17** The Government's strategy for extending employment opportunity to all builds on the strong performance of the UK labour market over recent years. UK unemployment has fallen to 4.6 per cent, the lowest of the G7 economies, while the working age employment rate has reached 74.7 per cent. Chapter 4 describes the successful action the Government has already taken to increase employment opportunity, through:

- **extending employment opportunity** and equipping people to take advantage of employment opportunities;
- **making work pay**, through the National Minimum Wage and tax credits which create a system of support that provides greater rewards from work, improving incentives for individuals to participate in the labour market; and
- **ensuring responsive and flexible delivery**, so that providers are able to tailor policies to suit the specific needs of the community they serve.

Next steps **1.18** The 2004 Pre-Budget Report describes the further steps the Government is taking to build on this success and further strengthen the labour market, with a long-term vision for extending support to the inactive and those who face particular barriers to work. The Pre-Budget Report announces:

- **a major expansion of the Pathways to Work pilots for incapacity benefits claimants** to an additional 14 Jobcentre Plus districts covering the thirty Local Authority Districts with the highest concentrations of incapacity benefits claimants, thereby extending this groundbreaking approach to around one-third of the country;
- **a package of measures to further help people on incapacity benefits move into work**, including changes to permitted work rules to improve opportunities to move from benefits to full-time employment, and placing employment adviser support within GPs' surgeries;
- **an extension of the £40 per week In-Work Credit for lone parents to six further pilot areas**, to reinforce the gains to work for lone parents in the areas that need it most;
- **a Housing Benefit Reform Fund worth £180m during 2006-08** to enable the roll out of flat-rate allowances and to improve the administration and structure of the Housing Benefit system;
- **piloting a Learning Allowance** that will allow benefit claimants to participate in full-time training; and
- **increasing by £3 per week the income threshold above which the Working Tax Credit is tapered, in line with inflation to £5220 in 2005-06**, so that families whose incomes are rising retain more of their tax credits, ensuring gains to work are maintained.

BUILDING A FAIRER SOCIETY

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

Action so far **1.20** Chapter 5 describes the range of reforms the Government has undertaken to achieve its goals in these areas, including:

- **support for families and children** to lift children out of poverty and so ensure that they have the opportunity to fulfil their potential;

- **support for pensioners** to tackle poverty and ensure security in retirement for all pensioners, with extra help for those who need it most and rewards for those who have saved modest amounts;
- **steps to encourage saving**, including through the introduction of the Child Trust Fund, stakeholder pensions and Individual Savings Accounts (ISAs); and
- **measures and reforms to improve the tax system**, and to ensure that everyone pays their fair share toward extra investment in public services.

Next steps

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

- **a ten-year strategy for childcare**, setting out the Government's long-term vision of affordable, flexible, high-quality childcare for all parents who need it, and providing parents with real choices in balancing work and family life;
- **an extension of paid maternity leave from six months to nine months from April 2007**;
- **an increase in the entitlement to free nursery education for all 3 and 4 year olds** to 15 hours a week for 38 weeks a year, reaching all children by 2010;
- **improvements to the childcare element of the Working Tax Credit**, with an increase in the maximum eligible costs to £175 a week for one child and to £300 a week for families with two or more children from April 2005, and an increase in the maximum proportion of costs covered from 70 to 80 per cent from April 2006;
- **further steps to encourage saving and asset ownership**, through ISAs, the Saving Gateway and Stakeholder products;
- **consultation on the value of payments at age seven in the Child Trust Fund**;
- **a package of measures to promote financial inclusion**, by increasing access to banking services, affordable credit and face-to-face money advice;
- **a £50 payment to households with someone over age 70 in addition to the Winter Fuel Payment in 2005**, to help meet the cost of council tax and other living expenses;
- **action to protect tax revenues and modernise the tax system**, including measures to combat tax fraud and avoidance; and
- **the development priorities for the Presidencies of the G7/8**, and further steps to tackle global poverty and reduce developing country debt.

DELIVERING HIGH QUALITY PUBLIC SERVICES

1.22 The Government's goal is to establish world class public services, with extra investment tied to reform and results. Investment in key public services provides the foundation on which the UK will be able to meet the long-term global economic challenges. A healthy, skilled and educated workforce, modern and reliable transport networks and adequate supply of affordable housing will promote productivity and flexibility and also help to ensure opportunity and security for all, both now and in future generations. The Government's strategy is to deliver improvements in public services through sustained investment and reform to ensure that taxpayers receive value for money.

Action so far **1.23** Chapter 6 sets out the steps the Government has taken to deliver lasting improvements in the delivery of public services, including:

- **a new framework for managing public spending** that strengthens incentives for departments to plan for the long term;
- **significant extra resources for public services**, consistent with the fiscal rules. The 2004 Spending Review set departmental spending plans for the three years to 2007-08, locking in previous increases in investment, while providing for further investment in priority areas of the public services. Current spending will increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08; and
- **challenging efficiency targets for all departments**, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

Next steps **1.24** The Government's long-term goal is to deliver world class public services through investment and reform, while ensuring efficiency and value for money. The Pre-Budget Report announcements include:

- **a further £520 million assigned to the special reserve** for 2004-05 for military operations in Iraq and the UK's other international obligations, and additional resources for counter-terrorism and resilience; and
- **taking action to reduce pressures on council tax in 2005-06 by £1 billion** by releasing an extra £125 million of resources for England alongside a reduction in ring fencing and other obligations and £512 million from departmental reallocations.

1.25 The Pre-Budget Report details progress departments have already made in delivering efficiencies against the 2004 Spending Review targets:

- **savings on branded and generic medicines for the NHS of £1 billion per year from 2005-06**;
- **value for money gains of £2 billion in central civil government procurement**; and
- **a total of around 4,000 posts moving out of London and the South East by the end of 2004-05**.

PROTECTING THE ENVIRONMENT

1.26 The Government's goal is to deliver sustainable growth and a better environment, by addressing the challenges of climate change, poor air quality and environmental degradation in urban and rural areas. Sustainable development is vital to ensure a better quality of life for everyone, today and for generations to come. Economic growth is key to rising national prosperity. However, growth must not come at the expense of the environment or social progress. Continued growth in the developed world, combined with the rapidly growing and highly populated economies of China and India, will place increasing demands on the world's resources and environment over the coming decade. Meeting this long-term challenge requires action at a local and national level, but crucially also through international cooperation.

Action so far **1.27** Chapter 7 describes the steps the Government has taken to deliver its environmental objectives, including:

- **tackling climate change** and reducing emissions of greenhouse gases to minimise the potential costs;
- **improving air quality** to ensure that air pollutants are maintained below levels that could pose a risk to human health;
- **improving waste management**, so that resources are re-used or recycled to deliver economic value; and
- **protecting the UK's countryside and natural resources** to ensure they are sustainable economically, socially and physically.

Next steps **1.28** The Government is committed to delivering sustainable growth and a better environment and to tackling the global challenge of climate change. It is using a range of economic instruments to address the challenges posed by sustainable development, whilst taking into account other social and economic factors. This Pre-Budget Report reviews progress and announces new steps and decisions including:

- **the forthcoming launch of the UK climate change programme consultation** and prioritisation of climate change as a key theme for the UK's presidencies of the G8 and EU;
- **the launch of a joint Energy Efficiency Innovation Review with Defra,** supported by a new R&D fund aimed at accelerating energy-efficient technology;
- **continuation of the freeze on the main road fuel duties** in response to the sustained volatility in the oil market;
- **narrowing of the duty differential between rebated oils and main road fuels by one penny per litre** to help tackle oils fraud and a **consultation on vehicles using rebated oils**;
- **a package of measures to support the development of biofuels**, including a consultative process and feasibility study on a Renewable Transport Fuels Obligation;
- **plans to align the VAT fuel scale charge with the company car benefit charge** to provide consistent tax incentives for less polluting cars, subject to informal consultation with businesses; and
- **restoration from April 2006 of the company car tax diesel supplement on new diesel cars** registered from January 2006, to reflect the mandatory introduction of Euro IV emissions standards.

PRE-BUDGET REPORT POLICY DECISIONS

1.29 Consistent with the requirements of the *Code for fiscal stability*, the updated public finance projections in the Pre-Budget Report take into account the fiscal effects of all firm decisions announced in the Pre-Budget Report or since Budget 2004. The fiscal impact of these measures is set out in Table 1.2. Full details are provided in Annex B.

Table 1.2: Estimated costs of Pre-Budget Report policy decisions and others announced since Budget 2004[1]

£ million

	2004–05	2005–06	2006–07	2007–08
Meeting the productivity challenge				
National Employer Training Programme	0	0	–80	–160
New Deal for Skills	0	–10	–10	–25
Increasing employment opportunity for all				
Incapacity benefit: additional Pathways to Work	0	*	–60	–65
Increasing Working Tax Credit thresholds	0	–140	–140	–140
Building a fairer society				
Social Fund reform	0	0	–5	–5
£50 payment for the over 70s	0	–260	0	0
Tax consequences of the Civil Partnerships Act	0	–10	–25	–30
VAT: grant to Band Aid 20	0	–5	*	*
Modernising the taxation of leasing	0	0	65	170
10 year Childcare Strategy				
Working Tax Credit: increase childcare element to 80%	0	0	–130	–130
Working Tax Credit: increase childcare limits to £175/£300 per week	0	–30	–30	–30
Extension of paid maternity leave to 9 months	0	0	0	–285
Improving childcare quality and sustainability	0	0	–240	–155
Protecting revenues				
Capital gains options avoidance	10	50	80	80
Remuneration based avoidance	200	500	500	500
Reform of film tax reliefs	20	90	110	120
Life Insurance companies avoidance	0	35	50	50
Abuse of Controlled Foreign Companies regime	0	30	50	80
Abuse of double tax relief	0	145	200	200
VAT: abuse of input tax rules	15	45	45	50
Loans and financial instruments avoidance	10	115	150	150
Protecting the environment				
Company car tax: reform of diesel supplement	0	0	40	100
Fuel duties: freeze of main rates	–370	–665	–685	–710
Rebated oils: narrowing of the differential	–80	–105	–110	–110
Other Pre-Budget Report policy decisions				
Addition to local authorities	0	–150	0	0
Addition to special reserve	–520	0	0	0
TOTAL POLICY DECISIONS	**–715**	**–365**	**–225**	**–345**

** Negligible.*

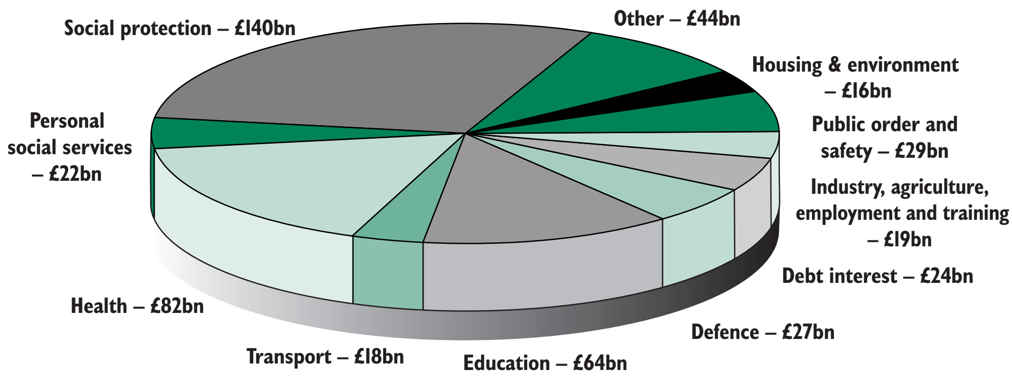
[1] Costings shown relative to an indexed base.

GOVERNMENT SPENDING AND REVENUE

1.30 Chart 1.1 presents public spending by main function. Total managed expenditure (TME) is expected to be around £485 billion in the current financial year, 2004-05. TME is divided into Departmental Expenditure Limits (DEL), shown in Table B18, and Annually Managed Expenditure (AME), shown in Table B16.

Chart 1.1: Government spending by function

Total managed expenditure: £485 billion

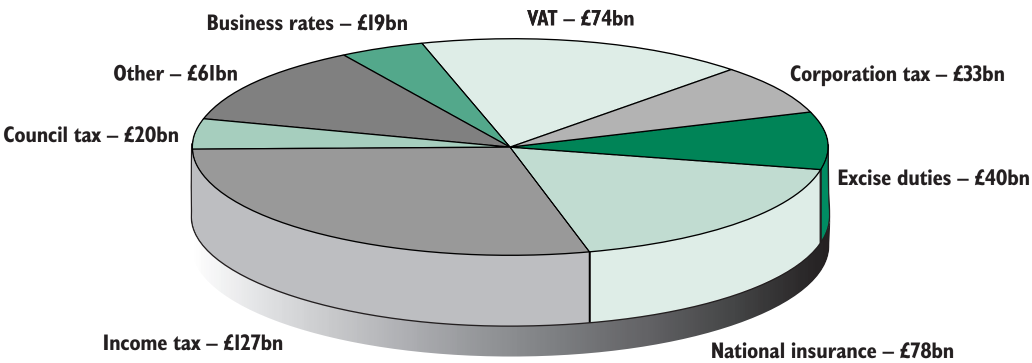


Source: HM Treasury, 2004-05 figures. Other expenditure includes spending on general public services; recreation, culture and religion; international cooperation and development; public service pensions; plus spending yet to be allocated and some accounting adjustments. Social protection includes tax credit payments in excess of an individual's tax liability, which are now counted in AME, in line with OECD guidelines. Figures may not sum to total due to rounding.

1.31 Chart 1.2 shows the different sources of government revenue. Public sector current receipts are expected to be around £451 billion in 2004-05. Table B13 provides a more detailed breakdown of receipts consistent with this chart.

Chart 1.2: Government receipts

Total receipts: £451 billion



Source: HM Treasury, 2004-05 figures. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts – for example, interest and dividends. Figures may not sum to total due to rounding.

2 MAINTAINING MACROECONOMIC STABILITY

Entrenching macroeconomic stability will be essential if Britain is to respond to the global economic challenges of the next decade. This chapter sets out the action the Government is taking to maintain macroeconomic stability and build on the progress made since 1997. The UK economy is currently experiencing its longest unbroken expansion since quarterly national accounts data began 50 years ago, with GDP now having grown for 49 consecutive quarters. And with inflation low and stable, interest rates set by the Monetary Policy Committee in order to meet the Government's symmetric inflation target, fiscal policy supporting monetary policy over the economic cycle, the UK weathered the international economic downturn, which began in 2001, better than many other industrialised countries.

The global recovery has been gathering momentum during 2004, despite higher world oil prices. In the UK GDP has grown strongly over the past year with significant evidence of a rebalancing in the composition of demand. While a number of risks continue to surround the international outlook, sound macroeconomic fundamentals, recent strong and more broadly-based growth and continued expansion in the world economy point to a further period of relatively strong UK output growth. UK GDP is expected to grow by 3¼ per cent in 2004, in line with the Budget 2004 forecast. Growth of 3 to 3½ per cent is forecast for 2005 as the remaining slack in the economy is absorbed before the output gap is closed in early 2006.

The interim forecast update of the projections for the public finances published in this Pre-Budget Report are broadly unchanged since the Budget 2004. Where there are changes, these are small and affect the short-term projections. The projections show that the Government is meeting its strict fiscal rules:

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

An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2004 *Long-term public finance report*. The report confirms that on the basis of current policies, the public finances are sustainable in the longer term. In addition, the UK is in a strong position relative to many other countries to meet the challenges of an ageing population.

THE MACROECONOMIC FRAMEWORK

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

2.2 In an increasingly integrated global economy, financial and economic instability in one region or country can be rapidly transmitted around the world. Flexible markets play an important role in dealing with these shocks, allowing the economy to adjust quickly and efficiently, with minimum impact on output and employment. A macroeconomic framework designed to maintain long-term stability is also key to allowing the economy to adjust smoothly to global shocks, an issue discussed further in Box 2.3.

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

Monetary policy framework

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

- clear and precise objectives. While the primary objective of monetary policy is to deliver price stability, the adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt publication of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC.

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

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

Fiscal policy framework

2.6 The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*[2] – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

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

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

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

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

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

Public spending framework

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

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

Box 2.1: Caution in the public finance projections

Forecasting the public finances inevitably involves a significant margin of uncertainty, particularly for the fiscal balances, which represent the differences between two very large aggregates. The Government's fiscal framework specifically recognises this uncertainty. The projections for the public finances are therefore based on cautious assumptions, including for trend growth, which help to build a margin against unexpected events.

These assumptions are audited by the NAO on a three-year rolling-review basis to ensure that they remain both reasonable and cautious. It is important that the assumptions remain reasonable as well as cautious, as excessive caution could distort the management of the public finances, particularly public spending. The NAO-audited assumptions include those for: privatisation proceeds; trend GDP growth; UK claimant unemployment; interest rates; equity prices; projecting the VAT gap; consistency of price indices; shares of labour income and profits in national income; funding; oil prices; and tobacco smuggling.

One of the key audited assumptions is that for the trend rate of GDP growth for the public finance projections, which is assumed to be ¼ of a percentage point below the neutral view. This means that the rate of economic growth used to forecast the public finances is the bottom end of the projection range. For example, in this Pre-Budget Report, the forecast for economic growth used in the public finance projections over the period 2005-06 to 2009-10 averages under 2½ per cent, ¼ per cent below the central case, implying the level of GDP used in the public finance forecast is 1.4 per cent below the neutral view in 2009-10.

For the 2004 Pre-Budget Report, no assumptions were due for audit and the assumptions examined in previous audits have not been changed. A full description of the assumptions used in the 2004 Pre-Budget Report can be found in Annex B.

2.10 A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system, with distinct roles for the Treasury, the Bank of England and the FSA. A Memorandum of Understanding[3] in 1997 established a framework for co-operation between these three bodies on financial stability.

2.11 The Bank of England is responsible for the stability of the financial system as a whole, including the payments infrastructure. The FSA is responsible for the authorisation and supervision of financial institutions including banks, for supervising financial markets and securities clearing and settlement systems, and for regulatory policy. The Treasury has responsibility for the overall institutional structure of regulation and the legislation that governs it.

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

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

Box 2.2: Government policy on EMU

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

An assessment of the five economic tests was published in June 2003. This concluded that: *"since 1997 the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area."* The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the assessment.

The Government is committed to publishing six-monthly reports on trends and progress in increasing flexibility in the UK economy, the third of which is published as Annex C to this Pre-Budget Report.

As the Chancellor announced in Budget 2004: *"while the Government does not propose a euro assessment be initiated at the time of this Budget, the Treasury will again review progress at Budget time next year"*.

The Government continues to emphasise the need for a more prudent interpretation of the Stability and Growth Pact, as described in *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004. This would take into account:

- **the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy;**
- **sustainability – low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate and providing a sound basis for investment in public services. Assessment of sustainability should also take into account the long-term budgetary impact of ageing populations, such as that set out in the 2004 *Long-term public finance report*; and**
- **public investment – public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.**

The Government also remains committed to the EU's Lisbon strategy on economic reform, launched in March 2000, and will continue to work with Member States and the EU institutions to build on progress so far and to accelerate the pace of reform, as discussed further in Chapter 3.

PERFORMANCE OF THE FRAMEWORK

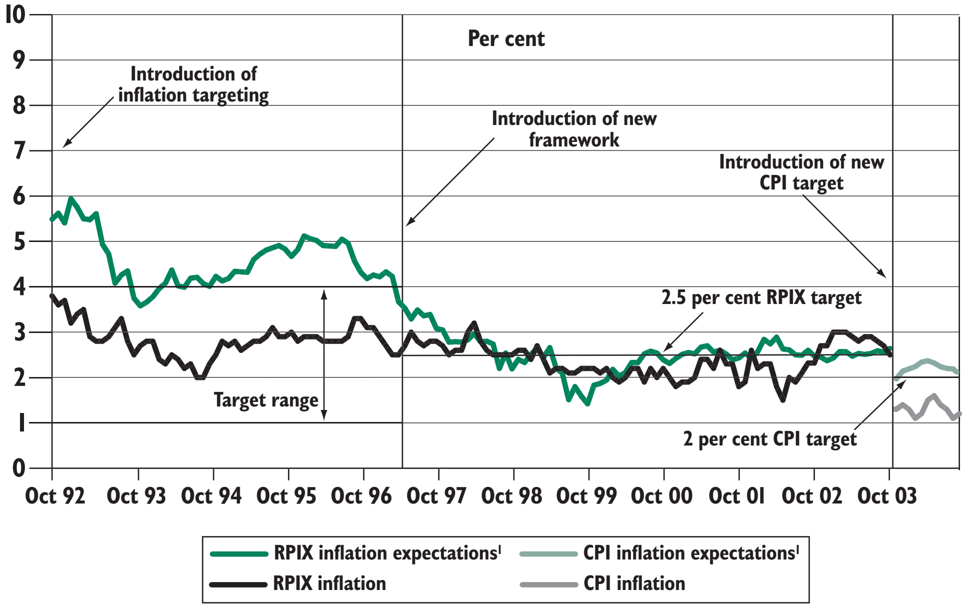
2.13 The frameworks for monetary policy, fiscal policy and public spending provide a coherent strategy for maintaining high and stable levels of growth and employment, and for minimising the adverse impact of external events.

Monetary policy

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

- the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target of 2.5 per cent, the longest period of sustained low inflation for the last 30 years; and
- inflation expectations have remained close to target following the switch from a 2.5 per cent RPIX target to a 2 per cent CPI target – implied market expectations are that CPI inflation will be close to the 2 per cent target. CPI inflation has been within 1 percentage point of its target since its inception in December 2003.

Chart 2.1: Inflation performance and expectations



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

2.15 The monetary policy framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3.5 per cent. This helped to keep output relatively close to its trend level, while ensuring that inflation remained close to target. Consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation as growth strengthens, the MPC has raised interest rates on five occasions since November 2003 to reach 4.75 per cent.

2.16 Long-term interest rates have remained at historically low levels and have averaged just under 5 per cent this year. Low long-term rates reduce the Government's debt interest payments, free up resources for public services and help to promote investment throughout the economy. Ten-year forward rates, which abstract from cyclical influences, remain below those in the United States and the euro area. Ten-year forward rates have fallen marginally in the United Kingdom over the year from 4.7 per cent in March 2004 to 4.6 per cent in November 2004[4] as they have in the United States and the euro area.

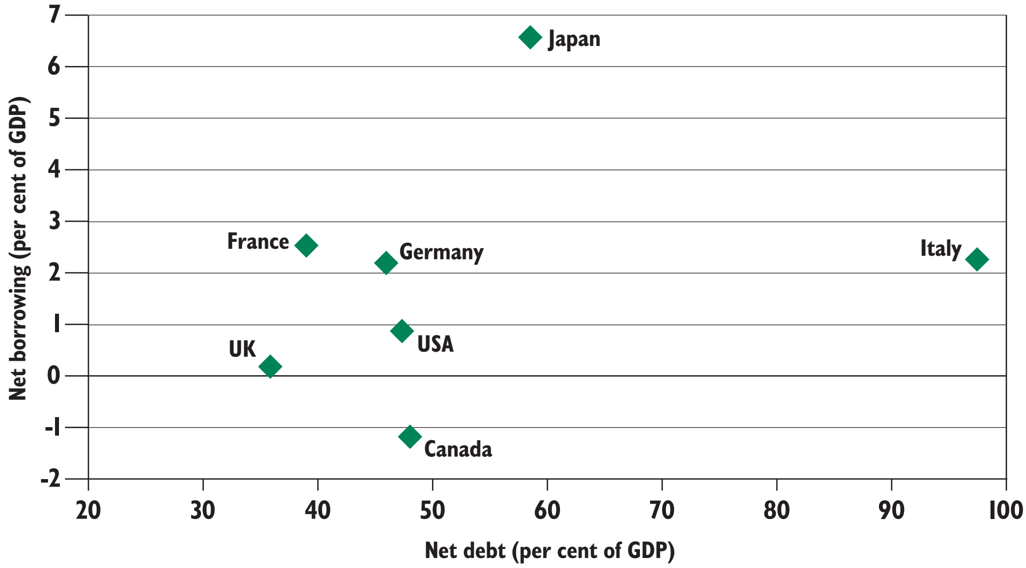
[4] Source: www.bankofengland.co.uk and Bank of England.

2.17 Since Budget 2004, the sterling effective exchange rate has depreciated by just under 3 per cent. Over a longer period, the effective exchange rate has been relatively stable. The volatility of sterling's effective exchange rate has been around half that of the euro and just over a third of that of the US dollar since 1999.

Fiscal policy

2.18 The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by around 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend. In more recent years, fiscal policy supported monetary policy as the economy moved below trend: between 2000-01 and 2003-04, the fiscal stance eased by around 3 per cent of GDP. Public sector net debt was also reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03. As Chart 2.2 shows, since 1997 the UK's public finances have compared favourably with other countries.

Chart 2.2: Public finances in the G7, average 1997 to 2003



Source: OECD Economic Outlook 75, June 2004.

2004 Spending Review

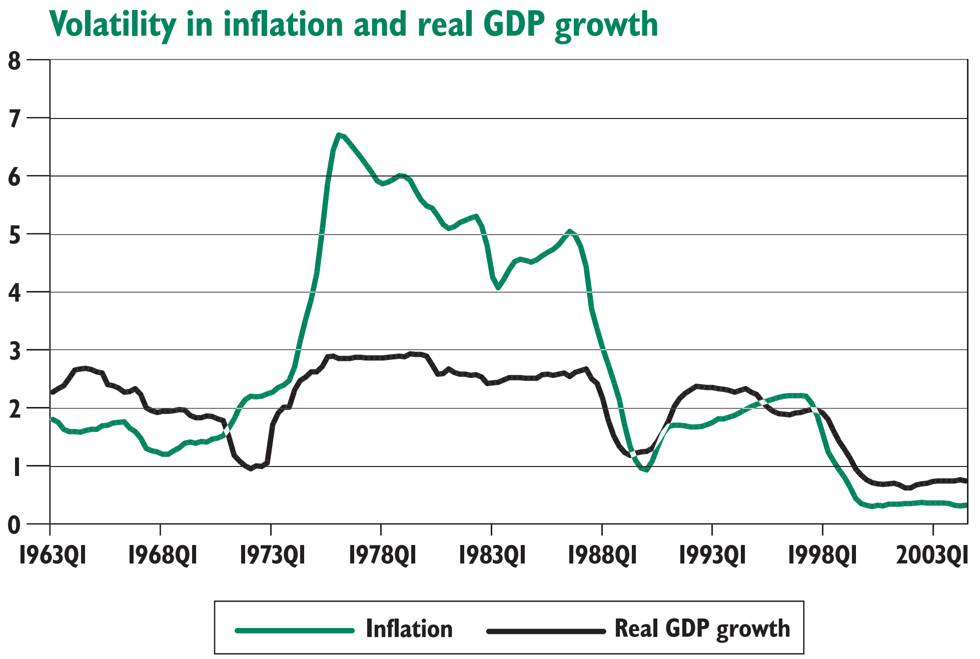
2.18 The 2004 Spending Review set spending plans for the years 2005-06 to 2007-08, locking in the increased investment of previous spending reviews while providing for further investment in the most crucial areas of the public services. These plans provide for:

- current spending to increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;
- public sector net investment to rise from 2 per cent of GDP to 2¼ per cent by 2007-08, to continue to address historic under-investment in the UK's infrastructure while meeting the sustainable investment rule; and
- agreed efficiency targets for all departments, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

2.19 The overall spending limits set in Budget 2004 and confirmed in the 2004 Spending Review remain sustainable and fully consistent with the fiscal rules.

Box 2.3: Increased stability in the UK economy

Economic stability allows consumers, firms and governments to plan effectively for the long term. The UK has experienced unprecedented macroeconomic stability in the past decade, with volatility in inflation and real GDP growth at its lowest levels since at least the early 1960s.



Note: Volatility is measured by the standard deviation over rolling seven-year periods. Inflation is measured by the RPI before 1976 and the RPIX thereafter.

***Long-term global economic challenges and opportunities for the UK*, published alongside the Pre-Budget Report, examines how the increased integration of global product and capital markets, and the pressures of an ageing society, reinforce the need for a stable and sustainable macroeconomic framework. Closer economic integration increases the speed and magnitude of global economic shocks affecting the UK.**

The UK's macroeconomic framework has performed well in the face of global economic shocks in recent years, including: the Asian economic crisis, the global equity price fall in 2001 and 2002, geopolitical uncertainty that followed the events of 11 September 2001 and the recent large rise in oil prices. A key factor has been the proactive response of monetary policy against a background of low inflation expectations, combined with a fiscal framework that allows fiscal policy to respond flexibly to the cycle and to support monetary policy. In particular, the Bank of England's Monetary Policy Committee took decisive action to cut short-term interest rates between February 2001 and July 2003, while maintaining long-term inflation expectations close to the inflation target.

The UK and many other countries also face the challenge of demographic change over the coming decades. The updated 2004 *Long-term public finance report*, published alongside the Pre-Budget Report, confirms that the UK fiscal position is sustainable in the long term on the basis of current policies. It also demonstrates that the UK remains in a strong position relative to many other developed countries to face the challenges of an ageing society.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.20 Over the past four years, many industrialised countries have suffered economic downturns, including the US and much of the euro area. More recently, the international economy has been affected by geopolitical uncertainty, rising oil prices, large current account imbalances and shifting exchange rates between the US, Asia and Europe. The UK has grown continuously throughout this period of global economic uncertainty, supported by monetary policy, and an easing of the fiscal stance and the full operation of the automatic stabilisers as the economy moved below trend. The UK continues its longest unbroken expansion since quarterly national accounts data began 50 years ago, with GDP now having grown for 49 consecutive quarters.

2.21 As many of the key uncertainties which had substantially dampened international activity receded in 2003, business and consumer confidence rose around the world and supported a solid resumption in world trade and output growth. Indeed, global growth is currently robust by historical standards, despite higher oil prices, which have been driven to record nominal highs in large part by exceptionally strong demand growth, although the real price of oil remains well below its peak. Against these positive international developments, UK GDP accelerated from mid-2003, and annual growth has now remained above trend for four consecutive quarters.

Table 2.1: Summary of world forecast

	Percentage change on a year earlier unless otherwise stated				
	Outturn	Forecasts			
	2003	2004	2005	2006	2007
Major 7 countries[1]					
Real GDP	2¼	3½	3	2¾	2¾
Consumer price inflation[2]	1½	3	2¼	1¾	1¾
World trade in goods and services	5	9½	8½	7¾	7¼
UK export markets[3]	3¾	8¾	8	7¼	6¾

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

2.22 The composition of UK GDP growth has already undergone a significant degree of rebalancing since the world economy began to pick up in the course of last year. Consumption growth has continued to moderate in response to increases in short-term interest rates. At the same time, the strong global environment has underpinned the pick-up in business investment seen over recent quarters.

2.23 In 2003 as a whole, UK GDP rose 2.2 per cent, in line with the Budget 2003 forecast. Quarterly growth moved above trend by the third quarter of 2003, for the first time in three years, and it continued at above trend rates through the first half of 2004. Preliminary data suggest that growth in the economy eased in the third quarter compared with the first half of the year, with GDP currently estimated to have risen by 0.4 per cent between the second and third quarters, up 3.1 per cent over the year, consistent with the Budget 2004 forecast.

Box 2.4: UK Presidencies of the G7/8 and EU

***Long-term global economic challenges and opportunities for the UK*, published today alongside the Pre-Budget Report, explains that the global economy is in the midst of a radical transformation, with far-reaching and fundamental changes in technology and trading patterns. The rapid growth of large emerging economies, in particular China and India, is shifting the balance of global economic activity. These changes have significant long-term implications for the world's economies. As part of its response the UK will tackle, through its leadership of the G7/8 and EU in 2005, the following key challenges:**

- **international poverty reduction, to ensure that all countries and regions of the world benefit from, and contribute to, increased global growth and prosperity. The Government will press for action from the international community in the key areas needed to meet the Millennium Development Goals (MDGs): increasing aid flows, including the implementation of the International Finance Facility (IFF); further debt relief; and ensuring fair trade for developing countries. The Commission for Africa, launched by the Prime Minister earlier this year, will report in the run-up to the July 2005 G8 Summit in Gleneagles;**
- **structural economic reform, to increase flexibility and improve the ability of developed countries to adjust quickly and efficiently to rapid economic changes. The Government will use the Presidencies to develop a global consensus on the actions necessary, in particular a renewed emphasis on boosting employment and growth across the developed world, including through more flexible labour, product and capital markets. Europe in particular must build on Wim Kok's report on the Mid-Term Review of Lisbon, and take concrete steps on regulatory reform and strengthen transatlantic economic integration;**
- **trade. Governments have a critical role to play in shaping global trends through multilateral action. Openness to free and fair trade and outward-looking internationalism will help boost competitiveness and strengthen the drivers of productivity, and the Government will push for further progress on the Doha trade negotiations during 2005, that recognises that developing countries can carefully design and sequence their own trade reform; and**
- **climate change. The UK Presidencies will support the drive to tackle climate change as a priority for all industrialised nations.**

Economic prospects

2.24 Sound macroeconomic fundamentals, recent underlying growth at above trend rates, and continued expansion in the world economy, point to a further period of relatively strong growth in demand for UK output. Moreover, on the supply side, evidence of remaining slack in the economy supports the judgement that the economy has the potential for a period of further above trend growth in the short term, without risking inflationary pressures. UK GDP is expected to grow by 3¼ per cent in 2004, up from 2.2 per cent last year and 1.8 per cent in 2002, and unchanged since the 2002 Pre-Budget Report forecast. Annex A provides more information on the Treasury's recent economic forecasting performance.

2.25 Growth is forecast to remain within the 3 to 3½ per cent range for 2005 as a whole. However, the annual figures mask an underlying gradual slowing since the second half of 2003. By early 2006, the output gap is forecast to have closed and GDP growth is expected to be back to trend rates. In 2007, GDP growth is forecast to ease to 2¼ to 2¾ per cent in line with the trend projection.

2.26 Consumer Prices Index (CPI) inflation stood at 1.2 per cent in October. Going forward, CPI inflation is expected to rise gradually back to target by mid-2006, as upward pressure from import prices, accentuated by the recent depreciation of sterling, feeds through. The credibility of the Government's monetary policy framework is also expected to contribute to returning inflation to target through anchoring inflation expectations.

Table 2.2: Summary of UK forecast

	Outturn	Forecast			
	2003	2004	2005	2006	2007
GDP growth (per cent)	2¼	3¼	3 to 3½	2½ to 3	2¼ to 2¾
CPI inflation (per cent, Q4)	1½	1¼	1¾	2	2

Composition of UK growth

2.27 GDP has grown strongly over the past year with significant evidence of a rebalancing in the composition of demand. Real private consumption has grown broadly in line with the expansion of the economy as a whole over the recent past, and is expected to rise by 3¼ per cent this year, broadly in line with GDP growth for the year. Thereafter, private consumption growth is forecast to be below GDP growth.

2.28 Business investment has strengthened significantly since early 2003, following what proved to be a relatively shallow decline in the face of weakness in the world economy. Business investment is expected to rise by 5¾ per cent this year, slightly stronger than forecast in Budget 2004. With profitability and corporate balance sheets having strengthened considerably, and demand still judged to be growing strongly, business investment is expected to continue to grow solidly over the forecast horizon, albeit at a slightly slower rate than this year.

2.29 With world trade growing at around 9½ per cent this year, there are also signs that improvements in external demand are beginning to feed through to UK exports, with goods export volumes up by over 4 per cent in the third quarter of 2004 on a year earlier. Export growth is expected to gather more momentum in coming quarters as the recent pick-up in external demand continues to filter through to UK exports. Moreover, the sterling Exchange Rate Index has depreciated by around 4 per cent since the summer, largely due to a fall in the pound's value against the euro. This should also provide some additional impetus to export growth over the forecast horizon. Against the background of continued strong growth in UK export markets, goods and services export volumes are forecast to rise by 6½ to 7 per cent next year, building on growth of around 2¼ per cent this year.

Risks

2.30 Although the overall shape of the economic forecast is broadly unchanged from Budget time, the configuration of the surrounding risks and uncertainties has changed. In particular, high oil prices – if sustained – would tend to dampen growth, though to the extent that they reflect strong global demand, rather than supply-side or risk premia shocks, there are likely to be offsetting effects. Global developments remain a key influence on the UK outlook and challenging judgements will continue to be faced in setting monetary and fiscal policy. In the UK forecast, as has been the case in 2004, business investment could continue to surprise on the upside, and there may be headroom for stronger consumer spending.

The economic cycle

2.31 On the basis of the Government's provisional judgement on the dating of the current and past economic cycles, the economy completed a full, though short, cycle between the first half of 1997 and mid-1999. The current economic cycle began in mid-1999 when actual output moved above the trend level. In the second half of 2001, the economy moved below trend with actual output remaining below the trend level since then. The economy is expected to return to trend by early 2006, as has been forecast since Budget 2003.

RECENT FISCAL TRENDS AND OUTLOOK

2.32 The public finance projections in the Pre-Budget Report have a different status from those produced at the time of the Budget. They represent an interim forecast update and not necessarily the outcome that the Government is seeking. The projections for the public finances presented below include the effects of firm decisions announced since Budget 2004 and in this Pre-Budget Report, in accordance with the *Code for fiscal stability*.

2.33 The forward-looking fiscal projections described in this section are complemented by the 2004 *End of year fiscal report*, published alongside this Pre-Budget Report, which provides detailed retrospective information on the public finances in 2002-03 and 2003-04.

Table 2.3: Fiscal balances compared with Budget 2004

	Outturn[1]	Estimate	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Surplus on current budget (£ billion)							
Budget 2004	**–21.3**	**–10.5**	**–5**	**0**	**4**	**9**	
Effect of forecasting changes	0.2	–1.2	–1	1	–½	–1	
Effect of policy decisions since Budget 2004	0.0	–0.8	–½	0	–½	0	
PBR 2004	**–21.1**	**–12.5**	**–7**	**1**	**4**	**9**	**12**
Net borrowing (£ billion)							
Budget 2004	**37.5**	**32.9**	**31**	**27**	**27**	**23**	
Changes to current budget	–0.2	2.0	1½	–½	½	½	
Changes to net investment	–2.5	–0.7	1½	2	½	0	
PBR 2004	**34.8**	**34.2**	**33**	**29**	**28**	**24**	**22**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2004	–1.0	–0.2	–0.2	0.0	0.3	0.7	
PBR 2004	**–1.0**	**–0.4**	**–0.4**	**0.1**	**0.3**	**0.6**	**0.8**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2004	2.4	2.1	2.3	2.1	1.9	1.6	
PBR 2004	**2.2**	**2.2**	**2.5**	**2.2**	**2.0**	**1.6**	**1.5**
Net debt (per cent of GDP)							
Budget 2004	33.2	34.4	35.3	35.9	36.3	36.4	
PBR 2004	**32.9**	**34.3**	**35.4**	**36.2**	**36.8**	**37.0**	**37.1**

Note: Figures may not sum due to rounding.
[1] The 2003–04 figures were estimates in Budget 2004.

2.34 The outturn for the current budget for 2003-04 is around £0.2 billion lower than the Budget 2004 estimate, while net borrowing is now around £2½ billion lower. Projections for the current budget are little changed compared with the projections set down in Budget 2004, as shown in Table 2.3. Where there are changes, these are small and affect the short-term projections; the situation in the medium term is broadly as set out in Budget 2004.

Estimate for 2004-05

2.35 Receipts from income tax, national insurance contributions and VAT have come in broadly as expected in Budget 2004. In 2004-05, the current budget is around £2 billion lower and net borrowing around £1½ billion higher than in Budget 2004, reflecting slower than expected growth in corporation tax revenues and the effect of discretionary measures, including the addition to the special reserve. In addition, the estimate of public sector net investment in 2004-05 is now lower than in Budget 2004, as described in Annex B.

2.36 Growth in receipts is likely to be stronger in the remainder of 2004-05 compared with the first seven months. In particular, the payment lags related to North Sea taxes, discussed in more detail below, means little of the additional revenue from higher oil prices has yet fed through to the monthly public finance data. On the other hand, growth in spending is likely to moderate as departments continue to adjust to the end-year flexibility arrangements and resource accounting, resulting in a flatter profile of spending through the year. In addition, the introduction of the Pension Credit in September 2003 will have increased the year on year growth rates in spending in the first half of 2004-05.

2.37 Table 2.4 explains the reasons for the change in public sector net borrowing. Before taking into account the discretionary measures announced in this Pre-Budget Report, the projections for the public finances are broadly unchanged from Budget 2004. Net borrowing is slightly higher in the short term compared to the Budget 2004 projections, but continues to fall back to the levels set out in Budget 2004 over the forecast horizon.

Table 2.4: Public sector net borrowing compared with Budget 2004

	Estimate[1]		Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09
Budget 2004	**32.9**	**31**	**27**	**27**	**23**
Changes since Budget 2004					
Effect of oil prices on oil taxes[2]	–1.3	–1½	–1½	–1½	–1½
Corporation tax	3.2	3	1	½	½
Other forecasting changes[3]	–1.3	1	1½	2	2
Total before discretionary measures	**33.5**	**33**	**28**	**27**	**24**
Discretionary measures	**0.7**	**½**	**0**	**½**	**0**
2004 Pre-Budget Report	**34.2**	**33**	**29**	**28**	**24**

Note: Figures may not sum due to rounding.

[1] *The 2004-05 figures were projections in Budget 2004.*

[2] *Includes NAO-audited assumption and the effect of higher oil prices on demand for road fuels and road fuel duty.*

[3] *Includes changes in the timing of investment, described in Annex B, other economic determinents (include GDP components) and fiscal forecasting changes.*

Changes in receipts

2.38 While the outlook for the public finances is broadly unchanged since Budget 2004, there are changes in the composition of the public finances. Other than the oil price, none of the NAO-audited assumptions have significantly affected projections for the public finances. The direct effect of higher oil prices, including the offsetting effect from higher pump prices, which is expected to reduce receipts by around £½ billion compared to the Budget projections, is forecast to boost receipts by around £1½ billion.

2.39 This direct price effect does not include other effects that may offset the additional revenues from oil taxes. These operate through the economic forecast, and the projections for various components of GDP, and cannot therefore be identified separately in the economic forecast. An important factor in this Pre-Budget Report forecast is that the higher oil prices largely reflect increased global demand. Strong growth in the world economy is, as described above, helping to maintain strong growth in the UK economy.

2.40 However, while the effect of higher pump prices on demand is felt immediately, there are important lags in the payment of higher receipts from North Sea taxes. While the oil price has risen strongly in the second half of 2004, little of the additional revenue has been reflected in monthly cash receipts so far. Corporation tax payments are made quarterly and the final payments for this period will not be made until April 2005. Payment of petroleum revenue tax (PRT) follows a different pattern based on six month chargeable periods, with a system of monthly instalment payments. This means that PRT receipts to the end of October reflect tax due for the first half of 2004 and earlier periods, and are slightly lower than in 2003 because of lower oil production. The high oil prices in the second half of 2004 will have no impact on PRT receipts until March 2005.

2.41 Projections for receipts of income tax, national insurance contributions and VAT are little changed from Budget 2004. In the short term, receipts from corporation tax are projected to be lower than forecast. While receipts from corporation tax have grown strongly, and the growth in receipts from non-financial companies is broadly in line with expectations, the increase in receipts from financial companies has been lower than expected. A number of factors may explain this, including companies offsetting higher profits against past losses or capital allowances to a greater degree than expected following the period of weakness in international capital markets. As the forecast horizon extends, corporation tax from financial companies returns towards its Budget 2004 level.

Changes in spending

2.42 Forecast expenditure is broadly unchanged from Budget 2004. Projections for DEL up to 2007-08 are based on the 2004 Spending Review allocations, and projections for current AME expenditure is unchanged from Budget 2004. More detail on projections for spending is provided in Annex B.

Discretionary policy changes

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

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

2.44 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all decisions announced in this Pre-Budget Report or since Budget 2004. This includes:

- a continuation of the freeze on the main road fuel duties, in response to the sustained volatility in the oil market;
- a ten-year strategy for childcare, setting out the Government's vision of affordable, flexible, high-quality childcare for all parents who need it;

- giving employers the opportunity to access free and flexibly delivered training for their low-skilled employees through a National Employer Training Programme; and
- action to protect tax revenues and modernise the tax system, including measures to combat tax fraud and avoidance.

2.45 In the 2002 Pre-Budget Report, the Government created a special reserve to meet the UK's international obligations. In this Pre-Budget Report, as a prudent allowance against continuing commitments, the Government is adding a further £520 million to the special reserve for 2004-05. Full details of the Government's spending and allocations for the military conflict in Iraq and on the war on terrorism at home and abroad are described in Chapter 6.

2.46 The Government is taking action to reduce pressures on council tax in 2005-06 by £1 billion by releasing an extra £125 million of resources for England alongside a reduction in ring fencing and other obligations and £512 million from departmental allocations. Full details are set out in Chapter 6.

2.47 The fiscal impact of these and other measures is set out in Annex B. As usual, the projections do not take account of measures proposed in this Pre-Budget Report for consultation or other proposals where final decisions have yet to be taken.

Box 2.5: The effect of oil prices on the UK's economy and public finances

While oil prices have risen strongly in 2004, as described in Annex A, their impact on the UK economy has so far been limited. Importantly, compared to other episodes of high prices, the real price of oil (the price adjusted for inflation) has remained below its peak. This, coupled with the sharp decline of energy intensity in developed economies since the 1970s, has resulted in a relatively muted impact. In addition, the UK remains a small net exporter of oil. Finally, the increase in oil prices reflects, in large part, strong global demand growth in 2004 whereas in previous periods oil prices rises were almost entirely attributable to supply-side shocks.

In the past, rising oil prices have often been accompanied by significant rises in inflation, which were compounded by a lack of clarity on the appropriate policy response. The Government's monetary policy framework has helped to keep inflation expectations anchored. As can be seen in Chart 2.1, inflation expectations have remained close to target over the last year, showing the credibility of the monetary policy framework.

Oil prices will also have an effect on the UK's public finances. Other things being equal, higher oil prices boost the tax take from petroleum revenue tax and North Sea corporation tax. There are, however, a number of offsetting effects that means the impact on the public finances as a whole will be limited. The scale of these offsetting effects, and in particular the effects that operate through the economic forecast, are extremely uncertain as they will depend on the response of individuals and businesses to rising prices. There will also be important timing effects, with any effects on inflation or the wider economy taking time to affect the public finances. The offsetting effects include those from:

- **higher pump prices, which reduces demand for road fuels and therefore reduces revenues from fuel duties;**
- **any temporary increase in inflation, which increases the indexation of allowances and limits for income tax and national insurance contributions and raises the level of indexation of tax credits and social security benefits; and**
- **possible impacts on the wider economy. In particular, other things being equal, higher input prices may reduce companies profit margins, reducing their profitability and therefore reducing receipts of non-North Sea corporation tax. However, with part of the rise in oil prices being demand driven, the negative effects on non-oil producers and oil consumers need to be assessed alongside the offsetting impacts from strong growth in the world economy.**

This suggests that care needs to be taken when considering estimates of the impact of higher oil prices on the public finances as a whole. This will be especially so if high oil prices are the result of increased demand, rather than purely a supply shock as often occurred in the past.

FISCAL POSITION AND MEDIUM-TERM PROSPECTS

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

Table 2.5: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Fairness and prudence							
Surplus on current budget	–1.9	–1.1	–0.6	0.0	0.3	0.6	0.8
Average surplus since 1999-2000	0.4	0.2	0.1	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–1.0	–0.4	–0.4	0.1	0.3	0.6	0.8
Long-term sustainability							
Public sector net debt[1]	32.9	34.3	35.4	36.2	36.8	37.0	37.1
Core debt[1]	31.6	32.4	33.4	34.3	35.0	35.3	35.4
Net worth[2]	22.0	19.6	17.1	16.5	15.4	15.5	14.8
Primary balance	–1.5	–1.3	–1.0	–0.5	–0.3	0.0	0.2
Economic impact							
Net investment	1.2	1.8	2.1	2.2	2.3	2.2	2.3
Public sector net borrowing (PSNB)	3.1	2.9	2.7	2.2	2.0	1.6	1.5
Cyclically-adjusted PSNB	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Financing							
Central government net cash requirement	3.5	3.4	2.9	2.5	2.1	1.7	1.8
Public sector net cash requirement	3.6	3.1	2.8	2.5	2.2	1.8	1.8
European commitments							
Treaty deficit[3]	3.1	2.8	2.7	2.2	2.0	1.6	1.5
Cyclically-adjusted Treaty deficit	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Treaty debt ratio[1,4]	39.5	40.9	41.8	42.4	42.8	42.8	42.6
Memo: Output gap	–1.4	–0.8	–0.1	0.0	0.0	0.0	0.0

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

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

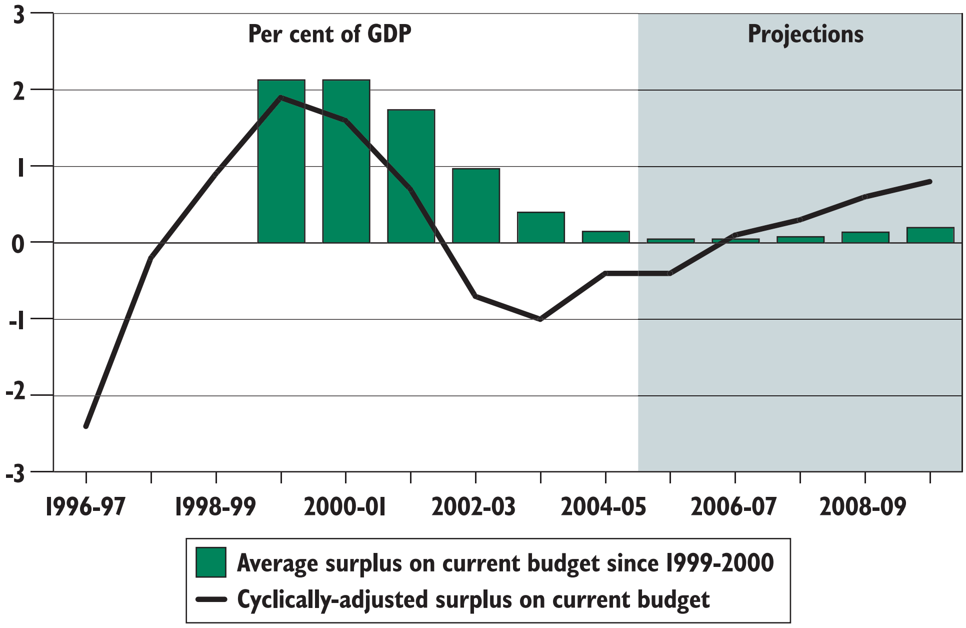
[3] *General government net borrowing on a Maastricht basis.*

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

Golden rule

2.49 The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of inter-generational fairness. The current budget strengthens through the projection period, returning to balance in 2006-07 and showing a surplus of 0.8 per cent of GDP by 2009-10.

Chart 2.3: Meeting the golden rule



2.50 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began.[5]

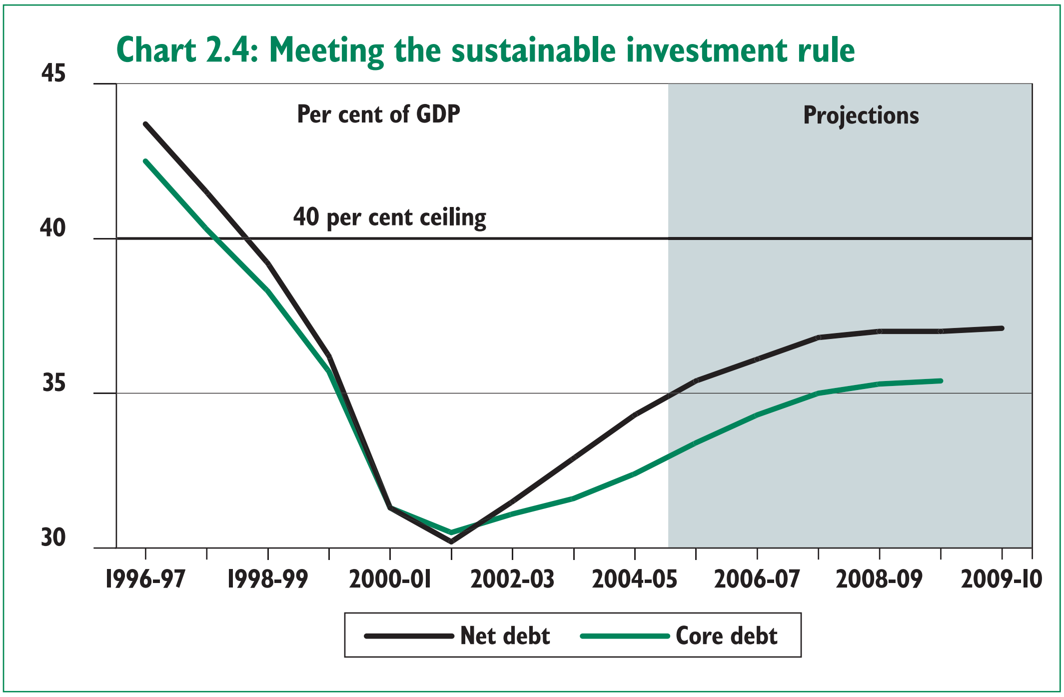
2.51 The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is positive in every year of the projection period. The economy is projected to return to trend by early 2006, meaning that over the whole cycle the average surplus on the current budget would be 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £8 billion in this cycle, including the AME margin.

2.52 With the economy assumed to be on trend from early 2006 onwards the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2009-10 is ¼ per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on course to meet the golden rule after the end of this economic cycle.

Sustainable investment rule

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

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

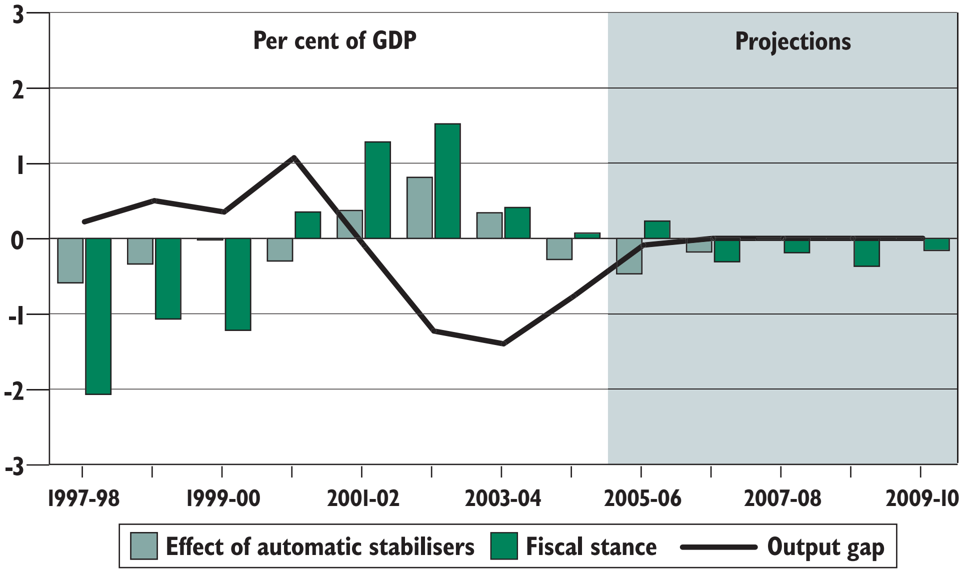


2.54 Chart 2.4 shows that, despite a sustained period of weakness in the world economy in 2001 and 2002, net debt is expected to remain low and stable, stabilising at around 37 per cent of GDP at the end of the projection period. Therefore, the Government comfortably meets its sustainable investment rule. Chart 2.4 also illustrates the Pre-Budget Report projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt is projected to rise to around 35½ per cent of GDP as the Government borrows modestly to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the key objective of intergenerational fairness that underpins the fiscal framework.

Economic impact

2.55 While the primary objective of fiscal policy is to ensure sound public finances, it also affects the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.5 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy.

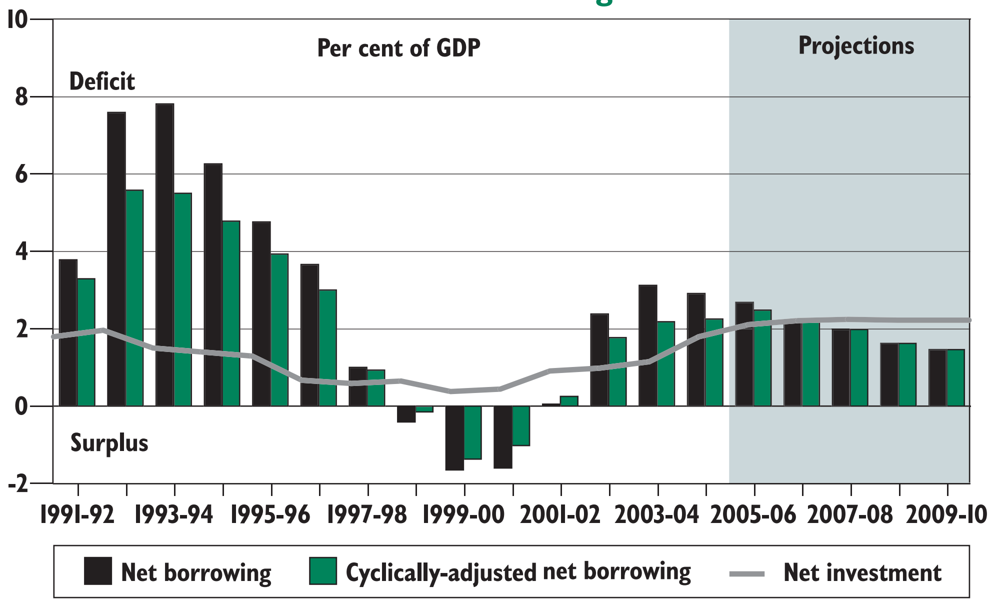
Chart 2.5: Fiscal policy supporting monetary policy



2.56 During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. More recently, fiscal policy has continued to support monetary policy in helping to deliver economic stability, through the automatic stabilisers and an easing of the fiscal stance when the economy moved below trend. Subsequently as the economy returns to trend the overall impact of fiscal policy moves back to a more neutral position.

2.57 The modest levels of borrowing over the forecast period reflect sustained capital investment in public services, as shown in Chart 2.6, and is fully consistent with meeting the Government's firm fiscal rules.

Chart 2.6: Public sector net borrowing and net investment



Financing **2.58** The forecast for the central government net cash requirement for 2004-05 has been revised from £35.6 billion in Budget 2004 to £39.7 billion, an increase of £4.1 billion. It has been decided to meet this increased financing requirement by increasing gilt sales by £3.2 billion to £50.3 billion and by increasing the planned end financial-year Treasury bill stock by £1.0 billion to £18.5 billion. Full details and a revised financing table can be found in Annex B.

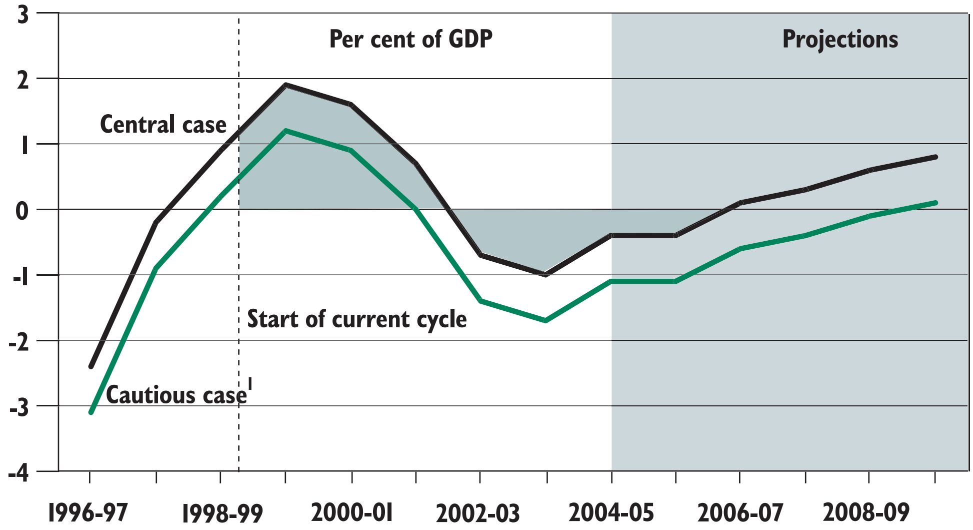
European commitments **2.59** The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box 2.2 and *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in this Pre-Budget Report, which show the Government is meeting its fiscal rules over the cycle, low debt and sustainable public finances, combined with sustainable increases in public sector net investment, are fully consistent with the prudent interpretation of the Pact.

Dealing with uncertainty **2.60** Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. As set out in Box 2.1, the use of cautious assumptions audited by the NAO builds a margin into the public finance projections to guard against unexpected events. To accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term, the Government bases its public finance projections on a trend growth assumption that is $^1/_4$ percentage point lower than its neutral view.

2.61 A second important source of potential error results from misjudging the position of the economy in relation to trend output. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart 2.7 illustrates the Pre-Budget Report projection for this cautious case.

2.62 The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. This was combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt. This has allowed the Government to safeguard the increase in investment in priority public services, allow the automatic stabilisers to work in full during the period of global economic uncertainty that began in 2000 and meet in full the UK's international commitments, while continuing to meet the fiscal rules.

Chart 2.7: 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.

2.63 The Government is, on the basis of cautious, independently audited assumptions, meeting the golden rule in the central case. However, in the cautious case, the average surplus on the current budget over the economic cycle is no longer positive as the Government draws on its safety margin against unexpected events. The projections show that this margin is being rebuilt at the end of the projection period as the current budget moves into surplus and the cyclically-adjusted surplus in the cautious case also moves back into surplus. In the meantime, the Government will remain vigilant to the risks and continue to base projections of the public finances on cautious assumptions.

LONG-TERM FISCAL SUSTAINABILITY

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

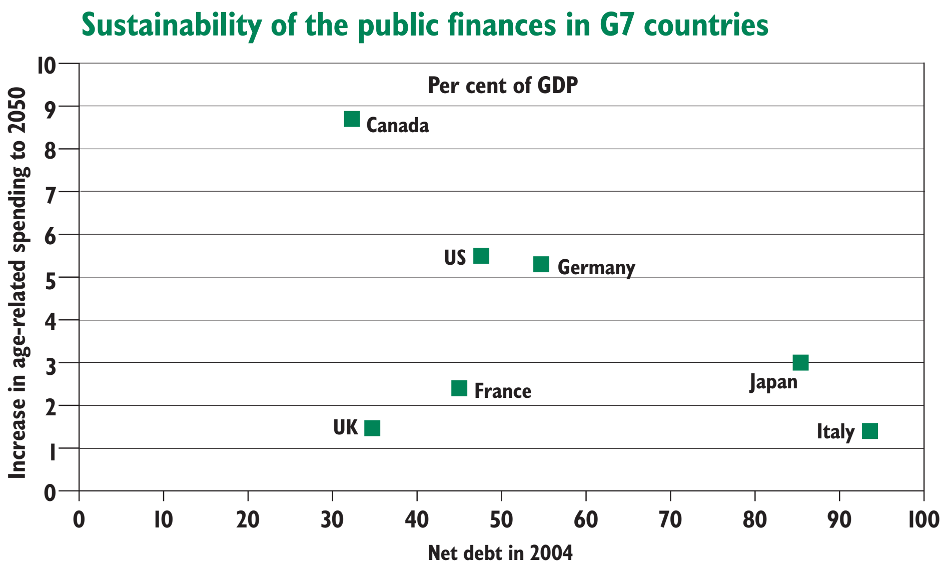
2.65 An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2004 *Long-term public finance report*. Based on the latest population projections the report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances, updating the illustrative long-term projections set out in Budget 2004. To provide a comprehensive and robust analysis, the report:

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

2.66 Using a range of sustainability indicators, including the intertemporal budget gap and fiscal gap, and based on current policies and reasonable assumptions, the report shows that the public finances are sustainable in the longer term. The UK is in a strong position relative to many other countries to meet the challenges of an ageing population.

Box 2.6: Long-term sustainability in the G7

The challenges posed by an ageing population vary considerably between countries. The chart below shows the relationship between the ratio of net debt to GDP and the projected increase in age-related spending over the period to 2050.



Source: Net financial liabilities from OECD Economic Outlook 75 (June 2004). Increase in age-related spending for UK from 2004 Long-term public finance report Chart 5.9, other EU countries from European Commission's assessments of Member States' Stability and Convergence Programmes 2004 and for non-EU countries from OECD Economic Outlook 69 (June 2001).

The chart shows that a number of countries face a large projected increase in age-related spending over the next 50 years or so, of up to around 9 per cent of GDP, primarily due to large increases in pension and health spending. Of those countries with relatively small projected increases in age-related spending, some have a high starting level of debt, which could prove a burden in the future. In contrast, the UK has one of the lowest debt to GDP ratios in the G7, and faces only a relatively small increase in age-related spending, illustrating that the UK is well placed to meet the long-term challenges of an ageing population.

A more detailed analysis of long-term trends and sustainability in different countries is presented in Chapter 5 of the 2004 *Long-term public finance report*.

3 MEETING THE PRODUCTIVITY CHALLENGE

Productivity growth underpins strong economic performance and sustained increases in living standards. The Government's long-term goal is for the UK to achieve a faster rate of productivity growth than its main competitors. Building on the reforms and initiatives already introduced, the Pre-Budget Report sets out the next steps the Government is taking to strengthen the drivers of productivity growth and meet the long-term challenges of the global economy, including:

- **giving employers the opportunity to access free and flexibly delivered training for their low-skilled employees through a National Employer Training Programme;**
- **establishing an independent review to examine the future skills needs of the UK economy, to be led by Sandy Leitch, (Chairman of the National Employment Panel and formerly a Chief Executive of Zurich Financial Services);**
- **reforms to reduce the regulatory burden on business, including the extension of Common Commencement Dates to other areas of legislation, and progress on the Panel for Regulatory Accountability;**
- **publication of the interim report of the Hampton Review recommending improvements to the current system of regulatory inspection and enforcement to reduce the administrative burden on business;**
- **setting out the vision of how significant reductions in compliance burdens for small businesses will be delivered through the integration of HM Customs and Excise and the Inland Revenue;**
- **implementation of the changes recommended by the Graham Review of the Small Firms Loan Guarantee by end 2005; and**
- **implementation of the ten-year Science and Innovation Investment Framework, through strengthening the partnership with business on raising investment in UK R&D, and taking forward the recommendations of the Lambert Review on business-university collaboration including through the Northern Science and Industry Initiative.**

3.1 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. The UK has historically experienced low rates of productivity growth compared to other major economies, partly due to past macroeconomic instability and historic under-investment in capital, skills and research and development (R&D). In recent years, however, data suggest that the UK's performance has improved. Box 3.1 suggests that the trend rate growth of productivity in the UK has increased in recent years, and that the productivity gap with major industrial competitors appears to be narrowing. However, there is still more to be done to match the productivity performance of countries such as the US.

The changing global economy

3.2 The Government is committed to further action to improve productivity both now and over the long-term, which will be key to the continuing success of the UK economy. *Long-term global economic challenges and opportunities for the UK*, published alongside this Pre-Budget Report and summarised in Chapter 1, sets out the challenges over the next ten years for the UK economy in an increasingly integrated global economy.

3.3 The global economy is undergoing a profound transformation, with far-reaching and fundamental changes in technology, production, and trading patterns. Faster information flows and falling transport costs are breaking down geographical barriers to economic activity. The boundary between what can and cannot be traded is being steadily eroded, and the global market is encompassing a greater number of services and goods. The rapid growth of large emerging markets, in particular China and India, is shifting the balance of global economic activity.

3.4 Global markets can deliver significant benefits, enhancing growth and living standards and providing new opportunities for UK businesses. *Trade and the global economy*, published by the Treasury in May 2004, explained that trade helps to drive economic growth and productivity, and the Government has prioritised making progress on multilateral trade liberalisation and seeks to strengthen economic co-operation with major partners, such as the US. Global change also puts a greater premium on economic flexibility. As the global economy restructures, the success of developed countries will depend on building a flexible economy with a highly-skilled workforce, which can respond quickly to change and which focuses increasingly on high value-added sectors. In this context, *Long-term global economic challenges and opportunities for the UK* identifies the policy challenges for the UK as enhancing skills, promoting enterprise and supporting science and innovation.

Meeting the long-term challenges

3.5 To meet these challenges, the Government is committed to taking the long-term decisions necessary to ensure the UK will succeed in the coming decades. This chapter sets out a new ten-year strategy to boost workforce skills, describes progress on the ten-year strategy for science set out in the 2004 Spending Review, and sets out further action to encourage enterprise and tackle excessive burdens of regulation. These reforms are described in the context of the five key drivers of productivity performance:

- improving *competition*, which promotes consumer choice and encourages flexible markets and increased business efficiency;
- promoting *enterprise*, by removing barriers to entrepreneurship and developing an enterprise culture. An enterprising and competitive economy will mean the UK is well-placed to respond to opportunities in a rapidly changing and increasingly integrated global market;
- supporting *science and innovation*, to promote the development of new technologies and more efficient ways of working. Increasing rewards to innovation mean that the UK will increasingly depend on its ability to create new knowledge and translate it into innovative goods and services;
- raising *skills* levels, to create a more flexible and productive workforce, which can adopt innovative technologies and enable individuals to move into new areas of work. This need is reinforced by the rapidly rising skills levels in emerging markets such as China and India; and
- encouraging *investment*, to increase the stock of physical capital, including through stronger, more efficient capital markets. Capital markets are becoming increasingly integrated in the global economy.

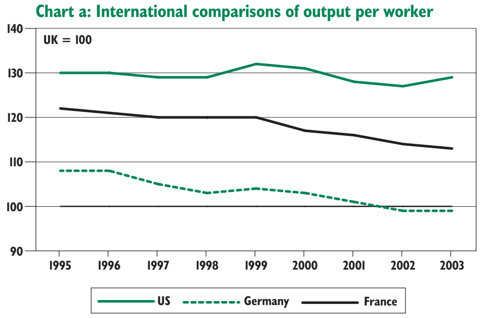
Box 3.1: UK productivity performance and the global economy

Productivity growth underpins strong economic performance and sustained increases in prosperity. In an open and competitive global economy, the success of developed countries will increasingly depend on rising productivity, and building a high value-added, innovative economy with a skilled workforce.

Between 1997 and 2001, the UK trend rate of underlying productivity growth (on an output per hour basis) is estimated to have grown by 2.7 per cent a year, compared with a growth rate in the previous economic cycle of just over 2.2 per cent a year. This improvement is encouraging, though it is too early to say whether it will be sustained.[a] The UK is also making progress towards narrowing the historic productivity gap with its competitors on both of the key measures of labour productivity – output per worker and output per hour worked – but a significant gap remains. In 2003, UK output per worker was 29 per cent lower than in the US (compared with 30 per cent in 1995), 13 per cent lower than France (22 per cent in 1995) and around the same level as Germany (8 per cent in 1995). The difference is greater on an output per hour basis. To produce the same output, UK workers work 14 per cent longer hours than German workers and 29 per cent longer than French workers.

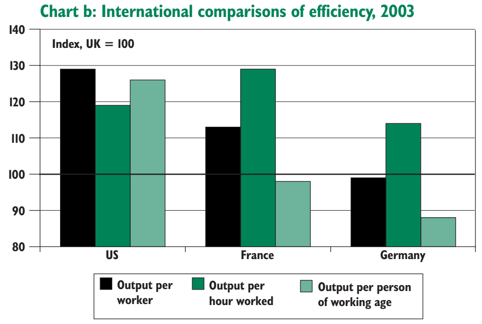
The UK performs relatively well in terms of output per person of working age, a measure which reflects both employment and productivity performance. This measure is closely related to prosperity and indicates how effectively an economy is using all of its potential labour resources. On this measure, UK performance is over 10 per cent higher than Germany and similar to France. However, the UK again lags behind the US which combines high labour productivity with high employment.

Chart a: International comparisons of output per worker



Source: ONS
Note: Data for 2001 to 2003 are provisional.

Chart b: International comparisons of efficiency, 2003



Source:ONS, HM Treasury
Note: Data for 2003 are provisional; output per hour worked are experimental data.

The UK's current performance reflects in part historic under-investment in skills, infrastructure, physical capital and research and development. The UK's future prosperity is likely to depend increasingly on the capacity to translate its strong scientific research base into innovative products and better services. To realise the full potential of innovation the UK needs a highly skilled and flexible workforce, able to adapt to capture the benefits of new technologies and innovate further. While the proportion of people in the UK with high skills compares well internationally, many other countries, including India and China, are rapidly developing skilled workforces. The HM Treasury and DTI Productivity Indicators[b] show that the share of the UK workforce with intermediate skills is relatively low and the share with low skills relatively high, despite improvements over the last few years.

[a] Annex A includes a detailed account of the trend productivity and trend growth projections.

[b] Available at www.dti.gov.uk/economics.

Monitoring progress on the five drivers

3.6 At Budget 2004, the Government consulted on a focused suite of indicators that would monitor performance against these five drivers and progress towards the Government's productivity target. In October 2004 the Government published its response to the consultation. The new set of productivity indicators[1] highlights how the UK is performing relative to its major competitors on key dimensions of each of the five drivers of productivity. They will be used to help monitor progress on the productivity target, provide early warning of where more policy action may be needed and will highlight how the UK is performing relative to its major competitors on key dimensions of each of the five drivers of productivity.

European economic reform

3.7 The European Union also has a key role to play in improving economic performance. At the 2000 Spring Council in Lisbon, Europe's leaders committed themselves to making Europe *"the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion"* by 2010.[2] The increased pressure of globalisation means that the need for reform is more urgent than ever. The 2004 Spring Council therefore launched a Mid-Term Review of the Lisbon strategy.

3.8 In November 2004, as part of this Review, the former Dutch Prime Minister Wim Kok published a report calling on Europe to speed up the pace of reform and to act urgently to implement the Lisbon strategy.[3] As set out in Chapter 2, European economic reform will be a priority for the UK's Presidency of the EU in 2005, and the Government welcomes Wim Kok's report. The Government will work closely with its European partners to secure a positive outcome to the Mid-Term Review at the European Council in spring 2005, and will highlight that greater openness to trade and investment acts as a spur to growth, employment and productivity, reinforcing the structural reforms that are the core of the Lisbon agenda.

Productivity in the regions

3.9 The Government is committed to boosting productivity across all regions and countries of the UK. Reflecting their important role in promoting economic development, the nine Regional Development Agencies (RDAs) in England have been asked to contribute to the development of Budget 2005 in several areas: closer alignment of regional strategies for economic development, housing, planning and transport; embedding a culture of enterprise in disadvantaged communities; developing knowledge transfer and science cities; regional and national roles in sustainable development; engaging with the voluntary and community sector; providing focused tailored coaching to business; and strengthening regional partnerships for adult skills provision. Box 3.2 sets out the Government's initial response to the Northern Way First Growth Strategy Report published by the three northern RDAs and regional partners.

COMPETITION

3.10 A strong competition framework drives productivity because competition puts downward pressure on prices, increases the diversity and quality of products available to consumers, and drives innovation. A framework which encourages domestic competition will also prepare the UK to respond to the challenges of the global economy. International markets are becomingly increasingly competitive, as technological advances, a reduction in trade barriers, and falling trade costs expand the geographical scope and accessibility of markets.

[1] HM Treasury and DTI Productivity Indicators, available at www.dti.gov.uk/economics.

[2] *Lisbon European Council: Presidency conclusions*, March 2000.

[3] *Facing the Challenge: the Lisbon strategy for growth and employment: Report from the High Level Group chaired by Wim Kok*, November 2004.

Box 3.2: The Northern Way Growth Strategy

The three northern RDAs, along with other regional partners, published the Northern Way First Growth Strategy Report[a] in September 2004. This sets out an ambitious strategy to establish the North of England as an area of exceptional opportunity with a world-class economy and a superb quality of life. The Government has welcomed this report and will respond in full in January 2005. The 2004 Spending Review announced several measures devolving more freedom, flexibilities and funding to support economic growth in the North. The Government is now building on this through a number of measures covered in more detail elsewhere in the Pre-Budget Report that respond to Northern Way proposals, including:

- **increasing regional role in national decisions, through a consultation on proposals for regional funding guidelines for transport, housing and economic development, described in full in Chapter 6;**
- **providing a more demand-led approach to skills provision in the North, tailored to the specific needs of the regions, through rolling out the Employer Training Pilots (ETPs) in a National Employer Training Programme providing free and flexibly delivered training for low-skilled adults. The Northern Way Report recognised the contribution that ETPs have made to improving workforce training and skills in the region. The Government has indicated that it will consider favourably proposals for 'dual key' arrangements for planning and funding adult skills, training and workforce development, where the RDA, LSC and other partners in the region want it. The three Northern Way regions have indicated that they plan to start using a 'dual key' arrangement by April 2005, working with the LSC, which the Government will consider favourably. The Government has asked all regions to report on progress ahead of Budget 2005;**
- **significantly extending the Pathways to Work pilots in the North, meeting the Northern Way's recommendation as part of a major expansion of the Pathways to Work pilots for incapacity benefits claimants, described in full in Chapter 4;**
- **ensuring that the Northern Way regions can take full advantage of support from the national strategy for Enterprise in Education, while welcoming the priority they put on this area through the Northern Enterprise in Education Programme; and**
- **welcoming the commitment of the three northern RDAs to promote science cities starting with Manchester, Newcastle and York, as part of their £100 million investment in university-business collaboration over the next six years.**

[a] *Moving Forward: The Northern Way: First Growth Strategy Report*, The Northern Way Steering Group, September 2004.

3.11 The Government has significantly reformed the UK competition framework. The reforms have created independent competition authorities with strong powers to combat anti-competitive activity as well as the power to investigate proactively markets that are not working well for consumers. The effectiveness of these reforms is monitored in regular peer reviews commissioned by the Government. The latest review published in 2004,[4] ranked the UK regime third globally behind the US and Germany, and described the UK competition authorities as having all the necessary powers to develop a world-class competition regime.

[4] *Peer Review of Competition policy*, KPMG and the Department of Trade and Industry, May 2004. Available at www.dti.gov.uk

Competition in specific markets

3.12 The Pre-Budget Report also sets out further steps to improve competition in particular sectors.

Spectrum use

3.13 The Government is the single biggest user of UK radio spectrum. Professor Martin Cave's 2002 Review of spectrum management[5] set out the case for introducing market mechanisms including trading and liberalisation of spectrum management. The Government's response recognised the potential efficiency gains from providing financial incentives to minimise public sector spectrum holdings and Ofcom is in the process of implementing the Review's recommendations. **Building on his 2002 Review, the Government announces that Martin Cave will conduct a comprehensive audit of public sector spectrum, with the aim of releasing the maximum amount of spectrum** to the market and increasing opportunities for the development of innovative new services.

Legal services

3.14 Sir David Clementi's independent review of the regulatory framework for legal services will be published by the end of the year, following wide consultation earlier this year. The Government set up the review to consider what regulatory framework would best promote competition, innovation and the public and consumer interest in an efficient, effective and independent legal sector because the current framework was found not to be meeting the demands of today's market place.

Payment systems

3.15 The Office of Fair Trading's (OFT) Payment Systems Task Force is working to identify and seek to resolve competition, efficiency and incentive issues relating to payment systems. The Government believes it is vital that this important market is efficient and open to real competition. It welcomes the industry's commitment to this process and expects it to continue to engage constructively with the Task Force on issues of mutual concern. The Government remains committed to legislating unless there has been a significant improvement in competition by the end of the Task Force's four-year lifespan.

Financial services

3.16 As part of the Treasury's Two-Year Review of the Financial Services and Markets Act 2000 (FSMA), the OFT has assessed the impact of the FSMA on competition in financial markets. Released today, the OFT's study concludes that there are no indications of areas where the Act might have had a significant adverse impact on competition in the activities and markets that it covers, and that the Act has had a positive effect on competition by improving how markets in the financial sector work.

Consumers

3.17 Consumers can play an important role in driving the development of competitive markets and consequently business performance. To help consumers understand their rights *Consumer Direct* was launched in summer 2004, providing consumers with clear, practical advice on consumer issues, and will cover the whole of Great Britain by early in 2006. The Government has reviewed the UK consumer framework and consulted[6] on proposals for empowering consumers and improving the legislative framework, access to redress, consumer representation in regulated industries, and enforcement of a fair and safe trading environment. The Government will produce its final proposals next year.

3.18 Consumer groups have an important role to play in ensuring markets are competitive. The 'super-complaints process', introduced in the Enterprise Act 2002, is a fast-track system for designated consumer bodies to make complaints about dysfunctional markets. The first super-complainants – the Consumers' Association, National Consumer Council and Citizens Advice – were designated in July 2004. The OFT is already addressing informal super-complaints on issues including private dentistry, home-collected credit and care homes.

[5] *Review of Radio Spectrum Management*, Professor Martin Cave, March 2002.

[6] *Extending Competitive Markets: Empowered Consumers, Successful Business*, DTI, July 2004.

Competition in the supply of goods and services to the public sector

Public procurement

3.19 As described in Chapter 6, the Government is committed to achieving greater value for money through better procurement across the public sector. This will also improve competition in the supply of goods and services to the public sector. The Office of Government Commerce (OGC) is implementing the recommendations of Sir Christopher Kelly's report[7] on increasing competition and capacity, and is working with the Office of Fair Trading (OFT) to spread best practice identified in the OFT's recent report[8] on procurement and competition. The OGC is completing its first market review covering the construction industry, working with the industry to identify capacity issues and to signal future demand to potential suppliers. It is also working with departments to improve client capability and commercial skills.

3.20 The Government will ask a leading business figure to work with OGC to ensure the full implementation by departments of the Kelly Review with an emphasis on ensuring adequate commercial skills and dealing with the barriers that prevent innovative solutions being adopted in the public sector. The Government has also decided that, from April 2005, OGC's remit should be expanded beyond central civil government to the wider public sector, to help to improve client capabilities in organisations outside central government, and to enable it to take a whole public sector approach in assessing future demands and competition issues in individual markets.

Improving access to public sector markets in Europe

3.21 The Government is also committed to improving access to public sector markets in Europe, and welcomes Alan Wood's report, published in November 2004, on the experiences of UK businesses in gaining access to public contracts in other EU Member States. Further detail on the Wood Report is given in Box 3.3.[9]

Enabling SMEs to compete for public sector business

3.22 Improving access to government procurement for small and medium-sized enterprises (SMEs) is important to improving competition, innovation and value for money in the delivery of public services. The OGC recently completed a project in the West Midlands, piloting solutions to help SMEs overcome barriers to competing for public sector business. The pilot successfully tested a number of measures with SMEs and procurement staff in the public sector, demonstrating that significant increases in the numbers of SMEs competing for and winning contracts can be achieved. The Government will implement nationally a number of the successful measures.

3.23 All government departments and agencies should have the right procurement systems in place to deal with SMEs. To support this objective the Small Business Service (SBS) will work with departments, including OGC, to review the pattern of existing government procurement from SMEs, enabling departments to improve the effectiveness of their procurement systems, reporting on progress by Budget 2005; and will collate and publish this information on an annual basis.

[7] *Increasing Competition and Improving Long-Term Capacity Planning in the Government Market Place*, December 2003.
[8] *Assessing the impact of public sector procurement on competition*, Office of Fair Trading, September 2004.
[9] *Wood Review – Investigating UK business experiences of competing for public contracts in other EU countries*, Office of Government Commerce, 2004.

Box 3.3: Wood Review of European public procurement

In the 2003 Pre-Budget Report the Government asked Alan Wood, chief executive of Siemens plc, to review the experiences of UK businesses in gaining access to public contracts in other EU Member States. Alan Wood's report, which was published in November 2004, shows that a range of obstacles stand in the way of effective competition in EU public procurement markets, to the detriment of UK and other EU businesses. Despite the existence of single market rules in awarding public contracts, the report identifies complex public procurement procedures, cultural differences, and wavering commitment to competition and market liberalisation as key factors holding back the creation of a competitive and dynamic EU public procurement market. The report proposes a range of steps to improve the functioning of public procurement markets across the EU and to ensure that UK firms can compete effectively for contracts, including:

- **action to identify, spread and report on best practice among EU Member States;**
- **action by Member States to open up more markets to public procurement and remove barriers to effective competition, as well as to raise the skills of procurement practitioners and to eliminate bad practice; and**
- **support from the Government through the Office of Government Commerce and UK Trade & Investment to help business compete successfully.**

The Government will work with the Commission and other Member States to implement the recommendations of the review. Improvements in public procurement practice will deliver better value for money and put EU firms in a better position to compete in global markets.

ENTERPRISE

3.24 Enterprise is a key driver of a modern, high-productivity economy in which opportunity is open to all. The Government believes it is essential to make the UK a more entrepreneurial economy, so that it is well placed to meet the long-term opportunities and challenges of an increasingly globalised economy.

3.25 The Government is committed to improving the UK business environment. The UK also needs to do more to promote enterprise across all regions of the UK. Rates of entrepreneurial activity in the UK compare favourably with those of other European economies, but lag behind those in the United States.[10] UK business creation is still half that of the United States. If the UK had the same level of entrepreneurial activity as the US, then up to 1.8 million more people could be engaged in entrepreneurial activities. Business start-up rates in deprived areas are up to 10 times lower than in the most successful areas of the UK.

3.26 To help close the productivity gap over the next decade, the UK must remove barriers to competition and enterprise to encourage individuals and firms to move into new markets to capitalise on the new opportunities created by the expansion of global economic activity. This Pre-Budget Report sets out further action to addresses these long-term policy challenges.

3.27 *Long-term global economic challenges and opportunities for the UK* explains how the global economy has become more open and competitive, as communication and technology continues to improve. Production processes are becoming increasingly flexible, with production dispersed across continents and accompanied by an increasing level of

[10] Global Entrepreneurship Monitor, Executive Summary, 2003 and HM Treasury and DTI Productivity Indicators, 2004, available at www.dti.gov.uk/economics.

specialisation. This means that new sectors are opening up to international trade and developing countries increasingly have the means to compete in global markets. Rising entrepreneurship in China and India is expanding markets and creating new avenues for trade.

3.28 The Government is committed to ensuring that British firms can act upon the expanding opportunities to trade provided by falling global barriers and the rapid growth of Asian markets. **To maximise the potential gains for British businesses and develop education, science and technology links, the Government will introduce an Asia Task Force.** The Asia Task Force will aim to deliver the benefits of greater cooperation with China, India and other emerging economies to UK businesses and individuals, raising awareness of the potential market opportunities. It will expand on the lessons learned from the successful China Task Force by utilising the expertise of leaders in industry, education, and science.

Leading regulatory reform

3.29 The Government recognises that over-burdensome regulation imposes a significant cost on business. Inefficient regulation diverts businesses' time and resources from developing opportunities, innovating, investing and growing; especially for small businesses, where owner-managers' time and energy is both their greatest asset and their scarcest commodity. Since 1997, the Government has pursued an agenda of better regulation, applying the five principles of good regulation: proportionality, accountability, consistency, transparency, and targeting.[11] The Government's approach focuses on:

- minimising the burdens on business of paperwork, inspection and enforcement, particularly for SMEs, by ensuring that the administration of regulations and business taxes is efficient;
- ensuring that regulation is used only where necessary to achieve policy outcomes for which there is a clear rationale and where alternatives to regulation are not feasible; and
- pursuing an agenda of regulatory reform in Europe.

3.30 Substantial progress has already been made. Measures to reduce the administrative burden of regulation have included rationalising regulatory structures, including the creation of the Financial Services Authority from nine bodies, and Ofcom from five previous regulators; while over 400 deregulatory measures from the 2003 Regulatory Reform Action Plan have been delivered. The Panel for Regulatory Accountability (PRA), now chaired by the Prime Minister, provides strategic oversight to departments' regulatory activity and challenges regulations with a high cost to business.

3.31 However, the Government recognises that there is more to do to keep the UK at the forefront of regulatory reform. It is taking steps to identify and respond to businesses' concerns, and welcomes the role businesses are playing in identifying specific areas in which the regulatory system can be improved, and influencing regulatory proposals at an early stage. This Pre-Budget Report sets out the next steps on the Government's agenda to improve the UK's regulatory system and business tax administration.

[11] *Principles of Good Regulation*, Better Regulation Task Force, January 1998.

Minimising administrative burdens on businesses: Hampton Review

3.32 In Budget 2004, the Chancellor asked Philip Hampton to lead a review into regulatory inspection and enforcement with a view to reducing the administrative cost of regulation to the minimum consistent with maintaining the UK's excellent regulatory outcomes. The Government welcomes the interim report of the Hampton Review, *Reducing administrative burdens: effective inspection and enforcement*, published alongside this Pre-Budget Report, and looks forward to the final report in spring 2005.

Box 3.4: Hampton Review of regulatory inspection and enforcement

The interim report of the Hampton Review finds many positive elements in UK regulators' approach to reducing administrative costs on business. The UK performs well in many international comparisons of regulatory reform, but the review also concludes that reform and best practice must be embedded and shared across all bodies involved in inspection and enforcement activity. The review identifies a range of possible reforms, including:

- **general use of comprehensive risk assessment methodologies so that no inspections take place without a reason;**
- **better tailored advice for businesses;**
- **rebalancing advice and inspection because good advice-giving leads to better regulatory outcomes, especially for small business;**
- **more effective incentives for compliance including reform of the penalty regime;**
- **more joint working including information sharing and cross-training between regulators;**
- **measures to consolidate information resulting in fewer, simpler forms, and for Government to have a single data-set on businesses in the long-term; and**
- **continuing the recent trend of consolidation of functions into national regulatory bodies.**

The review also identifies the need to ensure that the right structures are in place for local consistency and national standards, for example for trading standards. The interim report contains a number of consultation questions, on which responses are sought by 4 February 2005. The review will take forward this analysis and produce a final report with recommendations in spring 2005.

Reforming the administration of business taxes

3.33 To reduce administration burdens on businesses in the tax system, the Government announced in Budget 2004 that payment of Working Tax Credit by employers would in due course be phased out and replaced by direct payment by the Inland Revenue. The Government is consulting on the detail of implementation.

3.34 The integration of HM Customs and Excise and the Inland Revenue provides an opportunity to reform further the administration of the tax system to deliver compliance cost savings for businesses, in particular small businesses. The Government is setting out steps that the new department will take in delivering its long-term goal of significant deregulatory benefits, consistent with the interim findings of the Hampton Review: reducing the burden of compliance visits and inspections; moving towards a single account for all payments and repayments; examining the practicability of a single return for all taxes; reducing the number of forms and returns; and providing more advice to those starting up to help them get things right from the start. Further details are set out later in this chapter.

Transparency and predictability

3.35 The Government is taking a number of other steps to minimise the administrative burden on businesses:

- the Government has asked the Better Regulation Task Force (BRTF) to study the system used by the Dutch Government to measure and reduce their administrative burden. The BRTF is working closely with the Hampton Review team and will make recommendations in spring 2005; and
- frequent changes to regulation cause uncertainty for business about which rules they need to comply with, and when. Following a consultation led by the SBS and the success of the DTI pilot for employment law, the Government will now extend common commencement dates for new and amended domestic legislation that impacts on business, starting with health and safety, work and pensions, company and consumer legislation from 2005. New regulation in these areas will in future be introduced on two dates each year, 6 April and 1 October, unless there are exceptional reasons for not doing so. This approach will be introduced to other areas of legislation as far as is possible and practical from 2005.

Regulating only where necessary

3.36 The Prime Minister's Panel for Regulatory Accountability (PRA) was established at Budget 2004 to reduce the flow and improve the quality of regulation at UK level ensuring that regulation is used only where necessary. Under new arrangements announced in Budget 2004, the PRA scrutinises all new regulations likely to impose a significant cost to business before they can become law. Clearance is based on a thorough impact assessment of the proposal, agreed by the Regulatory Impact Unit. The PRA has already rejected or delayed a significant proportion of regulatory proposals, where departments had not properly justified extra burdens on businesses, and will increasingly provide strategic oversight of regulatory activity, challenging departments to tackle the cumulative burden of their regulations.

3.37 For example, following PRA scrutiny, Defra will build upon the deregulatory reform of the Common Agricultural Policy by ensuring that the number and burden of inspections that farmers face are minimised. The DTI will look to simplify existing regulation in the consumer area to take account of the duty not to trade unfairly that will be introduced through the Unfair Commercial Practices Directive. DTI has agreed there will be no extension of the coverage of the Operating and Financial Review regulations beyond quoted companies and, across its regulatory remit, will set out deregulatory measures to reduce businesses' costs by more than £1 billion over the lifetime of its five-year plan.

3.38 The BRTF has been asked to conduct a feasibility study on the 'one in, one out' model, which will look at how the Government might bring forward compensatory deregulatory and simplification measures when it seeks to introduce new legislation. It will report in spring 2005, and the Government will consider whether this model could be used to complement existing systems for managing the overall regulatory burden on businesses, including the PRA.

Reviewing the effects of regulations

3.39 As well as driving up the quality of Regulatory Impact Assessments (RIAs) conducted before regulations are introduced, the Government believes that regulations should be reviewed after they are implemented to ensure that they are having the intended effect. RIAs will in future specify how and when new regulations will be monitored and reviewed. The Better Regulation Task Force (BRTF) will be asked to monitor this requirement, and to report on each department's compliance in its annual departmental assessments of regulatory performance.

Regulating only where necessary: EU legislation

3.40 The Government does not go beyond the minimum requirements of European legislation unless there are exceptional circumstances, justified by strong cost benefit analysis and extensive consultation with businesses. A good example is the 2001 Money Laundering Directive. The Government is putting in place safeguards to ensure that strict adherence to this approach will be continued in the future, and in addition the Foreign and Commonwealth Office has proposed a range of measures to ensure that Parliament has a greater and more effective role in scrutinising draft EU legislation. Following the Bellis report[12], commissioned by the Foreign Secretary, which compared transposition practices across Member States, the Chancellor and the Foreign Secretary are today setting out new measures to continue to ensure that businesses do not face unnecessary burdens from European law. In future:

- all emerging European legislation, and measures to implement this legislation in the UK, with significant costs for businesses, will be given tough scrutiny by the Prime Minister's Panel for Regulatory Accountability (PRA);
- the transposition of European directives into UK law must avoid costly additions to the requirements for businesses, meet only the minimum standards and scope necessary to comply with the European legislation, and take advantage of derogations when less burdensome for business, except where there is a strong cost benefit rationale for doing otherwise, specifically approved by PRA. Transposition should mirror as closely as possible the original wording of the directive except where there is a clear justification for doing otherwise, having regard to the impact on business and the workability and fit of the legislation in its domestic context. The Government will publish revised transposition guidelines for European legislation early next year;
- a comparison with other Member States' approaches to transposition will be required during implementation so that the relative burdens of different approaches are well understood, and the Government will be exploring the scope for introducing this on a comprehensive basis, and for sharing best practice across Member States, with the Commission;
- all departments will publish annual implementation plans for European legislation, so that the effects on UK businesses are transparent;
- legal advice will take into account the policy context consistently and rigorously, with specific consideration of the costs and benefits for businesses;
- the Government will take into account the approaches taken by other Member States when implementing directives and the potential impacts on the competitiveness of UK businesses; and
- the Government proposes to work with the European Commission and other Member States to create stronger enforcement mechanisms, which will provide incentives for Member States to implement legislation on time.

Improving clarity and accountability

3.41 The BRTF recently published *Avoiding Regulatory Creep*, a report which examined instances of regulation or compliance with regulation that goes beyond its original source of authority. The report concluded that while there has been progress across government to meet the principles of good regulation, there are nevertheless a number of factors which can lead to unintended additions to the scope or impact of regulation. These include: lack of clarity about the intention of regulation, ambiguity on the status of guidance, and enforcement arrangements which can encourage over-compliance. The BRTF recommendations – for the Government, independent regulators and industry bodies – call for greater clarity, consistency and better communication to make regulation less burdensome. The Hampton Review is addressing a number of these issues, and the Government will respond fully to the report early in the new year.

[12] *Implementation of EU legislation, an independent study for the Foreign and Commonwealth Office by Robin Bellis.* November 2003.

Delivering better regulation

3.42 The Government is also taking forward other steps to improve the design and quality of regulations:

- a new industry/Government regulatory forum will be established for the food industry;
- in response to concerns expressed by the construction industry, especially SMEs, a review of Part II of the Housing Grants, Construction and Regeneration Act 1996 was announced at Budget 2004. The first stage, chaired by Sir Michael Latham, is now complete. DTI will issue a consultation paper early next year on measures to improve payment practices and the adjudication process for business in the construction sector;
- the Government has now implemented more than 400 of the measures identified for reform in its Regulatory Reform Action Plan published in December 2003. For example, the Business Tenancies Regulatory Reform Order came into force in June of this year, modernising procedures for renewing or terminating tenancies, saving businesses £6.5 million per annum; and
- several initiatives are being introduced to deliver a culture change towards better regulation across Government and other public sector bodies. These include, for example, improved trainintg policy-makers, board-level regulation champions in each government department and, sponsored by the BRTF, a new award for public servants who develop innovative and deregulatory solutions to policy problems. The new award will be included in the Public Servants of the Year Award Scheme, with the first winners announced in April 2005.

Advancing regulatory reform in Europe

3.43 Half of significant new regulations affecting businesses in the UK originate in EU law. The 2004 Four Presidencies initiative, launched by the Chancellor and the Finance Ministers of Ireland, the Netherlands and Luxembourg, set out a series of joint proposals designed to place regulatory reform at the heart of these EU Presidencies, spanning 2004 and 2005.

3.44 Significant progress has been made. Strengthened procedures for competitiveness-testing new EU regulations have been developed and Member States have agreed new proposals for simplifying existing EU law in 2005. Consistent with the Government's commitment to minimise the administrative burden on business in the UK, Finance Ministers have also called for further action to measure and control the administrative burden associated with new and existing laws, which the Commission will implement in a pilot phase starting early in the new year. The Government welcomes these developments and will continue to work with other Member States and the European Commission to advance European regulatory reform, in particular by:

- ensuring that the administrative costs of EU regulation are included in all impact assessments, and clear and measurable objectives and goals are established for controlling the administrative burden associated with all EU regulation;
- ensuring the effective implementation of competitiveness testing to ensure that the implications of proposals for business and the wider European economy are fully taken into account;
- strengthening external input into the regulatory process in Europe, with enhanced quality control of EU impact assessments and improved consultation and input from business; and
- identifying further priority areas of EU regulation for simplification during 2005.

3.45 The Government also supports the Commission's consultation on priority areas for closer EU-US cooperation to break down barriers to trade and investment flows caused by differences in regulatory approaches on both sides of the Atlantic.

Modernising and simplifying the tax system

3.46 The Government is currently implementing the recommendations of the O'Donnell Review,[13] published alongside Budget 2004. In May 2004, it announced that the new department integrating HM Customs and Excise and the Inland Revenue would be called Her Majesty's Revenue and Customs (HMRC) and David Varney was appointed as the first Executive Chairman of the new department. The Commissioners for the Revenue and Customs Bill was introduced on 24 November.

Simplifying tax administration for small business

3.47 The Government is determined to deliver a fair and efficient tax system for small business. The integration offers a unique opportunity to simplify the administration of the tax system, and to deliver a package of major deregulatory gains and reductions in the costs associated with compliance. The O'Donnell Review highlighted how small businesses, many of which are customers of both existing departments, have the most to gain from a co-ordinated approach to support and compliance. Tackling areas of tax administration and compliance that are unnecessarily burdensome, as well as providing enhanced support and education to improve the capacity of firms to comply with their obligations, will be a key priority for the new department, as described further in Box 3.5.

[13] *Financing Britain's Future*, Review of the Revenue Departments, HM Treasury, March 2004.

Box 3.5: Delivering a simpler tax system for small business

The new department's long-term goal, consistent with the interim findings of the Hampton Review on reductions to the administrative costs of regulation described earlier in this chapter, will be to enable its support and compliance staff to have a 'whole view' of any customer with whom they are dealing and to minimise the burden of paperwork and contact by providing:

- a reduced number of forms and returns and examining the practicability and advantage of moving to a single return for all taxes;
- a single account through which all payments and repayments may be made;
- an integrated approach to audit informed by better risk assessment, with a single visit to inspect records rather than separate inspections for different taxes; and
- more effective support and streamlined access to information in ways that better suit customers, including better use of information technologies.

This vision of a fully integrated relationship with business will require enabling legislation, as well as new information and IT systems that will take a number of years to build. In the meantime, significant steps will be taken to improve delivery of the tax system for small businesses, through:

- **creating a small business unit** at the heart of the new department led by a senior official to champion the needs of small businesses;
- **setting up a high level advisory group with strong private sector membership** to guide the unit's work and ensure the department's activities harness the business community's ideas for improved compliance at lower cost;
- **carrying out research into small business customers' needs and attitudes**, to inform the detailed implementation of the vision set out above, and responding to small businesses' concerns that the tax system creates or adds to their cash flow difficulties; and
- **publishing details of a review of links with medium sized businesses**, focusing on future channels of communication between those businesses and the revenue department.

Work has already started on a number of early pilots, the results from which will inform thinking in the new department on how best to deliver this step change in small businesses' experience of the tax system. The pilots include looking at:

- integrated support on indirect and direct taxes for small businesses at key stages of their development;
- helping people who have drifted into the informal economy to set their affairs in order and gain all the benefits of being legitimate businesses; and
- paving the way for co-ordinated audit and enquiry work through improved targeting of compliance.

3.48 The new department will ensure that tax policy development in HM Treasury is fully informed by its experience of providing services to small business customers and from its compliance activities. It will publish further details of their proposals to integrate and streamline services to small businesses at Budget 2005, and a report on progress in the autumn.

Business tax reform

3.49 Modernising the structure and administration of the tax system as it applies to businesses is a key component in maintaining competitiveness. A modern business tax system should avoid creating barriers to innovation and business activity, and keep pace with changes in the global economy. It should also ensure that businesses contribute their fair share to funding public services – measures to guarantee this are set out in Chapter 5.

3.50 To meet the challenges of an increasingly knowledge-driven global economy, the Government is keen to ensure that people who choose to set up in business have the flexibility to adopt the legal structure that will best suit their commercial requirements, quickly and efficiently, and that this decision is not distorted by tax planning. The Government has therefore today published a discussion paper[14] on the strategic issues relating to the tax treatment of small businesses and invites comments from interested parties. Further details are set out in Chapter 5.

Corporation Tax reform

3.51 The Government is committed to maintaining a modern, fair and competitive corporation tax system and is taking forward consultation on a range of issues, including reform of the schedular system for companies. As described in Chapter 5, following a period of consultation, the Government will modernise the treatment of leased plant and machinery. **The Inland Revenue has today also published a Technical Note including draft legislation on schedular reform and leasing.**[15]

International Accounting Standards

3.52 As part of the modernisation of financial reporting in the UK, International Accounting Standards will be adopted from 1 January 2005. The Government has considered carefully the transitional adjustments arising from the change and has decided to defer any tax effects from this transition until the impact can be determined and managed. **Measures will be introduced in Finance Bill 2005 to enable securitisation vehicles to continue applying existing UK accounting standards for tax purposes for a further year and to address specific technical issues.**

Further business tax reform

3.53 In addition this Pre-Budget Report also announces:

- a report on the review of tonnage tax, together with draft legislation, will be issued by the Inland Revenue shortly. Following consultation **the Government will put forward legislative amendments in Finance Bill 2005**. The Government **has also decided that leasing reform should apply to tonnage tax leases not on ships within tonnage tax**;
- **a consultation into the conditions that property owners should meet, from 2009, in order to revoke their option to charge VAT to tenants**. Setting the conditions early will give certainty for businesses that are already planning the use of their property in 2009 and beyond; and
- following an announcement in Budget 2004, publication shortly of a technical note and draft clauses detailing changes to UK tax law that will **allow companies based in the UK formed under the European Company Statute to be taxed on a similar basis to UK companies**.

[14] *Small companies, the self-employed and the tax system: a discussion paper*, HM Treasury, December 2004.
[15] *Corporation Tax reform: Technical Note*, Inland Revenue, December 2004.

Creating an enterprise society

3.54 The Government believes that the UK needs a stronger culture of entrepreneurship to compete in the global economic market. Creating a climate of enterprise for all, in which entrepreneurial achievement is valued underpins a strong business sector and is critical in providing economic opportunity to all. The Government believes that anyone with the initiative, drive and talent to succeed in business should be able to do so.

3.55 The UK's first national Enterprise Week in November 2004 was organised by Enterprise Insight with support from the business community, schools, Government and others. More than 1,000 events were held in the UK, with the aim of raising the profile of enterprise in society and encouraging young people to consider entrepreneurship as a career option. Building on this year's success, the Government looks forward to Enterprise Week in 2005.

Enterprise in education

3.56 The Government is taking action to equip people with the skills and confidence to engage in entrepreneurship, in particular through enabling young people to acquire entrepreneurial skills and to prepare them for an ever-changing employment market:

- DfES have launched draft web-based guidance for schools, in advance of the national roll-out of enterprise education in September 2005; and
- from February 2005, the National Council for Graduate Entrepreneurship will offer 15 individuals or groups from each region across the UK places on a new 'Flying Start' business support programme to develop their business ideas.

3.57 The Government is also promoting the role of enterprise in driving productivity growth and opening opportunity to all, including through:

- making regional nominations for Enterprising Britain, the competition to find the UK's most enterprising city. The national winner will be announced early next year. Developing this model, the Government has called for a European Centres of Enterprise competition;
- Isabella Moore, former President of the British Chambers of Commerce, will head a new national Women's Enterprise Panel, working closely with the Small Business Council to advise government and champion female entrepreneurs;
- a new Transatlantic Enterprise Partnership with the US, to share best practice on approaches to entrepreneurship and productivity; and
- the Chancellor will host *Advancing Enterprise,* a conference for business leaders in London in February 2005, focusing on the role of entrepreneurship in meeting the opportunities and challenges of globalisation.

Supporting small businesses

3.58 The 2004 Spending Review announced a new approach to supporting SMEs. It gave the nine Regional Development Agencies (RDAs) in England devolved powers to lead the provision of government support for small businesses including, from April 2005, responsibility for delivering the Business Link service.

3.59 Devolution provides a new opportunity for the RDAs to go beyond the one-size-fits-all business support of the past, and to target additional focused coaching towards ambitious start-ups and tailored business development programmes for firms with high-growth potential. Evidence shows that well-designed focused programmes of support can significantly enhance the survival and growth prospects of new and growing business. The RDAs will help these firms to address specific barriers to growth such as raising risk capital, managing rapid growth, understanding regulations and taxes, planning investment and selling into wider markets. Brian Jackson, the new chairman of the East Midlands Development Agency, will work with each RDA to develop a framework by Budget 2005, drawing on evidence from existing programmes across the UK, to ensure that focused, tailored coaching is provided to businesses that will most benefit from it, enhancing the prospects for rapid business growth in every region. Additionally the Government is:

- supporting two projects in the North East and East Midlands to **join-up different business support services providers at the local level** and maximise the benefits of devolution by making it easier for businesses to find the support they need;
- addressing the hurdles that all successful businesses eventually face when their ownership changes. As a result of the review by Martin Wyn Griffith of the Small Business Service into the barriers to effective business transfer,[16] announced in Budget 2004, **new measures will be brought forward to address constraints that may inhibit the smooth succession of business ownership;** and
- welcoming the report published by the Small Business Council (SBC) on encouraging businesses out of the informal economy.[17] The SBS will convene a cross-departmental group to consider the Council's recommendations and will respond to them next year.

Small Firms Loan Guarantee

3.60 For new and innovative businesses to succeed, they need to be able to raise finance to invest and grow. The Small Firms Loan Guarantee scheme (SFLG) exists to help individuals overcome the problems they face in obtaining debt finance to start new businesses and to help small businesses to expand. The 2003 Pre-Budget Report announced that the Government had asked Teresa Graham to review the scheme, and in particular to consider whether it remained effective in tackling the financial barriers faced by start-ups and small businesses.

3.61 The Government accepts in full the recommendations set out in the Review's final report,[18] described in Box 3.5. They will be fully implemented, and the new scheme made operational, by the end of 2005.

[16] *Passing the Baton: Encouraging successful business transfers*, Small Business Service, December 2004.
[17] *Small Businesses in the Informal Economy: Making the Transition to the Formal Economy*, Small Business Council, November 2004.
[18] *Recommendations, Graham Review of the Small Firms Loan Guarantee*, September 2004. (www.hm-treasury.gov.uk/graham).

Box 3.5: Graham Review recommendations

The final report of the Graham Review of the Small Firms Loan Guarantee was published in October 2004. The review found that some start up and young SMEs with growth ambitions continue to find a lack of collateral a barrier to accessing debt finance, and set out a range of recommendations designed to maximise the support the scheme offers to small firms.

The review recommended that the SFLG offer more generous, but better targeted, support to small firms, and also made recommendations to widen availability of the scheme and to modernise and deregulate its administrative structure. Key recommendations included:

- **expanding lending limits to £250,000 per business;**
- **raising the turnover limit to £5.6 million for all eligible businesses;**
- **allowing serial entrepreneurs to benefit by removing the current £250,000 limit on lending to any individual;**
- **reducing bureaucracy by making radical changes to the operation of SFLG;**
- **targeting SFLG at start ups and young businesses by introducing a maximum age limit of three years' full trading;**
- **encouraging new lenders to join the scheme; and**
- **incentivising wider availability of SFLG throughout branch networks.**

Enterprise Capital Funds

3.62 In May 2004, the Government published draft guidance for investment managers interested in bidding to establish one of the new pathfinder Enterprise Capital Funds (ECFs). The Government hopes to receive European state aids clearance in time to launch the funds early in 2005, when final guidance will be published and the formal ECF bidding process will begin.

Delivering financial interventions

3.63 The 2003 Pre-Budget Report announced that any full-scale ECF programme would be managed at arms-length from Government by a new publicly-owned company. The Government also accepts the recommendation of the Graham Review that such a company should be responsible for managing delivery of the reformed SFLG scheme. Furthermore, it believes that the ongoing delivery of all of the DTI's risk-capital interventions for SMEs would be most effectively delivered by such a company.

3.64 While the decision to establish a delivery company remains dependent upon the establishment of a full ECF programme, the DTI are advertising for an advisory panel in the interim period. The principal role of this panel will be to provide expert advice to the Government on the implementation of the pathfinder round of ECFs and the Graham Review recommendations for SFLG. Should a full ECF programme go forward, the board of the new company will take over the role of the advisory panel.

Demand for finance

3.65 The Government recognises the need to match improved supply of risk capital with measures to ensure that firms understand the financial options available to them and is therefore:

- asking the RDAs to incorporate the lessons from the SBS's investment readiness programme as part of their strategies for providing focused business coaching to enhance business growth in each region, as outlined above;
- endorsing the recommendations set out in the *Facilitating Finance* report[19] of the Government and Accountants Working Group, led by Michael Snyder. **The accountancy profession and the Government will work together to establish a new self-accreditation programme for accountants and other business advisers who are able to provide advice to small businesses seeking finance to grow;** and
- **publishing a new no-nonsense guide to raising finance for business.**

[19] *Facilitating Finance*, The Government and Accountants Working Group, September 2004. (www.sbs.gov.uk/finance).

Financial regulation

3.66 Business angel investment provides finance to an estimated 3,000 to 6,000 UK businesses a year, which otherwise would have difficulty raising the necessary investment capital. Responses to the consultation on the Financial Promotion Order[20] highlighted the difficulties faced by small firms in identifying investors certified as sophisticated or high net worth, who are exempt from rules that restrict the ability of businesses to promote investment opportunities. **From January 2005, the Government will introduce self-certification for sophisticated or high net worth investors, making it easier for small firms to raise finance from these business angel investors**. Self-certification, based on objective tests, strikes a balance between allowing small firms to raise capital, and appropriate protection for investors.

Promoting local enterprise

3.67 Raising levels of enterprise and economic activity is essential for sustainable neighbourhood renewal and enabling opportunity for all. The 2002 Pre-Budget Report designated 2,000 Enterprise Areas in which policies to boost enterprise would be focused. The toolkit of measures available in Enterprise Areas is set out in Box 3.6.

Box 3.6: Enterprise Areas

Enterprise and business activity are essential to achieving sustainable regeneration of communities through higher employment and wages. The 2002 Pre-Budget Report designated 2,000 Enterprise Areas where policies to boost enterprise would be focused. Measures currently available to Local Authorities and Regional Development Agencies to integrate with their regeneration strategies include:

- **stamp duty exemptions on property transactions to stimulate local property markets;**
- **Community Investment Tax Relief to improve access to finance for small business;**
- **City Growth Strategies to encourage a business-led approach to regeneration;**
- **Bridges Community Development Venture Fund to finance fast-growing small businesses;**
- **Phoenix Development Fund for business support services in disadvantaged areas; and**
- **New Entrepreneur Scholarships providing a package of support and training for young people looking to start their own business.**

The Planning and Compulsory Purchase Act 2004 will also enable local authorities to use Local Development Orders (LDOs) in Enterprise Areas. These will deliver automatic planning permission for types of development specified in the Order.

3.68 As powers and capacities at the local and regional level grow, the Government is keen to ensure that Enterprise Areas and other national measures support and complement local and regional regeneration strategies. The Government would welcome a dialogue with key stakeholders, particularly local authorities and RDAs, about how to maintain the attractiveness of the Enterprise Area package while increasing its responsiveness to local and regional needs.

Business Premises Renovation Allowance

3.69 The Government has today **published a consultation document and draft legislation for a Business Premises Renovation Allowance scheme.**[21] This would provide 100 per cent capital allowances in Enterprise Areas for the costs of renovating business properties that have been vacant for at least a year. The consultation period ends on 1 March 2005 and will be followed by Finance Bill legislation.

[20] *Informal capital raising and high net worth and sophisticated investors: A consultation on proposed changes to the Financial Promotion Order*, HM Treasury, January 2004. (www.hm-treasury.gov.uk/consultations).

[21] *Capital allowances: renovation of business premises in disadvantaged areas*, Inland Revenue, December 2004.

Local Authority Business Growth Incentives

3.70 To create a direct financial incentive for local authorities to promote local business growth the Government is introducing the Local Authority Business Growth Incentives (LABGI) scheme, starting in April 2005. This will allow local authorities to receive a proportion of increases in local business rate revenues to spend on their own priorities. Based on historical data, the Government estimates that local authorities in England and Wales could gain up to £1 billion over the three years of the 2004 Spending Review. The Government's second public consultation on LABGI concluded in October 2004, and results will be published shortly. The revised Comprehensive Performance Assessment from 2005 will include an assessment of local authorities' acheivement against the shared priority of promoting the economic vitality of localities.

3.71 Kingston upon Thames recently became the first local authority to secure voted agreement from local businesses to the introduction of a Business Improvement District (BIDs) scheme. BIDs allow local authorities and businesses to work together on agreed projects to improve their local area, additional to those already funded by local authorities, and are funded by a levy raised on business rates.

SCIENCE AND INNOVATION

3.72 In the global economy, the UK's future prosperity will depend increasingly on the capacity to expand knowledge through science and translate it into innovative products and better services. Countries at the forefront of research and innovation will be best placed to move into high-value added, technology driven areas, which can provide new sources of growth. Science and innovation are therefore key drivers of productivity growth. Recent OECD research found that a 1 per cent growth in public R&D leads to a 0.17 per cent increase in total factor productivity in the long run.[22] The UK already has a strong science base and is in a leading position in terms of the quantity and quality of its research output compared to other advanced industrialised countries.[23] However, the UK has been less effective at realising the commercial potential of research, and business expenditure on research and development (R&D) is currently below the OECD average.[24]

3.73 UK R&D intensity fell during the 1980s and 1990s as GDP growth outstripped growth in R&D. 2002 figures show that UK business is now investing 1.24 per cent of GDP in R&D, compared to 1.37 per cent invested by French businesses, 1.73 per cent by German businesses and 1.87 per cent by US businesses.

3.74 For the UK's science base to capitalise on its historical strength in research, the Government must tackle the market failures that can slow the diffusion and generation of new ideas, in order to encourage businesses to be innovative in their approaches and use of new technologies and, together with academic institutions work to further links between research and commercialisation.

3.75 In July 2004, the Government set out its goals for science and business innovation in the UK in the *Science & Innovation investment framework 2004-2014*. This section describes progress on implementing the framework.

3.76 The ten-year science framework set an ambitious target for the UK's spending on R&D to reach 2.5 per cent of GDP by around 2014, from a current level of 1.9 per cent – intended to place the UK in a strong position amongst its competitors. The 2004 Spending Review announced £1 billion in extra funding for the UK science base by 2007-08, an average annual increase of 5.8 per cent over the period of the 2004 Spending Review. The framework also set out a number of measures to promote knowledge transfer into the economy, support university research and enhance science and maths teaching and learning.

[22] *R&D and Productivity Growth: Panel data analysis of 16 OECD countries*, Guellec and van Pottelsberghe de la Potterie, 2001.

[23] Data available from HM Treasury and DTI Productivity Indicators, www.dti.gov.uk/economics.

[24] Data available from HM Treasury and DTI Productivity Indicators, www.dti.gov.uk/economics.

Business and public engagement

3.77 Delivering the Government's overall ambition for wealth creation and productivity growth from innovation will require sustained business investment in R&D, and increased business engagement with the UK science base. Over the past year, the Government has benefited from main board-level business input into the formation of the science and innovation investment framework, including through the group of chief executives of major R&D employers chaired by Sir Tom McKillop of AstraZeneca. To help secure a strong business voice in the allocation of R&D support, the DTI has now established a business-led Technology Strategy Board, which will advise Government on cross-sectoral technology priorities with commercial potential for the UK in order to shape Government support for collaborative R&D and knowledge transfer networks.

3.78 To strengthen this partnership between Government, business, universities and other R&D stakeholders behind the UK's science and technology mission, the Government will establish a regular forum between the Chancellor of the Exchequer, the Secretary of State for Trade and Industry and the Minister for Science and Innovation, with business leaders and scientists. The Chancellor has asked Sir Tom McKillop to chair the group which will meet with Ministers twice yearly.

3.79 This forum will support the goal of improving the UK's R&D and innovation performance, and will contribute directly to the evidence informing future public spending decisions on investment in the science base and technology development. Investment in UK science and innovation, by both the public and private sector, and individuals' career choices, will be influenced by social attitudes towards scientific research and its application in new technologies. To provide context for the discussion of science and society issues in this forum, the Council for Science and Technology will report on this subject in March 2005. In addition, **the Government will publish at Budget 2005 an updated assessment of UK business R&D and innovation including analysis across sectors and a comparison of global trends to inform debate at the forum's first meeting**. This assessment will also form a key measure of progress set out in the ten-year framework.

3.80 To complement this work, **Government will also be seeking to understand, through bilateral discussions between now and next spring, the forward commitments to UK R&D of the leading R&D businesses in the UK**, with the aim of deriving an aggregate indicator of future business investments in order to track progress towards the 2.5 per cent R&D intensity ambition.

R&D tax credits

3.81 Take-up of R&D credits has been very strong, with over 95 per cent of eligible SMEs making a claim in 2002-03. The tax credit has already provided over £600 million in support of SMEs since its inception. The Government is committed to ensuring the best possible delivery of the credits. Updated guidance has now been published, which forms part of a joint Inland Revenue and DTI programme to tackle the perceived complexity of the credit and ensure consistent treatment of claims. In-depth customer research will inform and shape future improvements in delivery.

3.82 In 2005, the Government will examine evidence on the impact of the credits on firms as they grow beyond the SME threshold. It will also look at the impact on companies in technology-based manufacturing and service sectors, where the latest evidence suggests that UK mid-sized firms lag behind their US counterparts in R&D intensity. In light of emerging evidence over the next 18 months, the Government will examine how it can best help those firms that are key to boosting R&D, including through R&D tax credits.

University spin-offs

3.83 The Government attaches great importance to the technology transfer sector and its potential to contribute to UK productivity and enterprise, and is committed to creating an environment that enables universities and public sector research establishments to grow companies based on their research. **The Government will introduce legislation effective from today to remove the tax uncertainty for researchers involved in these spin-off companies**. This legislation will provide the flexibility the sector needs to restore higher levels of spin-off activity. A draft Partial Regulatory Impact Assessment and a Technical Note[25] have been published today to enable consultation with the sector on the details of the legislation.

Accelerating energy-efficient technology

3.84 The Government recognises that energy efficiency and the development of low-carbon energy sources will be central to the UK's productivity performance in the future. The UK has world-class research strengths in future energy-efficient technologies, which will be a key part of the transition to a low carbon economy. The Government is developing a stronger research infrastructure through the Research Councils' programmes, including the UK Energy Research Centre and Towards a Sustainable Energy Economy. It is also growing support for business-focused collaborative R&D, primarily through the DTI Technology Programme.

3.85 The UK's business and research response to the challenge of developing a low-carbon economy relies on investment across multiple research disciplines, business sectors and Government agencies. Against this background, the Government will now help focus the growing public and private investment in this arena by investing in **a £20 million fund to help foster a new partnership to accelerate energy-efficient technology.**

3.86 This fund will be managed by The Carbon Trust, with the aim of securing matched funding from private sector sources for its programmes. It will capitalise on the UK's R&D strengths and commercial potential in the field of energy efficiency and bring together stakeholders from the business, research, and policy-making community to define and co-finance the challenges for R&D in this area over the next 5-10 years. It will draw on, and help to implement, the conclusions of the joint Treasury/Defra Energy Efficiency Innovation Review also announced in this Pre-Budget Report and outlined in Chapter 7.

Lambert Review

3.87 The Government accepted the recommendations of Richard Lambert's review of business-university collaboration in July 2004, and its response was reflected in the 2004 Spending Review outcomes and the science and innovation investment framework. A business-university group chaired by Richard Lambert is working to improve the way in which intellectual property arising from collaborative research is handled, reducing cost and uncertainty for businesses when working with universities. Practical guidance on intellectual property should be produced by spring 2005. Responding to another recommendation to share best practice in governance across the Higher Education sector, the Committee of University Chairmen published in November 2004 a voluntary code of good governance for the Higher Education sector.

Regional Innovation

3.88 The 2004 Spending Review enhanced the role of the RDAs in supporting business-university collaboration, a part of the Government's response to the Lambert Review. This will be reflected in the new strategic RDA "tasking framework", which will be published shortly. The RDAs will set out their contribution to promoting knowledge transfer in each region this spring. The three Northern RDAs have already committed in July to fund business-university collaboration and business innovation across the North by more than £100 million by 2010, enhanced by the creation of a Northern Science and Industry initiative, as part of the Northern Way plan described in Box 3.2. The Government has also asked RDAs for views on how they can best develop knowledge transfer and science cities, ahead of Budget 2005.

[25] *New tax measure to help researchers acquiring shares in spinout companies created with universities and research institutions*, Inland Revenue, December 2004.

3.89 Cities and urban areas can attract a critical mass of knowledge-based businesses and industries which improve prospects for growth, through mutually reinforcing factors, such as the availability of skilled workers, a strong research base, urban infrastructure and supportive locally-driven policies. High-performing universities and research establishments can contribute to such an effect, and Government has been encouraging universities to work with RDAs to exploit synergies and so help foster knowledge-based clusters around city university hubs. The Government encourages further cooperation between universities and RDAs when planning future research capital investments, commercialisation strategies and regional economic strategies. As part of their £100 million investment in university-business collaboration over the next six years, the Northern RDAs will be promoting science cities, starting with Manchester, Newcastle and York. The Government encourages other RDAs to do the same.

Science and maths skills

3.90 The ten-year investment framework highlighted the importance of ensuring a strong supply of those studying science and related subjects at every stage of the education system, and set out a range of measures to this end. Described further in Chapter 6, Mike Tomlinson's report on the curriculum for 14-19 year olds was published in October 2004. In considering its response, the Government will give careful consideration to the role of science and maths as an important part of the 14-19 curriculum.

Higher education finance

3.91 The ten-year framework also set out measures to improve the financial sustainability of universities, accompanied by significant extra resources. Government is keen to enhance the financial independence of higher education institutions by increasing and broadening their sources of funding. A recent report from a Task Force[26] set up by the DfES has noted that, in striving for excellence, there is further scope for universities to build their financial independence and add value to core funding through raising income from donations. Although the report identifies enhanced fundraising as a key responsibility for individual higher education institutions themselves, the Government would like to encourage this development, and intends to trial a **three year matched funding scheme to support the sector to build its capacity to increase the voluntary giving it receives**.

EU R&D

3.92 The UK, France, and Germany published a joint paper in February 2004,[27] setting out priorities for action at the European and Member State level to raise the EU's innovation performance. The Commission will shortly present a proposal for its 7th research Framework Programme (FP7), effective from 2007. The UK's main priorities for the use of this fund are to raise the EU's capacity to conduct the very best research, improve industrial competitiveness, and ensure that EU policies are properly supported by research. FP7 should also provide funding for a range of cross-cutting activities, in particular on human resources and skills, knowledge transfer, and key research infrastructures. The UK welcomes the Commission's plans to create a European Research Council (ERC) as part of FP7. The ERC should enable systematic competition between the best research teams in Europe, allocating funding on the basis of scientific excellence as determined by peer review. To ensure the transparency and credibility of the ERC, the Government believes it should be independent from the Commission.

3.93 The UK will work with other Member States to ensure that FP7 has a simplified structure, and adds genuine value to the efforts of individual Member States, as well as being consistent with an overall EU budget of no more than 1 per cent EU Gross National Income (GNI).

[26] *Increasing voluntary giving to higher education*, Task Force on Voluntary Giving to Higher Education, May 2004.

[27] *Towards on Innovative Europe: A paper by the UK, German and French Governments*, February 2004. (www.hm-treasury.gov.uk).

SKILLS

3.94 UK unemployment is now the lowest of the G7 economies and employment levels are at record highs. Chapter 4 describes the Government's strategy for promoting employment opportunity for all, building on this strong performance. However, the UK's skills levels compare less well with other major economies.[28] While the proportion of people in the UK with high skills compares well internationally, the share of the workforce with intermediate skills is relatively small and the share with low skills relatively high, despite improvements over the last few years.

3.95 *Skills in the global economy*, published alongside this Pre-Budget Report, sets out the Government's ambition for enhancing skills and provides details of new proposals to build on success in this area. As described in Box 3.7, enhancing skills is an increasingly important long-term economic challenge for developed countries, and there is a clear economic case for Government to address market failures that exist around investment in skills.

Box 3.8: Enhancing skills in the global economy

***Skills in the global economy*, published alongside this Pre-Budget Report, explains that in the long run, the prosperity of an economy depends upon how productive it is. In turn, productivity depends in part upon the skills of the workforce, known as human capital. As set out in Box 3.1, the UK is less productive than many other countries and relatively poor skills explain part of the gap.**

The increasing importance of skills in the global economy

Structural change is inevitable in a well-functioning, flexible economy. As some sectors decline, so other sectors – requiring different skills – will expand. More integrated global markets and cross-border trade and investment are likely to lead to an increased pace of change. This places an increased premium on ensuring everyone can update their skills. In addition, while the comparative advantage of emerging economies will still lie in labour-intensive industries, their relative importance in knowledge-intensive industries will also rise. For example, each year China and India together produce more than 4 million graduates, compared with 265,000 in the UK. Global changes will create great opportunities for the global economy, but for the UK to take advantage of these it needs to ensure it has a highly-skilled, flexible workforce.

The case for Government intervention to improve skills

The benefits to businesses, from more productive workers, and to individuals, from better work prospects and higher pay, suggest that both should have an incentive to invest in skills. However, investment by firms can be constrained by lack of information about the benefits and the direct and indirect costs of allowing workers time to train. In addition, surveys show many individuals face barriers to learning such as cost, time to train and a lack of information about the opportunities available. This suggests that investment in training is lower than optimal, constrained by the following broad categories of market failure:

- **externalities that occur as firms cannot capture the full benefits of investment in training (for example, in industries where staff retention is low);**
- **imperfect information that means employees and employers cannot correctly judge the benefits of training; and**
- **credit and time constraints, particularly for the lower paid and small organisations.**

The Government's approach, set out in more detail in *Skills in the global economy*, is to focus funding where there is market failure. These market failures are particularly prevalent at low skill levels.

[28] Data available from HM Treasury and DTI Productivity Indicators, www.dti.gov.uk/economics.

Workforce development

3.96 As described in Box 3.8 a range of market failures limits workforce training in the UK. These market failures affect low-skilled workers in particular – people with lower qualifications are much less likely to receive training. Reducing the number of people with low skills is a key priority for the Government. Nearly 30 per cent of the workforce do not have a level 2 qualification (equivalent to five good GCSEs). Over 5 million people have basic skills needs in literacy, numeracy or IT. The White Paper *21st Century Skills* set out the Government's national strategy for improving adult skills.[29] In particular it set out a new entitlement to free training for any adult with basic literacy, numeracy and ICT skills needs and for any adult to gain their first full level 2 qualification. *Skills in the global economy*, published alongside this Pre-Budget Report, sets out how the Government will build on this approach through the New Deal for Skills and a new National Employer Training Programme.

New Deal for Skills

3.97 The New Deal for Skills, announced in Budget 2004, is a package of measures to support low-skilled adults to gain the skills necessary for sustainable and productive employment, as well as to help them progress to higher skill levels. **From April 2005 'skills coaches' will be piloted in eight Jobcentre Plus districts, providing low-skilled benefits claimants face-to-face, personalised advice on training – continuing this support as they make the transition into work. From April 2006 the Government will pilot the approach of allowing longer-term unemployed benefit claimants, along with economically inactive adults, with the agreement of their personal advisor, to take up free, full-time training where this is judged by their personal advisor to be the best way to help them into work.** More details of pilots of the Learning Allowance are set out in Chapter 4.

Employer Training Pilots

3.98 Employer Training Pilots, launched in September 2002, provide a package of support to encourage employers to train their low-skilled employees. This includes free or heavily subsidised training, information and advice for employers and learners, paid time for training for employees and, in most pilot areas, support for employers to meet the costs of giving staff paid time to train. The partnership approach tested in the pilots has proved very successful and the pilots now cover over one third of the country, with over 15,000 employers and over 100,000 employees participating. Most employees involved in the pilots left school at or before age 16 and half have no qualifications at all. 70 per cent of all firms participating have less than 50 employees.

A National Employer Training Programme

3.99 Building on the success of the pilots, the Government will **roll out a National Employer Training Programme from 2006-07 that will cover the whole country by 2007-08. The Government will now guarantee that, as part of the national programme, where employers are prepared to offer their low-skilled employees paid time to train up to level 2, the costs of this training will be fully subsidised.** The Government will allocate a further £197 million over 2006-07 and 2007-08 to fund this national programme. Further details of the national programme are set out in *Skills in the global economy*. The key features of the national programme are:

- brokers who will act for employers and their employees to assess training needs, and source high quality training provision that can be delivered flexibly in the workplace;
- fully subsidised costs of training to level 2 where employers are prepared to offer their low-skilled employees paid time to train;
- financial support – equivalent to that for a level 2 qualification – towards the cost of a level 3 qualification for those who can jump straight to level 3;
- support from brokers to design and source training packages at level 3 and higher; and
- creation of links with Jobcentre Plus in order to support adults making the transition into work to get training in a way that meets the requirements of their employer.

[29] *21st century skills: Realising our potential*, Department for Education and Skills, July 2003.

3.100 Most of the pilots tested the impact of compensating employers for the paid time that their employees take to train – 'wage compensation'. The evidence on wage compensation is mixed, but early evidence suggests that it may be more important as a way to initially engage those employers who would not usually provide training. The Government will continue to consider this issue and look to further evaluation before making a final decision on the inclusion of wage compensation within the national programme.

The Leitch Review of Skills

3.101 To inform the Government's view of how to respond to the long-term challenges set out in *Skills in the Global Economy*, **the Government has asked Sandy Leitch, Chairman of the National Employment Panel and formerly a Chief Executive of Zurich Financial Services, to undertake an independent review to examine the nature of the UK's long-term skills needs and priorities of business and the economy**.

Regional skills partnerships

3.102 In the 2004 Spending Review, the Government restated its commitment to tackle differences in regional and sub-regional economic performance across the UK. Evidence shows variations in the skills of different regions are a key factor in explaining these differences. To help address this issue, Regional Skills Partnerships (RSP) were announced in July 2003 to bring together the work of a number of bodies, including the Regional Development Agencies (RDAs), on skills, training and business support. By April 2005, each RSP will have published a prospectus setting out the partners' shared vision; what they will do to improve regional skills, enterprise and employment needs; how they will stimulate demand for skills and how their impact will be measured.

3.103 The effectiveness of RSPs will be reinforced by closer links between RDAs and Learning and Skills Councils (LSC). The Government has already committed to consider proposals for further integration of planning and funding of adult skills and workforce development at the regional level, including, where the partners in the region want it, 'dual key' arrangements for planning and funding adult skills, training and workforce development. As described in Box 3.2, the three Northern Way regions have indicated that they plan to start using a 'dual key' arrangement by April 2005, working with the LSC, which the Government will consider favourably. For each region, the RDAs, the LSC and the RSP have also been asked to contribute to Budget 2005 with an update of progress in aligning regional priorities for adult skills provision. Where regional partners identify obstacles to further integration of skills provision in supporting regional economic development the Government has already committed to working with them to remove obstacles.

Migration

3.104 As the global economy integrates, labour markets are becoming increasingly globalised. To remain competitive it is important that the UK continues to attract and retain talent. Alongside work-permits, the Highly-Skilled Migrants Programme (HSMP), introduced in 2002, has proved successful in enabling highly-skilled individuals to enter the UK to seek and take up work. To help tackle particular shortages in science and engineering, UK graduates in these subjects are now able to seek work for a year after graduating without the need for a work permit. Budget 2004 announced a new provision for MBA graduates from 50 of the world's top business schools to come to the UK and seek work for up to a year after graduating. **A list of eligible institutions is now available and graduates from these institutions will benefit from a streamlined HSMP process from April 2005**.

Developing the skills of young people

Primary, secondary and higher education

3.105 High standards of primary, secondary and further education provide the foundation for a productive and highly-skilled workforce. Chapter 6 describes the Government's programme for driving improvement at all levels of the education system, and the significant progress that has been made so far.

Post-16 learning

3.106 Post-16 qualifications and skills are vital if young people are to benefit from, and contribute to, a modern, highly-skilled and productive economy. Post-16 participation rates are rising and a smaller proportion of young people are not in education, employment or training – but more must be done to meet the Government's goal of moving the UK from being among the worst performing OECD nations in terms of post-16 participation rates to one of the best. The 2004 Spending Review acknowledges this ambition and has set challenging targets to improve educational achievement.

Education Maintenance Allowances

3.107 The roll-out of Education Maintenance Allowances (EMAs) will help achieve these targets. EMAs provide a regular weekly payment of up to £30 to those continuing in post-16 education, with further bonuses paid to students on satisfactory academic progression. EMAs also form a key part of the Government's framework of financial support for young people. Reform in this area is ongoing, and Chapter 5 outlines in more detail other changes to the systems of financial support for young people.

Apprenticeships

3.108 The Government has continued to develop the apprenticeship route for young people wishing to combine vocational learning with work experience and has set a target of 28 per cent of young people to enter an apprenticeship by the age of 22. The Government is on course to meeting this target, and in May 2004 there were over 250,000 participating apprentices. To build on this progress, in May 2004 the Government announced a comprehensive new apprenticeship structure to expand opportunity. To improve apprenticeship completion rates the Government has introduced a quality improvement strategy involving the Learning and Skills Council, Adult Learning Inspectorate and the DfES, and a new performance indicator has been adopted to drive reform.

3.109 Important work in reforming, improving and expanding the apprenticeship learning route is being taken forward by the Apprenticeships Taskforce, under the leadership of Sir Roy Gardner. The Taskforce is considering a range of issues affecting apprenticeships including the involvement of small and medium-sized companies in apprenticeship schemes, the overall apprenticeship framework as well as sector specific challenges faced by employers and learners. The Government welcomes the publication of the Taskforce's interim report, and particularly its recognition and articulation of the benefits to business of participation in the apprenticeships scheme. The Taskforce will publish its final report in 2005.

INVESTMENT

3.110 Capital investment is a crucial driver of productivity. The UK economy has historically lagged comparable economies both in terms of the overall level of investment, in part due to consistently low levels of investment in public infrastructure, and in the capital intensity of production. Evidence suggests that this 'capital gap' is an important explanatory factor in the UK's relatively poor productivity performance.[30]

3.111 The past twenty years have seen a huge increase in the scale of international capital flows and financial integration, with capital increasingly able to flow across national borders to the most attractive investment opportunities. These trends are likely to intensify over the next decade. In this environment, macroeconomic stability and a strong investment climate are prerequisites for attracting and retaining new business and investment, either domestic or foreign. To address this challenge the UK will need to consolidate and strengthen its performance in certain areas, while addressing historical weaknesses in others. In particular there is a need to ensure that capital markets are operating efficiently and providing funds to worthwhile investment projects, by ensuring:

[30] *Britain's Relative Productivity Performance: Updates to 1999*, National Institute of Economic and Social Research, O'Mahony and de Boer, 2002,

- the right skills are being supplied in the economy to stimulate investment and to enable workers to respond flexibly to technological change;
- the tax system and the regulatory environment supports business investment and entrepreneurial activity;
- barriers to knowledge creation, innovation and technology transfer are removed to ensure that the UK economy is at the leading edge of translating new technologies into investment opportunities; and
- the UK enjoys a world-class public infrastructure of sufficient quality to attract and support high quality business investment.

The investment chain

3.112 UK institutional investors manage almost half of UK equities, investing much of the long-term wealth of British savers and exercising indirect control and significant influence over much of British industry. This ownership is intermediated through an 'investment chain' of relationships connecting ultimate owners with their investment in companies. Ensuring this chain works efficiently is of vital economic importance for productivity and long term growth, because the chain is a critical mechanism for ensuring that investment is efficiently allocated.

3.113 The chain is complex: in pensions, for example, pension fund trustees – stewards on behalf of pension fund sponsors and members – are themselves advised by investment consultants; assets are in turn invested through fund managers and brokers with whom companies have crucial relationships; and companies' financial statements are verified by auditors acting on behalf of shareholders – such as pension funds.

3.114 Since the 1998 Pre-Budget Report, the Government has systematically investigated how well the investment chain works, notably through the Myners,[31] Sandler[32] and Higgs[33] reviews. These reviews have identified critical and inter-connected areas where the chain has not been functioning as well as it should, including its various principal-agent relationships. Further analysis is in train through Sir Derek Morris' wide-ranging review of the actuarial profession, which provides key advisory services to pension funds and investment institutions; and Paul Myners will shortly be concluding his review of the governance of mutual life insurance offices.

3.115 For example, issues identified at the 'owner' end include:

- as Paul Myners' review identified, pension fund trustee boards are in general weak customers. Typically unpaid, part-time and with little in-house investment support, many pension trustees lack the necessary investment expertise to act as strong and discerning customers of the investment consultants and fund managers who sell them services;
- a number of problems have resulted, including poor evaluation of advisers and their advice; a reliance by trustees on a small number of investment consultants, supplying actuarial and investment advice bundled together; insufficient resources devoted to the process of asset allocation; unclear contractual structures which generate strong and unnecessary incentives for herding and short-termism in investment; and insufficient focus on the potential for adding value through active shareholder engagement; and

[31] *Institutional investment in the UK: a review*, Paul Myners, March 2001.
[32] *Medium and long-term retail savings in the UK: a review*, Ron Sandler, July 2002.
[33] *Review of the role and effectiveness of non-executive directors*, Derek Higgs, January 2003.

- as Ron Sandler's review identified, competition in medium and long-term savings tends to revolve around access to distribution and product tax features, rather than superior underlying investment performance. Moreover, consumer understanding of what drives long-term investment performance is itself weak, and the advisers' minimum standards of knowledge on investment issues are also low. As with pension funds, therefore, incentives for efficient and innovative investment management are weaker in the retail market than they could be.

3.116 Issues identified at the 'company' end include:

- Sir Derek Higgs' review identified substantial scope for improvement in the UK's corporate governance regime, in the role and independence of UK non-executive directors, and in the responsiveness of UK boards to the concerns of shareholders; and
- the Co-ordinating Group on Audit and Accounting highlighted scope for improvement in the UK's audit regulation framework, the approach to auditor independence and the enforcement of accounting standards.

3.117 The complex interactions between the issues at different points in the chain mean that each needs to be addressed if the overall goal of promoting more efficient approaches to investment is to be realised. In response to this analysis and the recommendations made by the reviewers, the Government has undertaken a comprehensive programme of reform. In particular:

- *to improve the quality of trustees' investment decision-making processes*, and the way they interact with their advisers and fund managers, the Government endorsed the 'Myners principles' as a voluntary best-practice framework. Its assessment of the progress made to date and of the further steps that need to be taken, will report before the end of the year. This assessment will look particularly at areas where progress has been slower, including trustee expertise and governance, ensuring more effective use is made of advisers, improving the quality of asset allocation activity, providing greater clarity on funds' investment time horizons, and getting more effective shareholder engagement;
- the new Pensions Act 2004 will require trustees to have appropriate knowledge and understanding of investment matters, and the Occupational Pensions Regulatory Authority is currently developing a detailed code of practice to provide trustees with guidance;
- to *tackle the problems of retail product complexity, poorly informed consumers, and adviser conflicts of interest*, the Government has worked with the Financial Services Authority (FSA) to develop a suite of simplified and more transparent products, which should increase the focus on investment performance. More generally, new FSA rules will enhance disclosure to consumers of the cost of the advice associated with a packaged product;
- the *bundling of services by investment consultants* has been addressed by Myners' recommendation that trustees should tender separately for actuarial and investment advice. Sir Derek Morris' work will provide further analysis of both the actuarial and investment consultancy markets;

- *to promote more active engagement on the part of shareholders*, in exercising their rights particularly where they have concerns about management, strategy or performance, the Government welcomed the Institutional Shareholders' Committee principles in October 2002, and the commitment to reflect these principles in fund management contracts and insurance fund practice. The Government will be reviewing their impact on engagement shortly. Shareholders now have an advisory vote on directors' pay, through the Directors' Remuneration Report Regulations. The Government is also working closely with the Shareholder Voting Working Group to improve the efficiency of the shareholder voting process;
- *the role and independence of UK non-executive directors, and their responsiveness to shareholders*, will be strengthened by the revised Combined Code on Corporate Governance, which incorporates Sir Derek Higgs's recommendations, and Sir Robert Smith's proposals to improve the way the audit committee works. Progress will be reviewed after two years; and
- *the quality, and transparency of information flows along the investment chain – vital if owners are to act effectively – have been significantly improved*. For example, the Government has reformed the regulation of the audit profession, enhanced audit transparency and auditor independence and strengthened the scrutiny of financial reporting. From April 2005, listed companies will be required to produce a forward-looking Operating and Financial Review of their business environment. The FSA is developing with the industry a rigorous transparency regime for broking transaction costs.

Investment in housing and property

3.118 A stable and flexible housing market is essential to a healthy and productive economy. Housing market imbalances between supply and demand are a potential brake on economic development, as the cost and availability of housing influences the geographical distribution and mobility of the labour force and may affect capacity levels in local labour markets.

3.119 At Budget 2004, the Government welcomed Kate Barker's final report *Delivering Stability: Securing Our Future Housing Needs*.[34] The report made a number of recommendations for improving the functioning of the housing market and delivering greater macroeconomic stability and greater affordability. The Government accepted the central recommendation that there should be a step change in housing supply and has committed to implementing a wide-ranging programme of reform. As described in Chapter 6, the 2004 Spending Review provided additional funding to begin to address the need for additional investment in housing and related infrastructure.

3.120 In addition to providing significant additional resources for housing, the Government is committed to bringing forward a series of major reforms to ensure the effective implementation of the Barker Review. The Government will review progress in delivering this package of reforms by the end of 2005, the principal features of which include:

- merging Regional Planning Bodies and Regional Housing Boards to create integrated bodies responsible for managing regional housing markets, supported by a new and independent national advice unit. Following consultation, the Government will announce its conclusions early in the new year, with the new arrangements in place by autumn 2005;

[34] *Delivering Stability: Securing Our Future Housing Needs*, Kate Barker, March 2004.

- introducing a long-term national goal for affordability in the housing market, incorporated within the PSA process, and reflected at the regional level through regional targets as part of the process of setting regional housing numbers. The Government will consult on the national goal in summer 2005, introducing it by the end of the year;
- increasing the planning system's responsiveness to housing market signals by reforming Planning Policy Guidance on Housing (PPG3) to provide improved guidance on balancing local housing markets. Consultation will take place by summer 2005; and
- working with the development industry to ensure that it makes a substantive response to the challenges laid down in the Barker report to improve productivity, design and customer satisfaction.

Planning reform

3.121 This programme builds on the significant steps the Government is taking to make the planning system work more quickly and predictably. The 2004 Planning and Compulsory Purchase Act put in place a new statutory framework for regional planning and a reformed more flexible local planning system. The new Regional Spatial Strategies will be closely aligned to Regional Housing Strategies and will make provision for social housing and determine the amount of market housing to be delivered through the planning system by local planning authorities. The Government will also shortly bring forward changes to PPG3 (planning for housing) to influence the household mix and provision of affordable housing so as to better balance housing demand and supply. It will also encourage local authorities to allow unneeded employment land to be used for housing or mixed use development.

3.122 The Planning Delivery Grant (PDG) will complement these reforms by rising to £150 million during 2005-06. This will help drive up the performance of the planning system. In 2004-05, £10 million was allocated specifically for the delivery of housing in areas of high demand. For 2005-06, the Government is planning to increase the allocation for housing in high demand areas.

Sustainable development

3.123 The Government's commitment to achieving 60 per cent of new development on previously developed land, and using higher average densities of 30 dwellings per hectare ensures that the land take and potentially adverse environmental impacts from new development are minimised. In 2003, this resulted in 67 per cent of new development being on brownfield land, up from 56 per cent in 1997, while the density of new dwellings rose from an average of 25 dwellings per hectare in 1997 to 33 dwellings per hectare in 2003. At the same time the Government is committed to protecting and enhancing the Green Belt. In 2003, designated Green Belt land in England amounted to 1,672,000 hectares, about 13 per cent of the land area. This was 19,000 hectares more than in 1997, when the extent of Green Belt was last measured. A further 12,000 hectares of Green Belt are proposed in new draft local development plans. Plans to extend the contaminated land tax credit are described in Chapter 7.

Implementing the Miles Review

3.124 Good progress has been made in taking forward the recommendations addressed to the FSA, Government and industry made in the Miles Review of the UK mortgage market, published in March 2004. The FSA has produced an improved mortgage information leaflet, as recommended by Miles, and has also developed a new factsheet on switching mortgages. The Financial Capability Steering Group has set up a working group focused on borrowing. The Group has considered its priorities, and understanding the risks of mortgage borrowing will be part of its work on risk messages. The FSA has also confirmed that it will start to review the effectiveness of the new statutory regime by the end of 2005, as part of which consideration will be given to further changes to the provision of advice and disclosures required by firms, as recommended by Miles. In addition, the FSA has committed to considering the recommendations on cross-subsidy within the mortgage market – potentially as part of its Treating Customers Fairly initiative.

3.125 Progress has also been made on work to remove potential supply side barriers to a long term fixed rate mortgage market as identified by Miles, including a Government decision to legislate to remove a constraint on the future ability of building societies to own securitised assets. Detailed work is also ongoing on the tax treatment of potential products to help consumers manage their interest rate risk. In addition a joint Treasury and Debt Management Office investigation into the viability of Government issued interest rate derivatives which could help lenders more effectively fund long-term fixed-rate lending is underway. A final statement on these recommendations will be made at the time of Budget 2005.

Property Investment Funds

3.126 The Government launched a consultation *Promoting more flexible investment in property* at Budget 2004[35] to consider the introduction of Property Investment Funds, equivalent to Real Estate Investment Trusts (REITs), common to many economies around the world. The consultation closed in July 2004 and the Government is grateful for the participation of a wide range of industry experts and individuals. The Government is continuing to explore whether the introduction of a REIT in the UK, as envisaged in many consultation responses, would meet the objectives set out alongside Budget 2004.

3.127 The Government continues to believe that tax reform in this area has the potential to improve the efficiency of the property market. **While the Government will not legislate in 2005, it will report back with a discussion paper by Budget 2005, for further dialogue with industry representatives. A summary of responses to the summer consultation will be published at the same time**.

Commercial lease flexibility

3.128 The Government has been working with the property industry to promote a voluntary code of practice on commercial leases aimed at improving flexibility. ODPM has consulted on possible legislative measures to address upward only rent reviews,[36] following the interim findings of an independent evaluation of the impact of the code.[37] **The Government is considering the results of that consultation and will decide upon the merits of a legislative approach in light of the full independent evaluation of the code of conduct, expected by the end of 2004**.

Encouraging North Sea investment

3.129 The Government is committed to working with industry to maximize economic recovery of UK oil and gas reserves. The Government supports the new Voluntary Code of Practice on Third Party Access to Infrastructure, launched in September, and will be working with the industry to ensure that the Code is effective and succeeds in improving the productivity of the UK continental shelf. The Government will continue its commitment to the joint industry and Government Task Force, PILOT, as it takes forward work on brownfields and other issues.

[35] *Promoting more flexible investment in property*, HM Treasury and Inland Revenue, March 2004.

[36] *Commercial property leases: options for deterring or outlawing the use of upward only rent review clauses*, ODPM and the Welsh Assembly Government, June 2004. (http://www.odpm.gov.uk/urbanpolicy).

[37] *Monitoring the code of practice for commercial leases: interim report*, ODPM and the University of Reading, April 2004. (http://www.odpm.gov.uk/urbanpolicy).

4 INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

The Government's long-term goal is employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. For the UK to meet the increasing challenges posed by the global economy, it is vital that all groups in society are given the opportunity to participate in a successful labour market. This chapter describes the further steps that the Government is taking to move towards its aim of employment opportunity for all, including:

- **a major expansion of the Pathways to Work pilots for incapacity benefits claimants** to an additional 14 Jobcentre Plus districts covering the thirty Local Authority Districts with the highest concentrations of incapacity benefits claimants, thereby extending this groundbreaking approach to around one-third of the country;
- **a package of measures to further help people on incapacity benefits move into work,** including changes to permitted work rules to improve opportunities to move from benefits to full-time employment, and placing employment adviser support within GPs' surgeries;
- **an extension of the £40 per week In-Work Credit for lone parents to six further pilot areas,** to reinforce the gains to work for lone parents in the areas that need it most;
- **a Housing Benefit Reform Fund worth £180m during 2006-08** to enable the roll out of flat-rate allowances and to improve the administration and structure of the Housing Benefit system;
- **piloting a Learning Allowance** that will allow benefit claimants to participate in full-time training; and
- **increasing by £3 per week the income threshold above which the Working Tax Credit is tapered, in line with inflation to £5220 in 2005-06,** so that families whose incomes are rising retain more of their tax credits, ensuring gains to work are maintained.

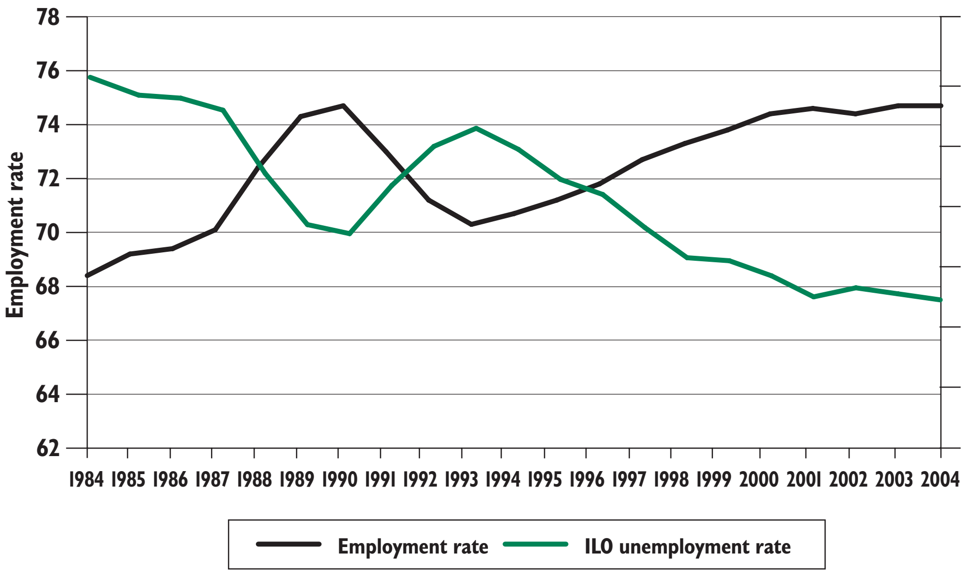
4.1 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. In an increasingly open and integrated global economy, the countries that will prosper are those with flexible and outward looking economies, which can react effectively to changing economic circumstances. This Pre-Budget Report sets out action to build on the successful recent performance of the UK labour market and tackle the long-term challenges of increasing flexibility, reducing inactivity and helping those groups in society which face particular barriers to work.

4.2 The UK labour market has performed strongly in recent years. Chart 4.1 shows that UK unemployment, on the International Labour Organisation (ILO) definition, has fallen to 4.6 per cent, the lowest of the G7 economies, while the working age employment rate has reached 74.7 per cent. The employment level has risen by almost 2 million since spring 1997. Claimant count unemployment has fallen by more than 780,000 since 1997, and has remained below one million since February 2001.

Flexibility and fairness in the labour market

4.3 The UK's strong employment performance is based on a foundation of macroeconomic stability and reforms that have enhanced flexibility in labour, product and capital markets. Box 4.1 summarises the Government's approach to creating a flexible and fair labour market, which will help the UK to prosper in increasingly integrated global markets where investment and production can move quickly between countries.

Chart 4.1: UK employment and ILO unemployment rates



Source: LFS seasonally adjusted annual averages.

4.4 Flexibility allows workers and businesses to adapt quickly and effectively to such changes and to seize opportunities in the global market. The Government's labour market policies ensure that flexibility goes hand in hand with fairness, providing security and support to ensure people can cope with economic change. The tax and benefit system, described in this chapter and in Chapter 5, provides security through financial support for those who need it most, when they need it most. The Government's active labour market policies support people back into work; for example, after a period of unemployment or economic inactivity.

Meeting long-term challenges

4.5 The Government is determined to build on the success of the UK labour market, and meet the long-term challenge of ensuring that all sections of society have the help and support they need to enter the workforce and fulfil their potential. This will be increasingly important to ensure that the UK can prosper in the global economy. The Pre-Budget Report sets out new action which focuses on the challenge of reducing inactivity levels and helping those groups in society which face particular barriers to work.

The New Deals

4.6 The Government's active labour market strategy is to provide the unemployed and inactive with the support and skills they need to move back into work as quickly as possible, with more intensive support provided through the New Deals.

4.7 The New Deals have been fundamental to the success of the Government's active labour market policy. Since their launch in 1998, over 1.1 million people have been helped into work through the New Deals, including nearly 520,000 young people, and nearly 200,000 unemployed adults aged between 25 and 50. Together, the New Deals for the unemployed have contributed to a fall in long-term unemployment of over three quarters since 1997, including a fall in long-term youth unemployment from 163,300 in 1997 to 38,600 in October 2004. More than 276,000 lone parents have been helped into work through the New Deal for lone parents (NDLP).

Box 4.1: Flexibility and fairness in the global economy

As set out in *Long-term global economic challenges and opportunities for the UK*, published alongside this Pre-Budget Report, globalisation can deliver significant potential benefits to the UK. However, global change also creates new challenges. Countries that will succeed in an increasingly open and integrated global economy are those that are flexible, open and outward looking. If markets and individuals do not have the flexibility and adaptability to respond to change, then exposure to overseas competition and new technologies may result in falling relative earnings, periods of unemployment, or a combination of the two, particularly among lower skilled workers.

A flexible labour market does not come at the expense of employment and security. Around the world, flexible economies are also the ones with higher employment. Combining flexibility with fairness – equipping people to cope with change and tackling the insecurities that surround it – is the best route to full employment. Since 1997, the Government has implemented wide-ranging reforms to ensure that the UK labour market promotes fairness and is flexible enough to adapt quickly to changes in global and domestic demand:

- **to strengthen skills and human capital and increase the ability of individuals to adapt to change, the Government has introduced a range of measures, which are discussed in more detail in *Skills in the global economy* published alongside the Pre-Budget Report, and in Chapter 3;**
- **through the introduction of the National Minimum Wage and tax credits, the Government is making work pay and has demonstrated that it is possible to combine flexibility with fair minimum standards; and**
- **the Government's active labour market policies are supporting people into work, including those who would previously have been adversely affected by the changing structure of economic activity. Too often in the past, many people, particularly those with few skills, were given little help and support to stay in contact with the labour market, and many ended up in long-term worklessness or inactivity.**

Such reforms are important irrespective of global economic change; they have helped to deliver record levels of employment in the UK and tackle social exclusion. However, global integration places a premium on a well-performing labour market. The Government will continue to ensure fairness alongside flexibility so that the most vulnerable are supported and are not left behind.

4.8 Independent research confirms the positive impact of the New Deal. In 2000, the National Institute of Economic and Social Research (NIESR) concluded that, without the New Deal for young people (NDYP), the level of long-term youth unemployment would have been twice as high.[1] More recent studies show that NDYP has reduced overall youth unemployment by between 30,000 and 40,000; that young men are now 20 per cent more likely to find work as a result of the New Deal;[2] and that overall, the social benefits of NDYP outweigh the costs.[3] Independent evaluation of NDLP suggests that *"the programme doubles the employment chances of participants: 50 per cent of participants entering work compared to 26 per cent of non-participants – an additional impact of 24 percentage points."*[4]

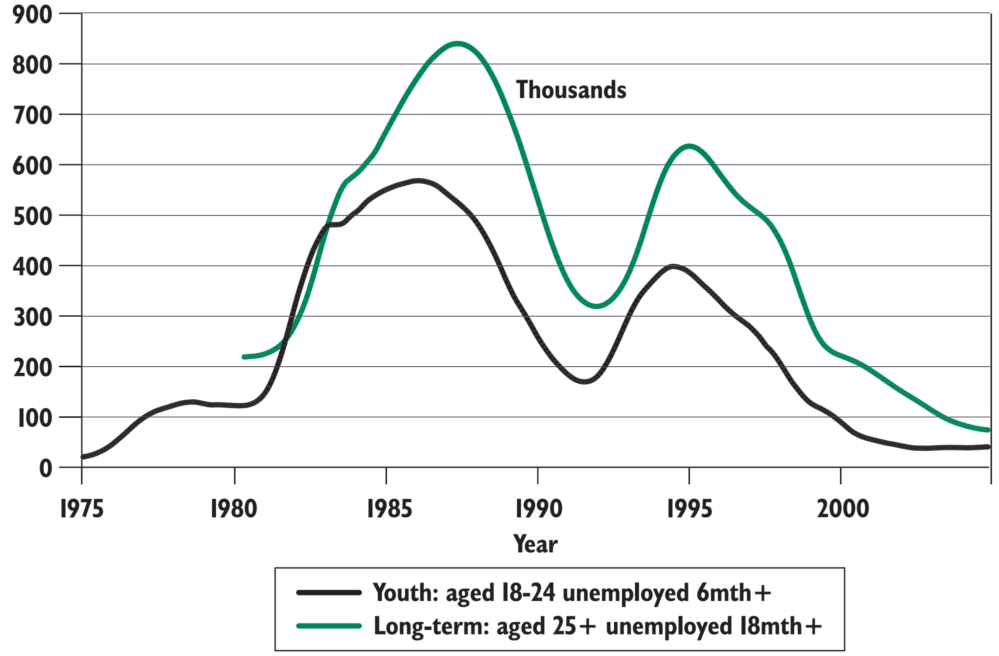
[1] *The New Deal for Young People: implications for employment and the public finances,* NIESR, December 2000.

[2] *New Deal for Young People: evaluation of unemployment flows,* Wilkinson, D., Policy Studies Institute, 2003

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

[4] *New Deal for lone parents: second synthesis report of the national evaluation,* Centre for Analysis of Social Policy, University of Bath (Evans, Eyre, Millar, Sarre), June 2003.

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



Source: LFS seasonally unadjusted monthly counts.

Skills **4.9** The Government's employment policies are succeeding in getting people into work. However, the UK has a large proportion of low-skilled adults in the workforce compared with other major economies. Enabling people to acquire skills is central to helping them obtain better paid work, and to ensuring that businesses have access to the skilled workforce they need to compete globally. *Skills in the global economy*, published alongside the Pre-Budget Report, and described in Chapter 3, sets out the progress that the Government has already made in improving the skills of the workforce and the future measures it is taking to build on this progress. This chapter describes the Government's approach to helping the longer-term unemployed and inactive gain access to full-time training.

EXTENDING EMPLOYMENT OPPORTUNITY TO ALL

4.10 The Government is committed to extending employment opportunity to all, ensuring that support is available to help everyone fulfil their potential. Having achieved significant falls in unemployment, the Government is determined to do even more for those who face the greatest barriers to work. This Pre-Budget Report sets out action to meet the challenge of high levels of inactivity, extending employment opportunity to all groups in society.

People with a health condition or disability

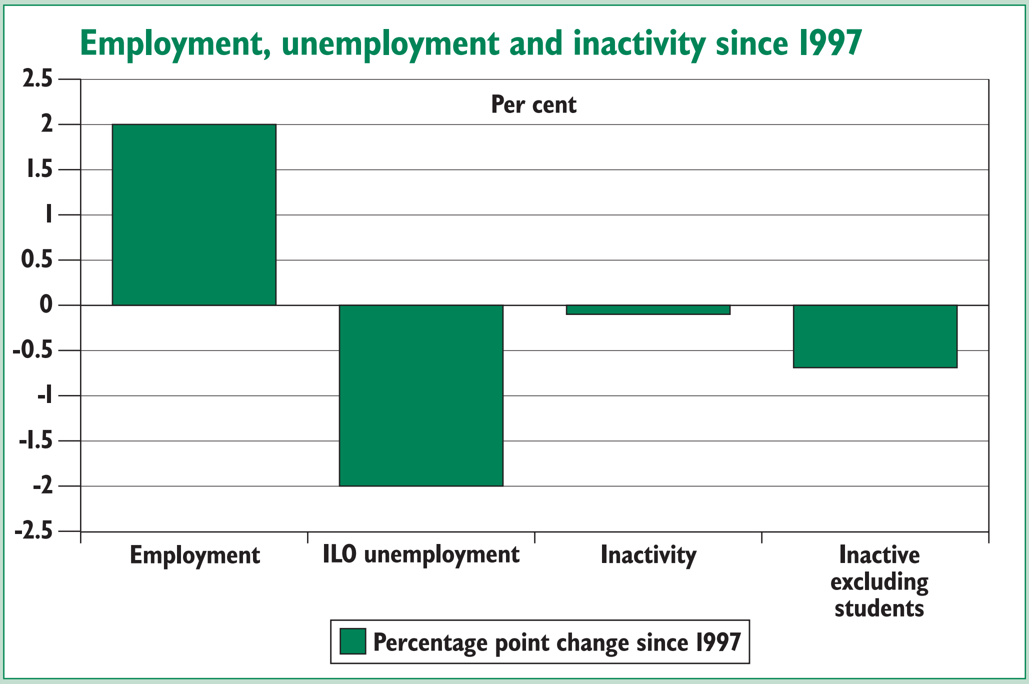
4.11 The challenge of a high and rising number of incapacity benefits[5] claimants, and the low rate at which people leave these benefits for work, is common to most modern economies. The labour market support extended to people with a health condition or disability to help them into work has historically been much more limited than that extended to many other disadvantaged groups.

4.12 In the UK, 2.7 million people, or 7½ per cent of the working age population, are claiming an incapacity benefit – a proportion close to the OECD average. The number of incapacity benefits claimants is now three times greater than the number of people claiming Jobseeker's Allowance (JSA), and the total figure represents almost a three-fold increase compared with 1979. However, since 1997 the caseload has stabilised. This reflects both economic success and the extra help and support that the Government has introduced.

[5] Incapacity benefits include Incapacity Benefit, Income Support on the grounds of incapacity and Severe Disablement Allowance.

Box 4.2: Employment, unemployment and inactivity since 1997

The UK has combined macroeconomic stability; active labour market policies; a tax and benefit system which ensures that work pays; investment in skills; and a flexible labour market to ensure strong labour market performance. This has meant that the rising UK employment rate of the past seven years has been accompanied by falls in both the unemployment rate and the inactivity rate, as the chart below demonstrates. The decline in the unemployment rate has not been caused by an increase in inactivity; it has, instead, reflected the success of those looking for work in finding it. Furthermore, student numbers have risen as the Government has taken steps to provide access to higher education for all. This has led to an increase in the number of students who are classified as economically inactive. Excluding students, the inactivity rate has fallen by a greater margin, as the chart also illustrates.



4.13 Nonetheless, the Government recognises that there is much more to do. Evidence suggests that around 90 per cent of new incapacity benefits claimants expect to get back to work. Often these aspirations are not realised due to a range of obstacles to work that are not necessarily related to an individual's health condition or disability. With prolonged inactivity, skills and expectations can diminish rapidly, and the probability of leaving incapacity benefits declines significantly over time.

4.14 The Government is committed to ensuring that more help is extended to people with a health condition or disability who are able to work, as part of its welfare to work strategy. Failure in this area represents a missed opportunity, both for the economy and for individuals themselves. Engagement in the labour market increases social inclusion, enables people to fulfil their aspirations and potential, and, in most cases, improves health and well-being.

The Government's vision

4.15 The Government's vision is to deliver a fundamental change in the way that people with a health condition or disability, but who want and are able to work, are given support to find, remain and progress in employment. The Government believes that everyone who wants and is able to get back to work should be helped and enabled to do so, maintaining a balance between rights and responsibilities. Moving towards this vision will help to ensure that:

- fewer people develop a health condition or disability at work or while looking for work, thanks to healthy and better managed work and jobseeking environments;
- significantly greater numbers of people who do develop a health condition or disability, are enabled and encouraged to remain in work or in job search by suitable management and adjustment; and
- significantly greater proportions of people who move onto incapacity benefits, return to work or job search.

4.16 Achieving this vision requires a balanced and principled approach across a number of different fronts, guided by evidence of what works. This means improving the support that people receive so that the welfare system:

- recognises that a person's health condition can affect their ability to work, but does not assume that they are incapable of, or do not want to, work;
- provides labour market support according to a person's individual needs, rather than the type of benefit they are on;
- encourages and supports people to take steps back to work and ensures they have access to a range of employment and health-related programmes of proven quality;
- ensures that incapacity benefits themselves do not constrain people's ability or motivation to move into work; that there are clear financial incentives to move into and stay in work; and that there is minimal risk and uncertainty in doing so; and
- is backed by a collective effort from all stakeholders to recognise the importance of ensuring that people with a health condition or disability are enabled to continue working.

Pathways to Work pilots

4.17 The Government's Pathways to Work pilots are a significant step towards achieving this vision and have put the UK at the forefront of policies supporting the active case management of incapacity benefits claimants. The Organisation for Economic Co-operation and Development (OECD) recently described the pilots as a "*radically new approach to dealing with those on incapacity benefits*".[6] The pilots, which began in October 2003, are currently being tested in seven Jobcentre Plus districts.[7] They are reshaping the culture and expectations of being on an incapacity benefit among individuals, the NHS and employers, ensuring a much greater focus on returning to work, while providing greater consistency of support and advice tailored to individual needs.

4.18 This innovative package of support includes a series of intensive mandatory work-focused interviews for most new claimants delivered by a skilled Jobcentre Plus personal adviser; new rehabilitation services provided jointly by Jobcentre Plus and the local National Health Service to manage the conditions that most often stop people working; improved links with New Deal for disabled people (NDDP) job brokers; improved financial incentives through a Return to Work Credit of £40 per week; and improving employer and GP awareness of the implications of sickness absence.

4.19 Early evidence suggests that the pilots are having a positive impact on incapacity benefit claimants' prospects of a return to work. In particular:

- in the first three Pathways to Work pilot districts, there has been an increase of between 8 and 10 percentage points in off-flows from incapacity benefits after

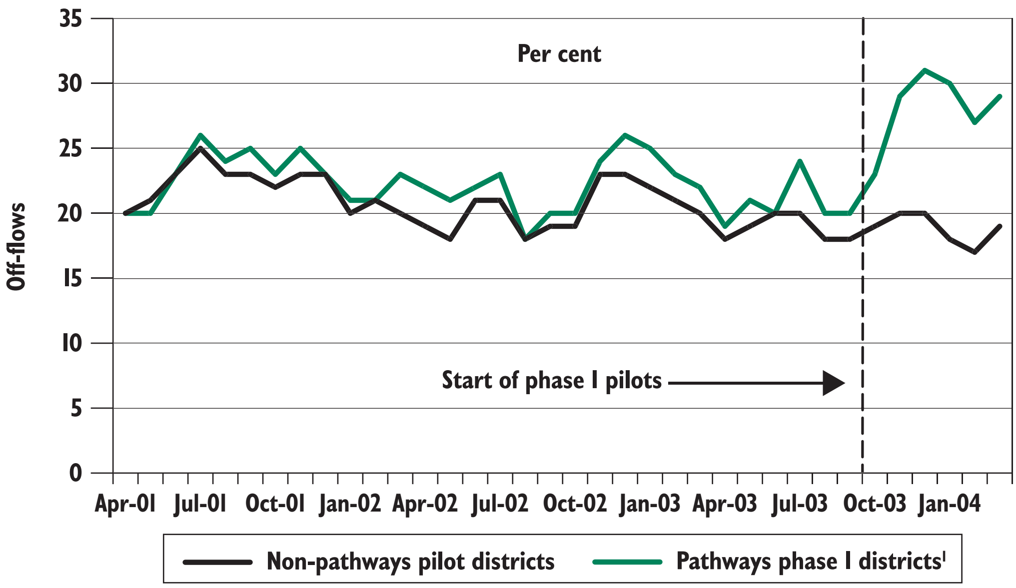
[6] Economic survey of the UK, OECD, 2004.

[7] The phase 1 pilots started in three Jobcentre Plus districts in October 2003 (Bridgend, Rhondda, Cynon and Taff; Renfrewshire, Inverclyde, Argyll and Bute; Derbyshire). A further four pilots commenced in April 2004 (East Lancashire; Essex; Gateshead and South Tyneside; Somerset).

four months of a claim.[8] This is illustrated in Chart 4.3 which shows the percentage of new claimants in a particular month who have left the benefit four months later;

- in the seven Pathways to Work pilot districts, following the initial work-focused interview at 8 weeks, between 15 and 20 per cent of claimants have taken up elements of the Choices package,[9] with over 10 per cent of claimants joining the NDDP. This compares with 4 per cent of claimants joining NDDP in Jobcentre Plus Pathfinder offices following a work-focused interview and 2 per cent nationally;
- in the seven Pathways to Work pilot districts around twice as many incapacity benefits claimants were helped into a job in August 2004 compared to the same time last year; and
- the pilots are also generating significant interest from existing incapacity benefits claimants in the pilot districts, who are not currently required to take part in the programme.

Chart 4.3: Four-month off-flows from incapacity benefits



Source: Department for Work and Pensions.
[1] The three phase 1 districts are: Bridgend, Rhondda, Cynon and Taff; Renfrewshire, Inverclyde, Argyll and Bute; Derbyshire.

4.20 The Government has been learning from the emerging evidence and putting lessons into practice. In the light of the positive first steps, Budget 2004 announced an extension to the provision in the Pathways areas and the Government's intention to pilot a mandatory work-focused interview regime for some existing incapacity benefits claimants, alongside a new job preparation premium. Following this announcement, the Department for Work and Pensions (DWP) carried out a consultation exercise on these new proposals with key stakeholders, which generated a number of useful suggestions. The new measures will be piloted from February 2005.

[8] There is currently no four-month off-flow data available for the April 2004 Pathways pilots districts.

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

4.21 The Pre-Budget Report announces that Pathways to Work will continue to provide support in the seven existing pilot locations after April 2006. In the light of the experience from the extension of the mandatory work-focused interview regime in February 2005, the Government will seek to broaden this approach to a further proportion of existing claimants, from April 2006 onwards. The Department of Work and Pensions (DWP) will seek the views of stakeholders during 2005 to ensure that the policy is designed in a way that provides the most effective support possible. The Government recognises that, while a number of longer-term benefit claimants want to work, they may face different and often greater barriers to doing so.

Extending the Pathways to Work pilots

4.22 The Government is determined to go further, both by building on the success of Pathways to Work and by making a number of wider supporting changes, to help push forward the realisation of its vision. **Therefore, additional resources will be allocated to extend the Pathways to Work pilots to a further 14 Jobcentre Plus districts from October 2005 onwards**. **The expansion means that Pathways to Work will support the 30 Local Authority Districts with the greatest concentrations of incapacity benefits claimants,[10] thereby extending this groundbreaking approach to cover around one-third of the country.**

4.23 The Pathways to Work pilots are providing a wider framework of support through which to deliver provision such as NDDP more effectively. NDDP, which is delivered through a national network of innovative job brokers, supports Jobcentre Plus in providing help and support for people on incapacity benefits to move into employment and has helped over 45,000 people into jobs since its national launch in July 2001. **The Pre-Budget Report announces additional financial support in 2005-06 to ensure NDDP job brokers can continue to help people on incapacity benefits to move into work**.

4.24 The Government is continuing to increase the support offered to incapacity benefits claimants and is learning from the Pathways to Work pilots to reshape overall Jobcentre Plus provision. The early evidence from the Pathways to Work evaluation shows that the specialist incapacity benefits personal advisers are highly motivated and much more equipped and confident to engage clients positively in the prospect of a return to work. The Government has extended this support more widely. There are now specialist incapacity benefits personal advisers in all of the integrated Jobcentre Plus offices. Once Jobcentre Plus is fully rolled out in March 2006, there will be specialist advisers in every district.

4.25 Contact with personal advisers through a work-focused interview can raise an individual's awareness of the employment and financial support available to them. As part of the Pathways to Work pilots, advisers are using mandatory action plans and undertaking the first work-focused interview at the eight week point to create a more positive and focused framework for considering possible returns to work. **This Pre-Budget Report announces that, across all Jobcentre Plus integrated offices, incapacity benefits claimants will similarly be required to complete an action plan and have a work-focused interview at the eight-week point.**

Permitted work rules

4.26 The incapacity benefits permitted work rules enable claimants to undertake some work while continuing to receive benefits. This support helps people who are able to work on a limited basis to take important steps from benefits to work. The Pre-Budget Report announces new measures to improve and simplify permitted work provision. The measures will:

- increase take-up and provide better support on entry to permitted work. **Alongside new guidance and training materials, people undertaking permitted work will be required to sign up to an action plan committing them to consider the prospects of a move into full time employment, with support where necessary;**

[10] This is defined in terms of the working age recipiency rate for incapacity benefits.

- facilitate progression within permitted work. The **initial period of permitted work will be extended to 52 weeks in all cases and the 26 week point used as an opportunity to ensure an ongoing commitment to, or a revision of, the action plan combined with fresh material on the help available to make the transition to full-time work; and**
- expand elements of the current permitted work provisions for people with the greatest barriers to full-time employment. **People with the most limiting conditions, for example advanced, progressive conditions will be covered by a widened version of the permitted work provisions, and enabled to work for a longer period of time while maintaining their entitlement to benefit**.

Test trading

4.27 The Pre-Budget Report also announces measures to provide a more attractive stepping stone from benefits to self-employment for incapacity benefits claimants by improving the test trading regulations. The arrangements for incapacity benefits claimants will be brought more in line with those for JSA and Income Support claimants. **From April 2006, test trading will be treated for benefit purposes as training irrespective of whether incapacity benefits claimants choose to take up the training allowance or to remain on benefit**.

Extra support for GPs

4.28 As described above, the Government's vision can only be delivered with effective support from external stakeholders. GPs have a key role to play in ensuring that their advice supports the recovery and rehabilitation of patients and, where appropriate, encourages a return to work or work-related activity. The Government wishes to support them in this role. **The Pre-Budget Report announces new measures to develop and embed best practice in training material for new and existing medical professionals. Moreover, from 2005, the Government will also pilot improved arrangements on fitness for work advice, including placing employment adviser support within GPs' surgeries and encouraging closer links with existing support to help people manage their condition**.

Helping the unemployed

4.29 The JSA regime has been effective in helping the unemployed move rapidly back into work, maintaining low unemployment and reducing the risk of long-term detachment from the labour market. Around 60 per cent of claimants now leave JSA within 13 weeks and nearly 80 per cent leave within six months, compared to 75 per cent leaving within six months in 1997. This has contributed to the fall in the number of JSA claimants from 1,619,000 in May 1997 to 836,700 in October 2004; a decrease of 50 per cent.

4.30 The Government is continuing to build on the success of the JSA regime. As announced in the 2003 Pre-Budget Report, from June 2005 the Government will be piloting a mandatory short intensive work-focused course for all JSA claimants, aged 25 or over, at the six-month stage. **In addition, the Government will be looking at a number of ways of improving the efficiency and effectiveness of the JSA regime.** These will be aimed at increasing personal responsibility for job search activity and improving the capacity of local managers and personal advisers to hold jobseekers to account for that activity, while responding flexibly to individual circumstances. Measures tested will also include:

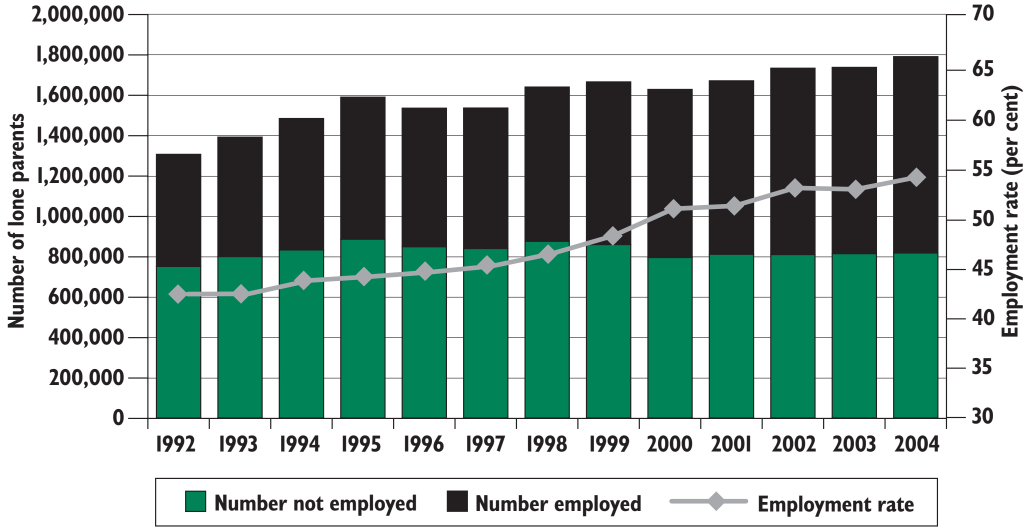
- **a revised and strengthened Jobseeker's Agreement with a clearer focus on the jobseeker's responsibilities and a personal record of job search activity to be reviewed at subsequent interviews; and**
- **new signing regimes for the first 13 weeks of the claim, requiring jobseekers to attend the Jobcentre irregularly with short notice call-in, backed up by a range of regular signing regimes and innovative use of IT.**

4.31 An effective balance between rights and responsibilities also requires effective penalties for non-compliance. Alongside the intervention regime pilots, the Government will therefore review the current JSA sanctions regime to ensure that the penalties for failure to carry out responsibilities are timely, fair, practical and effective.

Lone parents

4.32 The rise in the number of lone parent households in the UK, and the low employment rate for lone parents, were significant factors in the increasing number of children living in workless households in the 1980s and early 1990s. To support its goal of eradicating child poverty, described fully in Chapter 5, the Government has set a target of 70 per cent of lone parents being in employment by 2010. Significant progress has been made toward this target; between spring 1997 and spring 2004, the lone parent employment rate increased by 9 percentage points to over 54 per cent – the highest rate on record. There are now almost one million lone parents in employment, an increase of 40 per cent since 1997 and of nearly 50,000 in the past year. Chart 4.4 shows the rise in lone parent employment since 1992.

Chart 4.4: Lone parent population in and out of work and lone parent employment rate



Note: Before 1997 data has not been re-weighted to the 2001 Census population estimates.
Source: LFS Spring Quarters 1992-2004.

4.33 The Government's strategy to improve the support for lone parents to find work combines several elements: work-focused interviews to ensure that lone parents are aware of the job opportunities available to them, and compulsory action plans agreed at the interview; ensuring that work pays through, for example, the Working Tax Credit; providing accessible and affordable childcare, through the National Childcare Strategy and Sure Start; and individual help and support through the New Deal for lone parents (NDLP), which has already helped over 276,000 lone parents into employment.

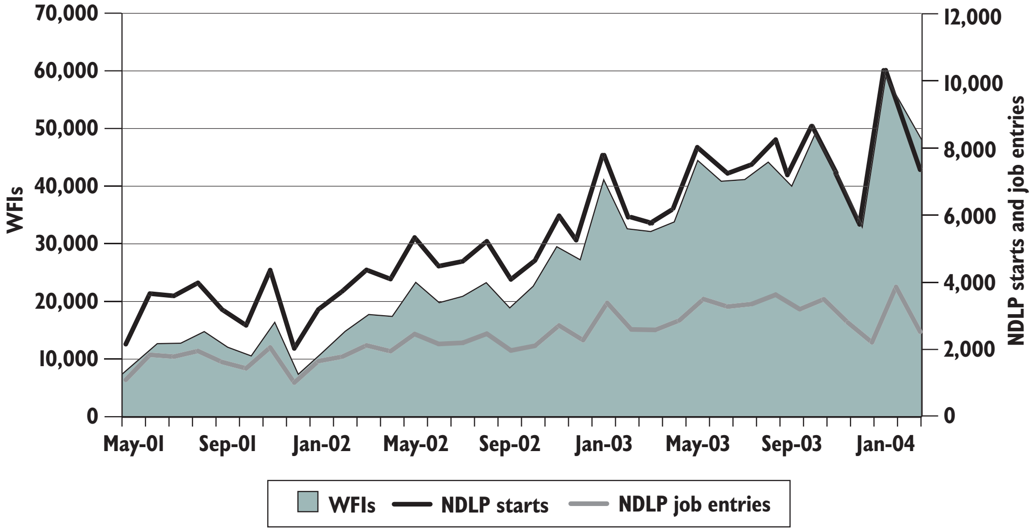
Work-focused interviews

4.34 Chart 4.5 shows the impact on job outcomes of the 1.1 million work-focused interviews for lone parents carried out since their introduction in 2001. Independent evaluation evidence[11] shows that lone parent work-focused interviews have substantially increased the numbers of lone parents participating in NDLP. Around 209,000 lone parents have joined NDLP following a work-focused interview, and of these, 88,000 have moved into work.

[11] *Integrated findings from the Evaluation of the first 18 months of Lone Parents Work Focused Interviews,* Insite Consulting (DWP Evaluation Series, W184), March 2004.

4.35 Work-focused interviews are extremely effective in helping lone parents return to work. Therefore, the Government plans to extend work-focused interview provision once the existing work-focused interview programme is fully rolled out in March 2006.

Chart 4.5: Lone parent work-focused interviews (WFIs) and subsequent NDLP starts and job entries



Source: Department for Work and Pensions.

In-Work Credit

4.36 The Government recognises that the barriers to work faced by lone parents are more difficult to overcome in some areas of the country than in others and that work incentives can be particularly affected by the higher cost of living in London and the surrounding area. The In-Work Credit – a £40 a week payment for lone parents who have been on Income Support for one year or more – introduced in the 2003 Pre-Budget Report and extended in Budget 2004, is a transparent method of increasing work incentives, and is targeted at those that need it most. **The Pre-Budget Report announces that the In-Work Credit, currently available in 12 pilot areas[12] – will be extended to six further areas in the South East, where the gains to work are weakest**. An additional 84,000 lone parents will become eligible for the Credit from October 2005, so that 40 per cent of lone parents in the UK who have been on benefit for a year or more will now be eligible for the In-Work Credit.

Support for childcare

4.37 A lack of quality, affordable childcare can represent a barrier to work for many parents. Working parents need to have childcare that is reliable and accessible. Good quality childcare can help facilitate access to work, therefore boosting employment and helping to reduce child poverty. The Government is publishing *Choice for parents, the best start for children: a ten year strategy for childcare* alongside this Pre-Budget Report. This sets out how the Government will work towards its vision of affordable, quality childcare for all who need it, and is discussed in more detail in Chapter 5.

4.38 The reforms to Housing Benefit outlined later in this Chapter will also help lone parents. **By aligning the definition of eligible childcare in Housing and Council Tax Benefits with that in tax credits, families will receive the full benefit of the WTC childcare element**.

[12] In-work Credit Pilot areas: Bradford; Cardiff and the Vale; Dudley and Sandwell; Edinburgh; Lancashire West; Leicestershire; Leeds; Staffordshire; Central London; North London; South East London; West London.

Return to work

4.39 Mothers in particular face a number of barriers to returning to the workplace after a prolonged absence. In some professions, a few years without practical experience can cause skill deterioration. More often, however, the experience of raising a family actually enhances skills and capabilities, and the real obstacles are confidence, proper recognition by employers and practical difficulties in returning to work.

4.40 To break down the barriers to mothers returning to work, **Regional Development Agency-led pilots in London, the East Midlands and the South East will offer integrated programmes of support to provide women returners with advice on career options, access to training, work placements and good quality affordable childcare.** The pilots will utilise strong links with local employers to ensure that the particular needs and advantages of returning women are recognised.

Partners

4.41 Since the mid 1980s, there have been significant changes in the way that households organise their work. The decline in male employment and rise in female employment has, by and large, occurred in different households. There has been a shift away from single earning households, and towards a polarisation between 'work rich' dual-earning households, and 'work poor' workless households which experience high levels of child poverty.

4.42 For this reason, in April 2004, the Government introduced work-focused interviews for partners of benefit recipients. Partners of new or repeat benefit recipients are interviewed after six months, while partners of existing claimants are being invited to interview over the next two years. To coincide with the introduction of work-focused interviews, the Government has re-launched the New Deal for partners, which now offers help and support similar to that offered in the NDLP, including access to a skilled personal adviser, able to help and support partners in overcoming barriers to work.

Ethnic minorities

4.43 Despite the overall success of the Government's labour market policies since 1997, ethnic minority groups still have significantly lower than average employment rates, with some groups – such as people from Pakistani or Bangladeshi origins – faring least well. Even highly-skilled people from ethnic and faith minorities have lower than average employment rates. For example, the employment rate for Pakistani graduates is around ten percentage points lower than the national graduate average. The Ethnic Minority Employment Taskforce has taken forward the recommendations of the Prime Minister's Strategy Unit report on the position of ethnic minorities in the labour market, and its first annual report, published in November 2004, set out good progress on implementation.

4.44 The Government has brought in a range of measures to support activity at local level, including the introduction of specialist advisers in Jobcentre Plus areas with high ethnic minority populations, and a fund of £8 million over two years to support innovative local programmes. In addition, Budget 2004 announced the establishment of 'Fair Cities' initiatives in three areas – Bradford, Birmingham and Southwark – to work with employers and other local stakeholders to develop local strategies to tackle ethnic minority worklessness. Boards and chairs have now been appointed in each area, and their strategies will be in place by April 2005.

4.45 The Government recognises the need to ensure that New Deal and other mainstream labour market and enterprise support meets the needs of ethnic minority clients, and that proper lessons are learnt from targeted initiatives. The National Employment Panel, working with the Ethnic Minority Business Forum, will report by Budget 2005 on measures to encourage employment, self-employment and the growth of small business for ethnic and faith minority groups.

Older workers

4.46 The Government is committed to increasing opportunities for older people to remain in, or return to, work. This is essential to ensure that the labour market and workforce adapt to meet the needs of an ageing population, and that individuals are able to build up an income in retirement that meets their expectations. Furthermore, evidence suggests most early retirement is involuntary, and that remaining in, or returning to, work can increase social inclusion and improve individuals' health.

4.47 Since May 1997, the employment rate for people aged between 50 and State Pension Age has increased by over five percentage points to 70 per cent, and there are now around one million people over State Pension Age in employment. Through Jobcentre Plus and policies such as the New Deal for people aged 50 and over (ND50+) the Government is continuing to develop its back to work support.

4.48 As described in Chapter 5, the Government is also increasing the choices people have over when, and how, they move from work to retirement. The Government is also encouraging age positive employment practices and is working with leading business partners to develop a national guidance campaign for employers in 2005 and 2006. In 2006, the Government will bring into force legislation to implement the age discrimation strand of the European Employment Directive.

Enhancing skills in the labour market

4.49 The Government's employment policies are focused not only on getting people into work, but also on giving people the support they need for sustainable employment and for accessing better-paid, higher-skilled work. *Skills in the global economy*, published alongside this Pre-Budget Report, and discussed further in Chapter 3, sets out the next stages in the Government's plans for enhancing skills levels in the UK economy. This is central to the Government's strategy for meeting the long-term challenge of ensuring the UK will prosper in the global economy.

Enhancing skills while claiming benefits

4.50 Benefit claimants have access to a wide range of support for training, including through the New Deals and Work-Based Learning for Adults. Since October 2003, the Government has been testing the effectiveness of a range of in-work support in the Employment Retention and Advancement Demonstration projects. Evidence shows that, for most people, the best way of finding and staying in work is actively to look for work, rather than to focus solely on training. While benefits claimants are not currently entitled to access full-time education or training outside the New Deals, many participate in part-time training. Advisers need to be able to ensure that this training, too, is properly focused on improving employability and does not get in the way of effective job seeking.

4.51 The Government believes there is a case for introducing more flexibility for advisers when it comes to allowing the longer-term unemployed and inactive benefit claimants to participate in full-time training, where this would both improve chances of moving into sustained, productive employment and meet the specific needs of local employers. **From April 2006, the Government will therefore test the impact of a Learning Allowance**. This will allow benefit claimants in pilot areas, with the agreement of their personal adviser, to take up full-time training towards a first level 2 qualification.[13] Support will include a £10 per week benefit supplement to cover the additional costs of learning and will be dependent on the participant meeting the conditions of a Learning Agreement agreed with their personal adviser. For jobseekers who do not have a Learning Agreement in place, the benefit rules will be strengthened to ensure that any learning is genuinely part-time and does not prevent job-search activity.

[13] A level 2 qualification is the equivalent of five GCSEs at grade 'A' to 'C'.

Labour mobility

4.52 The ease with which people are able to move within and between sectors and regions is a key indicator of the flexibility of the labour market. High geographic mobility means the workforce is able to respond quickly and easily to labour demand, smoothing the economy's response to changing economic circumstances and contributing to the Government's goal of full employment in every region. Low mobility may mean that economic downturns in a particular region are more prolonged than would otherwise be the case.

Reform of Housing Benefit

4.53 The structure of the housing market and of Housing Benefit has important consequences for the mobility of labour. Housing Benefit provides help with rent to 3.8 million low-income tenants, both in and out of work. However, the current system of Housing Benefit can be complex, both for claimants to understand and Local Authorities to deliver. This means it can act as a constraint on the ability of individuals to move between regions to seek and take advantage of new employment opportunities.

4.54 The Government's Housing Benefit reform programme is addressing these difficulties in the following ways:

- administrative improvement through the £200 million Performance Standards Fund;
- structural reform including Pathfinders for flat-rate Local Housing Allowances (LHAs) in the private rented sector, leading to national roll-out, and development of flat-rate LHA pilots in the social rented sector; and
- streamlining and alignment of benefits to make claiming, changes of circumstances and means tests more transparent and more closely aligned with those for other benefits.

Performance Standards Fund

4.55 The funding that the Government has introduced to help Local Authorities improve their administration of Housing Benefit has already led to significant improvements. More than 300 Local Authorities have benefited from an additional investment from the Performance Standards Fund. As a result the average time to process a new claim has improved by nearly two weeks compared to 2000-01. The £200 million Performance Standards Fund will continue to provide resources to help local authorities improve their administration of Housing Benefit until March 2006.

Local Housing Allowances

4.56 The Government is also making good progress with structural reforms to the Housing Benefit system. The flat rate LHA has been successfully implemented in nine Pathfinder areas,[14] with over 35,000 private sector tenants now receiving the LHA. The Government intends to roll out the flat-rate system throughout the country by March 2008, informed by the evaluation of the Local Housing Allowance Pathfinders. In preparation for full national roll out of the private sector LHA system, the Government will introduce a second round of nine local authorities implementing the Local Housing Allowance from April 2005.[15] These will help to develop best practice before the system is introduced nationally.

4.57 Tenants in the social sector are entitled to the same standard of service and should have the same opportunity to exercise choice as tenants in the private sector. Consequently, the Government is also committed to developing pilots of the flat-rate LHA in the social rented sector, based on the principles underlying the LHA system, to encourage choice, responsibility and fairness.

[14] The nine existing LHA pathfinders are in Blackpool; Coventry; Lewisham; Brighton and Hove; Edinburgh; North East Lincolnshire; Conwy; Leeds; and Teignbridge.

[15] The second round of LHA pilots will be in Argyll and Bute; East Riding of Yorkshire; Guilford; Norwich; Pembrokeshire; Salford; South Norfolk; St Helens; and Wandsworth.

4.58 The Government will introduce a £180m Housing Benefit Reform Fund from April 2006 to March 2008 to help DWP to roll out flat-rate allowances and to continue to improve the administration and structure of Housing Benefit.

Housing Benefit simplification

4.59 The Government is also continuing to simplify Housing Benefit and the Council Tax Benefit system in order to make further improvements in administration:

- **from April 2005 the Government will change the way in which income from tax credits is taken into account in Housing Benefit and Council Tax Benefit claims** in order to help speed up the administration of claims;
- **the Government will also align the rules in Housing and Council Tax Benefit to ensure that families receive the full benefit of the childcare element in the Working Tax Credit**; and
- **from October 2005 all charitable, voluntary and personal injury payments will be ignored when Housing Benefit and Council Tax Benefit is calculated.** This will allow charities to donate support to individuals without it affecting their entitlement to Housing Benefit and Council Tax Benefit.

RESPONSIVE AND FLEXIBLE DELIVERY

4.60 The Government recognises that each local area and individual may face specific barriers to work which are not easily tackled with a 'one size fits all' approach. While it is important that national standards of service provision are upheld, the Government is committed to ensuring that service providers are given the flexibility and discretion to tailor policies to the specific needs of the community they serve.

Service provision

Jobcentre Plus

4.61 Jobcentre Plus was launched in April 2002, bringing together the Employment Service with the working age sections of the Benefits Agency to deliver an integrated service. Jobcentre Plus helps unemployed and economically inactive people of working age move closer to the labour market and compete effectively for work, providing a high quality, integrated and accessible service for all of its clients. The nationwide rollout of this new business model represents a £2.2 billion investment in improved service and efficiency. The Government will complete the national rollout of Jobcentre Plus in 2006.

Local responsiveness

4.62 As emphasised in a recent Social Exclusion Unit report,[16] despite the success of Government policy in raising the overall employment rate, some local concentrations of unemployment and economic inactivity persist. Those areas with greater concentrations of workless people automatically attract additional labour market support. The Government has supplemented this with a range of further programmes:

- Working Neighbourhoods pilots were introduced in April 2004 in 12 neighbourhoods with very high concentrations of worklessness. The pilots combine more and earlier intensive intervention, community-based delivery and additional resources to help residents overcome barriers to accessing jobs that are often within easy travelling distance of where they live;
- Action Teams for Jobs focus on the long-term unemployed and inactive. They use innovative methods to address specific local barriers to work in 63

[16] *Jobs and Enterprise in Deprived Areas*, Social Exclusion Unit, 2004.

disadvantaged areas of the UK, many of which contain large ethnic minority communities, and have helped more than 105,000 people into work; and

- Employment Zones provide personal advisers with complete discretion over funds to overcome individual barriers to work. They have already helped over 46,000 long-term unemployed people aged 25 and over back into work in 15 areas of England, Scotland and Wales.

Self-employment

4.63 The Government offers a wide range of support to people moving from benefits into self-employment, including business advice, financial support through tax credits, and a 'test trading' period for those eligible for the New Deals or Work-Based Learning for Adults. The 2003 Pre-Budget Report announced a Small Business Service-led review of routes off benefits into self-employment. The interim report, published in June 2004, set out a number of practical steps, including better joint-working between Business Link operators and Jobcentre Plus, and a leaflet signposting the full range of support available. The Government followed up the leaflet's launch in November 2004 with the development of a wider self-employment communication strategy for disadvantaged groups.

Building on the New Deal

4.64 The Government intends to build on the success of the New Deal by strengthening its ability to address individual and local needs. *Building on New Deal: Local solutions meeting individual needs,* published by the DWP in June 2004, outlined the Government's proposals. These centre on greater empowerment of local Jobcentre Plus staff, enhancing their ability to respond ever more effectively to the needs of individuals and the challenges of their area.

4.65 Building on the best of current provision, and learning the lessons from existing flexible delivery models, Jobcentre Plus will test how best to deliver, and will thoroughly evaluate, the new flexible delivery model set out in Building on New Deal in 11 prototype areas from 2005.

MAKING WORK PAY

4.66 Through the National Minimum Wage and tax credits, the Government has created a system of in-work support that provides greater rewards from work. Financial support through tax credits is set out in further detail in Chapter 5. The strategy to make work pay has improved incentives for individuals to participate in the labour market, making it more flexible and dynamic. Making work pay tackles two key problems:

- the unemployment trap, when those without work find the difference between in-work and out-of-work income too small to provide an incentive to enter the labour market; and

- the poverty trap, when those in work have limited incentives to increase their hours or to move up the earnings ladder because it may leave them little better off.

The National Minimum Wage

4.67 The National Minimum Wage guarantees a fair minimum income from work. In October 2004, the rate for adult workers aged 22 and over was increased to £4.85 an hour; the youth and development rate, for workers aged 18-21 or in approved training, rose to £4.10. As a result of these increases, the adult rate of the National Minimum Wage has risen by 35 per cent since its introduction. In October 2004, the Government also introduced a new National Minimum Wage rate of £3.00 an hour for 16 and 17 year old workers. Providing coverage for this age group brings the UK into line with the majority of countries which have a minimum wage system.

The Working Tax Credit

4.68 The Working Tax Credit (WTC) provides financial support on top of earnings, improving incentives for households moving into work at low earnings. By July 2004, 2.35 million working families and 250,000 low-income working households without children were benefiting from the WTC. There were 80,000 households benefiting from the disabled worker element of the WTC, more than double the number who received support through its predecessor, the Disabled Person's Tax Credit.

Tackling the unemployment trap

4.69 **The income threshold above which the Working Tax Credit is taken away will rise in line with inflation in April 2005 to £5,220 per year.** The increase, equivalent to £3 per week, maintains work incentives for people moving into work and helps those progressing in work.[17] As part of the ten-year strategy for childcare published alongside this Pre-Budget Report, improvements to the childcare element of the WTC are set out in Chapter 5. The reforms will make eligible childcare more affordable for working families on low or moderate incomes and significantly increase the financial gains to work for families with eligible childcare costs.

4.70 Table 4.1 shows that, since the introduction of the National Minimum Wage in April 1999 and the Working Families' Tax Credit in October 1999, the Government has increased the minimum income that people can expect when moving into work, thereby reducing the unemployment trap.

Table 4.1: Weekly minimum income guarantees

	April 1999	October 1999	April 2005
Family[1] 1 child, full-time work (35 hours)	£182	£200	£258
Family[1] 1 child, part-time work (16 hours)	£136	£144	£199
Single person, no children, 25 or over, full-time work (35 hours)	£113	£113	£167
Couple, no children, 25 or over, full-time work (35 hours)	£117	£117	£198
Disabled person (single), working full-time (35 hours)	£139	£155	£209
Disabled person (single), working part-time (16 hours)	£109	£112	£150

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

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

4.71 The Government's reforms are also tackling the poverty trap, ensuring that workers have improved incentives to move up the earnings ladder. Marginal deduction rates (MDRs) measure the extent of the poverty trap by showing how much of each additional pound of gross earnings is lost through higher taxes and withdrawn benefits or tax credits.

4.72 Table 4.2 shows that, as a result of the Government's reforms, nearly half a million fewer low-income households now face MDRs in excess of 70 per cent than in April 1997. The increase in the number of households facing MDRs of between 60 and 70 per cent is primarily due to the introduction of tax credits, which have extended financial support so that far more families benefit.

[17] *Choice for parents, the best start for children: a ten year strategy for childcare*, HM Treasury, December 2004.

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

Marginal deduction rate[1]	Before Budget 1998	2005-06 system of tax and benefits
Over 100 per cent	5,000	0
Over 90 per cent	130,000	45,000
Over 80 per cent	300,000	195,000
Over 70 per cent	740,000	275,000
Over 60 per cent	760,000	1,715,000

[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, and the head of the household is not a disabled person.
Note: Figures are cumulative. Before Budget 1998 based on 1997-98 estimated caseload and take-up rates; the 2005-06 system of tax and benefits is based on 2003-04 caseload and take-up rates.

FUNDING FOR WELFARE TO WORK

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

Table 4.3: Allocation of the Windfall Tax

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

[1] In year figures rounded to the nearest £10 million, except where expenditure is less than £5 million. Constituent elements may not sum to totals because of rounding.
[2] Windfall Tax expenditure on welfare to work programmes is reduced from 2003-04 onwards as Windfall Tax resources are exhausted. Remaining in-year expenditure will be topped up with general Government revenues.
[3] Figures are provisional for the years from 2004 – 05 to 2005 – 06.
[4] Includes funding for the Innovation Fund.
[5] Includes £10 million in 1999-2000, an element of the November 1998 announcements on welfare reform.
[6] Includes £30 million for out-of-school childcare. The costs of the 1997 Budget improvements in childcare through Family Credit are included from April 1998 to October 1999, after which the measure was incorporated within the Working Families' Tax Credit.
[7] Start up and development costs. Other costs of the University for Industry are funded from within Departmental Expenditure Limits.
[8] Includes £219 million funding for Employer Training Pilots.
[9] Funding for repeat interviews. Other funding is from the Invest to Save Budget.
[10] Includes capital spending on renewal of school infrastructure, to help raise standards.

5 BUILDING A FAIRER SOCIETY

The Government is committed to promoting fairness alongside enterprise so that everyone can take advantage of opportunities to achieve their full potential in an outward-looking, flexible economy. The reforms of the welfare state introduced by the Government since 1997 reflect its aims of eradicating child poverty, supporting parents to balance their work and family life, promoting saving and ensuring security for all in old age. The Government is also committed to a modern and fair tax and benefit system which encourages work and saving and ensures that everyone pays their fair share of tax. This Pre-Budget Report sets out the next steps the Government is taking to support these aims, including:

- **a ten-year strategy for childcare**, setting out the Government's long-term vision of affordable, flexible, high-quality childcare for all parents who need it, and providing parents with real choices in balancing work and family life;
- **an extension of paid maternity leave from six months to nine months from April 2007**;
- **an increase in the entitlement to free nursery education for all 3 and 4 year olds** to 15 hours a week for 38 weeks a year, reaching all children by 2010;
- **improvements to the childcare element of the Working Tax Credit,** with an increase in the maximum eligible costs to £175 a week for one child and to £300 a week for families with two or more children from April 2005, and an increase in the maximum proportion of costs covered from 70 to 80 per cent from April 2006;
- **further steps to encourage saving and asset ownership**, through ISAs, the Saving Gateway and Stakeholder products;
- **consultation on the value of payments at age seven in the Child Trust Fund;**
- **a package of measures to promote financial inclusion**, by increasing access to banking services, affordable credit and face-to-face money advice;
- **a £50 payment to households with someone over age 70 in addition to the Winter Fuel Payment in 2005**, to help meet the cost of council tax and other living expenses;
- **action to protect tax revenues and modernise the tax system**, including measures to combat tax fraud and avoidance; and
- **the development priorities for the Presidencies of the G7/8**, and further steps to tackle global poverty and reduce developing country debt.

5.1 The Government's aim is to build a strong economy and a fair society, where there is opportunity and security for all. The Government is committed to ensuring that flexibility and fairness are advanced together, so everyone can achieve their full potential in a modern, dynamic economy.

5.2 In an increasingly competitive and integrated global economy, the pace of economic change will be ever quicker and more intense. This has great potential benefits in terms of growth and prosperity. Policies that ensure fairness are important to minimise the short-term consequences that can be associated with economic change.

5.3 Chapter 4 describes the Government's reforms to promote employment opportunity for all and to provide support to help people back into the labour market. This chapter describes the action the Government is taking to provide security for all, with more help for those who need it most, when they need it most. It sets out the progress the Government has made in a number of areas, including tackling child poverty and improving childcare to ensure that all children have the opportunity to fulfil their potential; promoting saving and asset ownership to provide security and enhance opportunity; and tackling pensioner poverty and ensuring security for all in old age. The Government is also committed to creating a modern and fair tax system, which adapts to changes in business and the global economy and ensures everyone pays their fair share toward building world-class public services.

5.4 Building on the progress that has been made in these areas, the Pre-Budget Report sets out new action the Government is taking to meet the long-term economic challenges facing the UK, including:

- a ten year strategy for childcare, setting out how the Government will support families in achieving the balance between work and family life that best suits them and their children. Access to affordable, flexible, high-quality childcare is key to tackling deprivation, removing barriers to parents' employment, and supporting children's long-term educational development, helping to provide the educated and highly-skilled workforce that the UK needs to prosper in the global economy; and
- measures to promote saving and asset ownership and ensure security for all in old age. Investment in assets, savings and pensions provides long-term independence and opportunity, and insurance against unforeseen events, allowing individuals the flexibility to adjust to changing economic circumstances.

5.5 The Government is also committed to tackling global poverty and achieving the Millennium Development Goals. This chapter describes the action the Government is taking to push for increased international resources for development and to widen and deepen debt relief for poorer countries. It also sets out the Government's development priorities for the UK's Presidencies of the G7/8 and the EU in 2005.

SUPPORT FOR FAMILIES AND CHILDREN

Eradicating child poverty

5.6 Tackling child poverty will both improve individuals' life chances and contribute to the development of an educated and highly-skilled workforce. The Government has an ambitious, long-term goal to eradicate child poverty by 2020. The Government's strategy is to provide financial support for families, with work for those who can and support for those who cannot; and to deliver high quality public services, which are key to improving poor children's life chances and breaking cycles of deprivation.

Progress to date

5.7 Significant progress has already been made in reversing the long-term trend of rising child poverty. By the mid 1990s, the UK suffered higher child poverty than nearly all other industrialised nations. However, as a result of investment in financial support for families and rising employment, the Government is on course to meet its Public Service Agreement (PSA) target to reduce the number of children in relative low-income households by a quarter between 1998-99 and 2004-05. The most recent data shows that by 2002-03, the numbers of children in relative low-income households had fallen by 0.5 million before housing costs (BHC) and by 0.6 million after housing costs (AHC), from 3.1 million and 4.2 million respectively. Over the same period, the number of children in absolute low-income households fell from 2.8 million to 1.5 million BHC and 4.0 million to 2.2 million AHC.[1]

[1] Data from *Households Below Average Income 1994-95 to 2002-03*, Department for Work and Pensions, 2004.

New child poverty target **5.8** Working towards the eradication of child poverty, the 2004 Spending Review announced a new PSA target to halve the number of children in relative low-income households between 1998-99 and 2010-11.[2] The Government will also set an additional target in the 2006 Spending Review to halve by 2010-11 the number of children suffering from both material deprivation and relative low income.

Delivering the new child poverty target **5.9** Building on progress to date, the Government is committed to providing more help for parents to work and guaranteeing affordable, good quality childcare for those who need it. It also has a long-term aspiration to improve financial support for large families. To reduce material deprivation the Government is increasing the availability of decent housing and tackling financial exclusion. Through measures such as improving early years services, raising standards in schools, tackling health inequalities and providing extra help for families at risk, the Government aims to improve the life chances of poor children. This approach was set out in the Treasury's recent Child Poverty Review.[3]

Child poverty accord **5.10** The Government will work closely with partner organisations as it develops policy across welfare reform and public services. In particular, central government and the Local Government Association have established a new 'child poverty accord' to enhance effective collaboration in tackling child poverty.[4]

Financial support for families with children

5.11 Since 1997 the Government has radically reformed the way it provides support to families with children, driven by two principal objectives:

- to support all families with children, recognising the benefit of a good start in life and that families with children face additional costs; and
- to deliver progress on its ambitious goal to eradicate child poverty, by offering greatest support to those most in need, while maintaining incentives to work.

5.12 This model of progressive universalism is delivered through a combination of Child Tax Credit (CTC), which was introduced together with the Working Tax Credit (WTC) in April 2003, and Child Benefit. Tax credits are benefiting 6.1 million families and 10.5 million children, including those families receiving their child allowances through their benefits. Tax credits are reaching far more low and moderate-income families than any previous system of income-related financial support.

Increased support for families **5.13** **This Pre-Budget Report announces that from April 2005 the child element of CTC will increase by £65 to £1,690 a year**, meeting the Government's commitment to increase it in line with average earnings. This means that the annual amount of the child element of CTC will have increased by £245 since its introduction in April 2003. A family with two young children and a full-time earner on £15,400 per year, half male average earnings, will receive over £103 per week in CTC and Child Benefit next year, a real terms increase of 85 per cent since 1997-98. Table 5.1 shows the levels of support that CTC and Child Benefit will provide for families from April 2005. Annex B provides further details of the changes to the rates and allowances within the tax and benefit system announced in this Pre-Budget Report.

[2] In line with international practice, low income will be measured on a BHC basis. The Government continues to monitor progress against a range of other indicators, including income measured on an AHC basis and data on regional variations in child poverty.

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

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

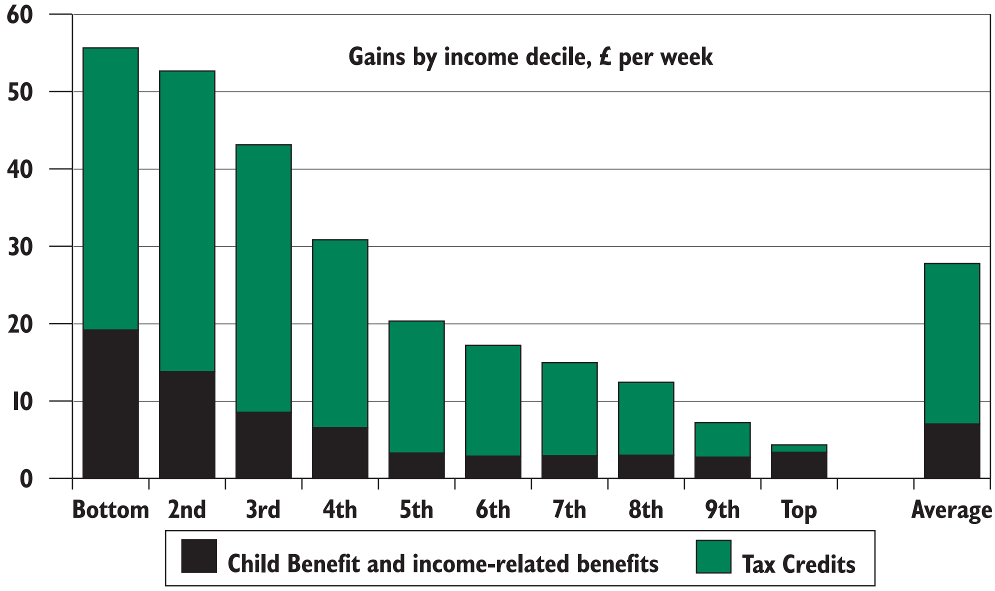
Table 5.1: Annual levels of support for families from April 2005

Family income (£ a year)	less than £13,910	less than £50,000	all families
Per cent of families	*30*	*82*	*100*
1 child	£3,125	£1,430	£880
2 children	£5,410	£2,020	£1,475
3 children	£7,695	£2,615	£2,065

5.14 Chart 5.1 shows the impact by income decile on families with children of the Government's reforms to the tax and benefit system since 1997. As a result, by April 2005, in real terms:

- families with children will be, on average, £1,300 per year better off, while those in the poorest fifth of the population will be, on average, £3,000 per year better off;
- a single-earner family on half average male earnings with two children will be £3,700 a year better off; and
- a single-earner family on average male earnings with two young children will be £255 a year better off.

Chart 5.1: Gains for families as a result of tax credits and other children's measures by 2005



Source: HM Treasury.

5.15 A range of Government policies aim to make utility bills more affordable for low-income and vulnerable customers by improving energy efficiency, tackling fuel poverty and providing financial support with fuel bills. The Fuel Poverty Action Plan, published in November 2004, sets out how the Government is working to tackle fuel poverty and extend the Warm Front scheme. Cold Weather Payments provide extra help with heating costs to vulnerable people during periods of very cold weather in their local area and households with someone aged over 60 receive Winter Fuel Payments. Further details on measures to support pensioner households are set out later in this chapter. The Department for Environment, Food and Rural Affairs is today publishing a report on water affordability.

Choice for parents, the best start for children: a ten year strategy for childcare

5.16 Good quality, affordable childcare and early education is central to several of the Government's long-term objectives: improving outcomes for children and helping parents move into work and training. The Government has invested heavily in childcare and early years support, creating 1.2 million new childcare places in England since 1997. Despite this progress, some parents are still not able to find the childcare that they need.

5.17 The Government is publishing *Choice for parents, the best start for children: a ten year strategy for childcare* alongside this Pre-Budget Report, setting out its long-term vision to ensure that every child gets the best start in life and to give parents more choice about how to balance work and family life.[1]

Choice and flexibility

5.18 The Government will ensure parents have greater choice in balancing work and family life, through:

- a goal of **twelve months paid maternity leave by the end of the next Parliament**. As a first step this Pre-Budget Report announces the extension of the entitlement to nine months from April 2007;
- **legislation to give mothers the right to transfer a proportion of this paid leave to the child's father by the end of the next Parliament**;
- **an increase in the flat rate of Statutory Maternity Pay, Maternity Allowance and Statutory Adoption Pay and Statutory Paternity Pay to £106 a week from April 2005. The Government is committed to increasing the flat rate over time** in the light of evidence on take-up of pay and leave rights;
- committing to consulting with employers, unions and other stakeholders, for extending the case for **extending the right to request flexible working to the parents of older children and carers of sick and disabled relatives**; and
- **giving every family easy access to integrated services through Children's Centres** in their local community, offering information, health, family support, childcare and other services for parents and children. 2,500 Children's Centres will be in place by 2008 and 3,500 by 2010.

Availability

5.19 The Government's vision is that **all families with children aged up to 14 who need it can find an affordable, flexible, high quality childcare place that meets their circumstances.** This will be achieved through:

- **legislation for a new duty on local authorities in place by 2008 so that over time they will secure sufficient supply** to meet the needs of families;
- **a goal of 20 hours a week of free high quality care for 38 weeks for all 3 and 4 year olds** with this Pre-Budget Report announcing **a first step of 15 hours a week for 38 weeks a year reaching all children by 2010**; and
- **an out of school childcare place for all children aged 3-14 between the hours of 8am to 6pm each weekday by 2010.**

[1] *Choice for parents, the best start for children; a ten year strategy for childcare*, HM Treasury, December 2004.

Quality 5.20 The Government is committed to high quality childcare provision with a highly skilled childcare and early years workforce that is among the best in the world, by:

- **ensuring all full daycare settings are professionally led;**
- **creating a Transformation Fund worth £125 million each year from April 2006** to invest in high quality, sustainable, affordable provision;
- **radically reforming the workforce, with the Children's Workforce Development Council consulting on a new qualification and career structure in 2005;** and
- **reforming the regulation and inspection regime** to improve standards and to give parents better information.

Affordability 5.21 The Government wants families to be able to afford flexible, high quality childcare that is appropriate for their needs. This Pre-Budget Report takes further steps to ensuring this by:

- **increasing the limits of the childcare element of the Working Tax Credit to £300 a week (£175 for one child) from April 2005, and an increase in the maximum proportion of costs that can be claimed from 70 per cent to 80 per cent from April 2006.** The definition of eligible childcare and the maximum eligible costs in Housing Benefit and Council Tax Benefit will be aligned with the childcare element of WTC. For a couple family on £34,000 a year with both parents working and typical childcare costs for two young children, these reforms reduce the proportion of childcare costs they pay from 85 per cent to 75 per cent, a saving to them of £700 per year. Building on this first step, the Government's long-term ambition is to reduce further the proportion of childcare costs paid by such families, making childcare increasingly affordable;
- announcing **£5 million from April 2006 for a pilot to work with the Greater London Authority** to address childcare affordability issues in London;
- extending the range of quality childcare that is eligible for financial support, by introducing **a childcare approval scheme for England, to complement existing registered childcare, which will be in operation by April 2005**. Further details of the scheme will be announced later this month by the Department for Education and Skills (DfES); and
- extending support for employer-supported childcare. **The Government announced in the 2003 Pre-Budget Report that from April 2005 where an employer offers childcare vouchers or childcare provision the first £50 a week will be free of tax and National Insurance contributions.** This exemption is subject to the benefit being offered to all employees and for childcare that is registered or approved. The £50 a week exemption applies to the cost to the employer of providing the childcare benefit. For childcare vouchers, this cost is normally the face value of the voucher plus associated administration charges. **This Pre-Budget report announces that from April 2005 the £50 a week limit will apply to the face value of childcare vouchers and that associated administration costs and service charges will also be exempt from tax and NICs.**

SUPPORTING YOUNG PEOPLE

5.22 *Skills in the global economy*,[2] published alongside the Pre-Budget Report and described in Chapter 3, sets out both the Government's ambition for enhancing skills and new long-term proposals to build on ongoing success in this area. Enhancing skills is an increasingly important long-term economic challenge for developed countries. For an individual, skills provide security and opportunity. Better qualified people are more likely to be in work, to be supported by their employers to improve their skills, and to be paid more. More widely, skills provide personal fulfilment and can enable people to contribute to their communities. The Government's aspiration is for all young people to continue in learning after the age of 16.

Financial support for young people

5.23 The national roll out of Education Maintenance Allowances (EMAs), described in Chapter 3, will raise the participation rate of young people in full-time education. The success of EMAs points to the importance of financial support and incentives in delivering higher rates of post-16 participation. Published alongside Budget 2004, *Supporting young people to achieve*[3] reviewed the system of financial support for 16-19 year olds. The report set out a package of short-term measures and a long-term vision to improve financial support for 16-19s, with the aim of increasing post-16 participation in learning. The Government is currently considering over 50 responses from individuals and organisations to its consultation on the long-term vision of financial support for 16-19s and will respond in Budget 2005.

Extending financial support for 16-19s

5.24 As an important, initial step towards its long-term vision, the Government will shortly publish the first Child Benefit Bill since 1975, for introduction in the current session of Parliament. The Bill will enable the extension of Child Benefit to unwaged trainees and 19 year olds completing their course. In consultation with external stakeholders, and subject to developments in Apprenticeship policy, the Government is considering extending Child Benefit to unwaged trainees in Government approved training. Alongside improvements to financial support for young people in learning, and to simplify the current system, the Government is also considering increasing support to 16-17 year olds on Income Support and Jobseeker's Allowance.

FAIRNESS FOR DISABLED PEOPLE

5.25 The Government is determined to advance the rights of and opportunities for disabled people, and ensure their full participation in society. Chapter 4 sets out the steps the Government is taking to increase employment and financial support for people with a health condition or disability who want and are able to work. The Government also continues to tackle discrimination in the workplace and beyond, and to provide support for those unable to work.

5.26 Since 1997, the Government has extended and improved the protection that the Disability Discrimination Act offers to disabled people. Since October 2004, duties on employers not to discriminate against disabled people have applied to employers with fewer than 15 employees, and to previously exempt occupations. This brings an additional one million employers and seven million jobs within the scope of the employment provisions of the Act. The Act also now requires all service providers to make reasonable adjustments, including to physical features of premises, to make services more accessible to disabled people. The Disability Discrimination Bill will provide protection to 175,000 more people with HIV, cancer and MS, and place a duty on public bodies to promote equality of opportunity for disabled people.

[2] *Skills in the global economy*, HM Treasury, December 2004.

[3] *Supporting young people to achieve: towards a new deal for skills*, HM Treasury, DfES and DWP, March 2004.

5.27 From April 2005, the disabled child element in the CTC will provide a supplement of up to £2,285 a year for each disabled child and a further £920 a year for each severely disabled child. The disabled child premium has increased by 70 per cent in real terms compared with the equivalent support offered in 1997. 110,000 working families were benefiting from the disabled child element of the CTC by July 2004; over three times higher than the number who benefited from the disabled child credits under the previous tax credit system.

PROMOTING SAVING, ASSET OWNERSHIP AND INCLUSION

5.28 Assets and savings provide opportunity and independence throughout life, flexibility to adjust to unforeseen events and financial security in retirement. Based on the principle of progressive universalism, the Government seeks to make asset ownership accessible to all, while providing more help for those who need it most.

5.29 Building on the platform of macroeconomic stability set out in Chapter 2, which provides an environment conducive to long-term planning, the Government seeks to provide targeted support and incentives for saving from childhood, through working life and into retirement. Set out in detail later in this section, the Pre-Budget Report announces action to further promote saving and asset ownership in three areas:

- *Individual Savings Accounts* – which provide accessible, tax-free savings;
- *the Saving Gateway* – which is piloting the provision of a Government cash contribution to 'match' individual savings for those on low incomes; and
- *Stakeholder savings and investment products* – simple, low-cost and risk-controlled, with a charge cap that protects consumers from high charges.

5.30 The Government is also introducing the Child Trust Fund, which will ensure assets for all children, promote positive attitudes to saving and improve financial capability.

5.31 The Government is also committed to promoting financial inclusion to ensure that everyone can access the financial services and products that they need to manage their finances, avoid high cost credit and start to save. Discussed later in this chapter, *Promoting Financial Inclusion*,[4] published alongside this Pre-Budget Report, sets out the Government's proposals to tackle financial exclusion.

Saving decisions

5.32 It is vital that saving and asset-building decisions are better understood. Individuals' saving preferences vary over their lifetimes and cover a variety of assets, from savings stamps, deposit accounts, pensions, stocks and shares, to homes and businesses. The Government is committed to a policy framework that enables people to choose how and when to save across the full range of asset-building activities. Traditional measures of aggregate saving, such as the saving ratio, often fail both to reflect this variety and to highlight the positive impact asset growth has had on households' balance sheets in recent years. Broader measures, for example including capital growth, indicate that saving behaviour has been more robust in recent years than is often appreciated.[5]

[4] *Promoting Financial Inclusion*, HM Treasury, December 2004.

[5] See, for example: Bank of England, *Quarterly Bulletin*, Spring 2001; New Zealand Treasury, *Household Net Wealth: An International Comparison*, 2001; and Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, September 2000.

5.33 Total household assets – including savings, pensions, life insurance and housing – stand at around £6 trillion. This greatly outweighs total household debt, the build up of which, at the aggregate level, has been primarily associated with asset accumulation, particularly housing, rather than with borrowing to fund current consumption.[6] Overall, household net wealth has grown by around 50 per cent in real terms since 1997. Nevertheless, the Government recognises that some households face acute problems of over-indebtedness. In response, the Government set out in July 2004 its strategy for tackling over-indebtedness.[7]

5.34 Tax incentives can encourage people to save and the Government already facilitates a wide range of tax-favoured saving and investment vehicles. ISAs and National Savings & Investment products, including Premium Bonds, offer a range of tax-advantaged savings opportunities and many savers benefit from the lower 20 pence rate of tax on savings income. These measures are supported by around £2 billion in tax relief every year. Further opportunities exist to invest tax-free in Venture Capital Trusts and Enterprise Investment Schemes, many employees have access to tax-free share option schemes and incentive plans and individuals automatically receive exemption from Capital Gains Tax on investment profits up to an annual limit of £8,200. Taken together, these opportunities are supported by a further £2 billion in tax relief every year. The Government also recognises that not all households are able to take advantages of these opportunities, and that a significant minority hold few or no savings or assets. The Government is committed to providing them with additional support, as access to even small amounts of savings can help to provide security and insulation from adverse shocks.

Promoting saving and asset ownership

Individual Savings Accounts

5.35 Over 16 million people now have an Individual Savings Account (ISA), with over £150 billion subscribed since 1999. ISAs have reached a wider section of the population than TESSAs (Tax Exempt Special Savings Accounts) or PEPs (Personal Equity Plans), which they replaced, with increased take-up among both low-income groups and the young. These savings are supported by around £1.6 billion in tax relief every year.

5.36 When ISAs were introduced in 1999 they were guaranteed to run for ten years to 2009, and the overall annual investment limit was set at £5,000, with a maximum of £1,000 in cash. A higher initial limit of £7,000, with a maximum of £3,000 in cash, was set for the first year to encourage new saving. In 2000, this higher limit was extended to April 2006. **The Government remains committed to ISAs and plans, subject to consultation, to further extend the existing higher ISA limits to 2009.** The Government would welcome views and evidence on this proposal from industry, consumer groups and others. For someone saving the maximum each year this would permit £70,000 in tax-relieved savings over ten years, well above the £50,000 orginally promised.

Matching and the Saving Gateway

5.37 In addition to using tax incentives to encourage saving, the Government can support saving through 'matching', by providing a cash contribution to individual savings. Matching provides: a more understandable, transparent and effective framework of support for savers; and greater incentives for those on low incomes who often cannot benefit from tax relief. Matching has been used since 2001 in the 'relief at source' scheme for personal and stakeholder pensions and is being piloted for low-income groups in the Saving Gateway.

[6] Further detail on the household balance sheet is set out in Annex A.

[7] *Tackling Over-Indebtedness: Action Plan 2004*, Department for Trade and Industry, July 2004.

5.38 The Saving Gateway is designed as an ideal starting point for individuals who would otherwise have difficulty getting on to the savings ladder. Under the pilot scheme established by the Government in 2002 and run by the Halifax bank, the Government matched pound-for-pound the savings of low-income households up to a limit. The Community and Finance Learning Initiative, run by DfES, provided tailored financial information and education alongside the Saving Gateway accounts to help individuals make informed saving decisions.

5.39 The pilot schemes have all now matured and the full evaluation of the pilot will follow in early 2005. The interim evaluation finds that matching can provide an important new dimension to Government support for saving.[8] **Therefore, the Government will launch a larger, £15 million Saving Gateway pilot in 2005.** The new pilot will investigate alternative rates of matching, measure the impact of matching for a wider range of income groups and, working with DfES, will use the support of a wider range of community financial education bodies. Evidence gathered through this pilot will be used to evaluate the future role matching could play in Government support for savings, both for those on low incomes and more generally. As set out in the Pensions Green Paper, the Government will also look to illustrate the generous matching top-up that tax relief on individuals' pension contributions provides.

Stakeholder savings and investment products

5.40 Following the Sandler review[9] of the retail savings industry, the Government announced in July 2003 the specifications of the new 'Stakeholder' suite of simple, low-cost, risk-controlled savings and investment products. This suite will include Stakeholder pensions. The new Child Trust Fund will also have a Stakeholder option. A key feature of the product suite is a charge cap that will protect consumers from high charges, while providing firms with the opportunity to sell these products viably. In June 2004, the Government announced that a charge cap of 1.5 per cent per year would apply to the medium-term and pension products for the first 10 years that an investor holds a product; thereafter a cap of 1 per cent will apply. The Government will review the charge caps in 2008.

5.41 In November 2004, the Treasury introduced legislation to create the full range of products for the Stakeholder suite, and DWP launched a consultation on amendments to the Stakeholder pension. To reduce the cost of distributing these products, the FSA introduced regulations on the basic advice process through which Stakeholder products may be distributed, which will be implemented in April 2005. The Government will continue to consult with industry and consumer groups on the most effective way to market these products.

Child Trust Fund

5.42 In recognition of the role that assets play in creating opportunity, independence and security, the Government is pioneering a universal, progressive, asset-based welfare policy. The Child Trust Fund, to be launched in April 2005, will be at the heart of this new strand of welfare policy. It aims to ensure assets for all children, promote positive attitudes to saving and improve financial capability. It will build on financial education by providing a long-term savings and investment account with which children can engage, raising their confidence as they use the account and deal with financial providers.

[8] *Evaluation of the CFLI and Saving Gateway Pilot Projects*, University of Bristol, Personal Finance Research Centre, October 2003.

[9] *Medium and Long-term Retail Savings in the UK: A Review*, Ron Sandler, July 2002.

5.43 To help children start saving, all those born since September 2002 will receive at least £250 to invest in a long-term Child Trust Fund account; children from families on lower incomes will receive £500, in line with the Government's principle of progressive universalism. To encourage the saving habit, children, parents, family and friends will between them be able to contribute up to £1,200 a year to each account and there will be no tax to pay on any interest or gains made on this money. Box 5.1 outlines the process for introducing the Child Trust Fund. The Child Trust Fund will also help tackle financial exclusion, since all children will automatically have access to financial services.

5.44 The Government has committed to make a further payment at age seven into all Child Trust Fund accounts. This payment will be progressive, like the initial endowment, as the Government believes that poorer children should receive more help. **The Government will now consult on a further universal payment of £250 at age seven, with children from low-income families receiving £500.**

Box 5.1: The Child Trust Fund: countdown to introduction

15 November 2004 **– Child Trust Fund website (www.childtrustfund.gov.uk) launched and Child Trust Fund Helpline opened (0845 302 1470).**

15 November to December 2004 **– The Government is writing to all families of eligible children to advise them that the Child Trust Fund is being introduced in April 2005 and to let them know that they will not need to make a separate claim for a Child Trust Fund account.**

17 January 2005 **– The Government will begin automatically sending out Child Trust Fund information packs and vouchers to all parents of children born since September 2002. Parents can use the voucher to open an account of their choice with a participating financial provider.**

17 January 2005 **– A major advertising campaign will start to raise awareness of the Child Trust Fund. This will ensure that parents understand what they need to do and encourage them to make an active choice of account.**

6 April 2005 **– Child Trust Fund accounts will become fully operational. After this date, Government funds will go into the account, and family and friends can start contributing.**

6 April 2005 onwards **– Information packs and vouchers will be sent automatically to parents of children once they have been awarded Child Benefit for their child.**

Promoting financial inclusion

5.45 Access to mainstream financial services is restricted for many people on low incomes. This imposes costs on those who can least afford them and prevents individuals from getting started on the savings ladder. Since 1999, the Government has sought to tackle financial exclusion, including working in partnership with banks to develop basic bank accounts and the Post Office Card Account, to which the banks have made a valuable contribution of £182 million. Despite these developments, financial exclusion remains a problem for millions of households. In 2002-03 there were about 2.8 million adults in households with no access to a bank account. Over one million basic bank accounts have been opened since 2003 and the banking industry has announced a welcome change to the Banking Code to make basic bank accounts more available for those who want them.

5.46 *Promoting Financial Inclusion*,[10] published today alongside the Pre-Budget Report, sets out proposals to tackle financial exclusion, including a £120 million Financial Inclusion Fund to support initiatives to tackle financial exclusion over the next three years. Brian Pomeroy, former Chairman of the National Lottery Commission, will chair a new Financial Inclusion Taskforce, to oversee progress on tackling financial exclusion.

Access to banking

5.47 The banks and the Government share the aim of reducing financial exclusion. **They have agreed to work together towards the goal of halving the number of adults in households without a bank account, and of having made significant progress in that direction within two years.** Developments will be reviewed at the end of the two-year period to see if further initiatives are needed.

Access to affordable credit

5.48 Many low-income households rely on the 'alternative credit market', where typical products have Annual Percentage Rates (APRs) of over 100 per cent, many times the APRs of standard mainstream products. The Government has been working to identify creative solutions to reducing the cost of lending and increasing access to affordable credit, building on existing good practice. **The Government is considering mechanisms whereby, in certain circumstances, private and 'third' sector lenders could apply for repayment to be made by deduction from benefit where normal repayment arrangements have broken down**, in order to boost the ability of private, voluntary and community sector partners to offer affordable loans to those on the lowest incomes.

5.49 Not-for-profit or 'third' sector lenders such as credit unions and Community Development Finance Institutions (CDFIs) have a key role to play in the provision of affordable credit to those on low incomes. ***Promoting Financial Inclusion*** **sets out a range of measures the Government will put in place to boost the coverage, capacity and sustainability of the sector in providing affordable loans to the financially excluded.**

Access to money advice

5.50 The Government recognises that face-to-face money advice provision is a particularly effective mechanism in tackling over-indebtedness for more vulnerable consumers. *Promoting Financial Inclusion* sets out how **the Financial Inclusion Fund will support an increase in the capacity of the face-to-face money advice sector, and pilot models of money advice outreach aimed at those who do not normally present themselves to debt advisers**.

Financial capability

5.51 The Government is also supporting wider efforts to improve financial capability. In 2001, personal finance education was introduced in schools as a non-statutory part of the national curriculum in England. The Government is now examining the scope to develop the subject and to better support teachers. In addition, the FSA is currently working with a range of parties to develop a national strategy for financial capability, focused on increasing capability across key the population at key life stages. This strategy is a critical platform to ensure that financial capability, particularly for the excluded, is built effectively.

The Social Fund

5.52 The Social Fund provides a safety net of grants and loans for the most vulnerable in times of crisis. The 2004 Spending Review announced the intention to abolish the 'double debt' rule in the Budgeting Loans scheme, which takes an applicant's outstanding Budgeting Loan debt into account twice in calculating the maximum amount he or she can borrow. The Government also announced the intention to lower the highest loan repayment rates. This means that the current 15 per cent repayment rate will be lowered to 12 per cent of a claimant's benefits. **This Pre-Budget Report announces that these reforms will be implemented in April 2006**. These measures, which amount to an increase in funding for the Social Fund of £210m over the three years to 2008-09, will enable the Social Fund to play a more effective role in helping those families most vulnerable to over-indebtedness. The Government is continuing to consider further reform of the Social Fund in the wider context of its vision for greater financial inclusion.

[10] *Promoting Financial Inclusion*, HM Treasury, December 2004.

Treatment of capital limits

5.53 The Government is committed to removing disincentives for those on lower incomes to save. It will keep under review the treatment of savings in income-related working age benefits, so as not to penalise saving unfairly. **As announced in Budget 2004, from April 2006, the threshold above which savings begin to reduce eligibility for Income Support, Jobseeker's Allowance, Housing Benefit and Council Tax Benefit will be raised from £3,000 to £6,000.**

FAIRNESS FOR PENSIONERS

5.54 A fair society guarantees security in old age and ensures that all pensioners can share in rising national prosperity. The Government launched the Pension Credit in 2003 to tackle pensioner poverty and reward saving. It has also launched a programme of informed choice to empower individuals to make their own decisions about working and saving for retirement. The Pensions Commission's recent report[11] explains that, in common with most developed countries, the UK faces a number of challenges in enabling individuals to meet their aspirations for retirement incomes in an ageing society.

Fairness for today's pensioners

5.55 Building on the foundation of support for retirement income provided by the basic and additional state pensions, the Government continues to focus resources on the poorest pensioners. From 2005-06 the poorest need not live on an income below £109.45; in 1997 this figure was £69. The successful launch of Pension Credit in October 2003 builds on this, further extending support to the poorest pensioners and rewarding those who have built up small savings for retirement as described in Box 5.2.

Security for today's pensioners

5.56 The Government is continuing to guarantee pensioners' security and tackle pensioner poverty by:

- guaranteeing that the April increase in the basic state pension will be in line with the Retail Price Index for the previous September or 2.5% (whichever is higher), meaning that the basic state pension will rise to £82.05 for single pensioners and £131.20 for couples from April 2005;
- increasing the guarantee element of Pension Credit in line with earnings to £109.45 for single pensioners and £167.05 for couples from April 2005; and
- increasing the Pension Credit savings reward to a maximum of £16.44 a week for single pensioners and £21.51 for couples.

5.57 This is in addition to existing measures, which provide:

- a Winter Fuel Payment of £200 per household for those over 60 rising to £300 for households with someone over 80, for the rest of this Parliament; and
- free television licences for the over 75s, and free eye tests and prescriptions for those aged 60 and over.

[11] *Pensions: Challenges and Choices, The First Report of the Pensions Commission*, Pensions Commission, October 2004.

Payment to over 70s

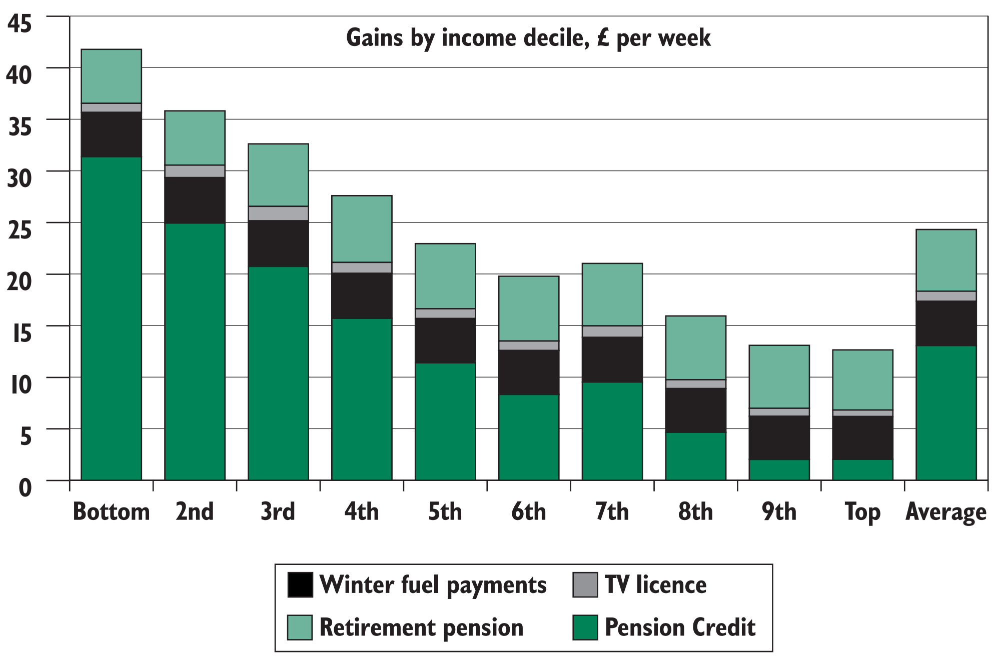
5.58 The Government understands the position of older people on fixed incomes facing pressures such as council tax bills. Alongside Council Tax Benefit, the Government believes that it is right to help older pensioner households with their council tax and other living expenses. **This Pre-Budget Report therefore announces that, in addition to these existing measures, the Government will make a payment of £50 to households with someone over age 70 in 2005.**

Effects of measures to support pensioners

5.59 Chart 5.2 shows the distributional impact of the Government's measures to support pensioners. Relative to the 1997 system, the Government will spend £10 billion more on pensioners in 2005-06 as a result of tax and benefit measures it has introduced, with the result that:

- the poorest ten per cent of pensioner households will be on average £2,170 a year, or around £42 a week, better off; and
- pensioner households will be, on average, £1,350 a year better off, or around £26 extra a week.

Chart 5.2: Overall gains for pensioner families from pensions policies by 2005



5.60 As a result of measures implemented since 1997, the Government is spending £10 billion a year more on pensioners – £7 billion a year more than if it had simply linked the basic state pension to earnings over the same period. The Government's strategy is not only more generous overall, but has also focussed support on those who need it most. If the extra £10 billion had been spent on raising the basic state pension then the poorest ten per cent of pensioners would on average be £23 a week worse off than they are now.

Support for pensioners who pay tax

5.61 Almost half of pensioners pay no income tax. For those who do, the age-related personal allowances in 2005-06 will rise in line with earnings to £7,090 for people aged between 65 and 74 and to £7,220 for those aged 75 and over. The age-related personal allowances will continue to rise at least in line with earnings rather than prices for the remainder of this Parliament. This means that no person aged 65 or over need pay tax on an income of less than £136 a week.

Box 5.2: Pension Credit

To tackle pensioner poverty while rewarding saving for retirement, the Government has built on the Minimum Income Guarantee with the launch in October 2003 of the Pension Credit. The Pension Credit already benefits 2.6 million pensioner households, and the Pension Service has a target of 3 million pensioner households by 2006 rising to 3.2 million by 2008, and is working with local authorities and the voluntary sector to achieve this.

Pension Credit currently provides a guaranteed minimum income of £105.45 a week for single pensioners, which will rise to £109.45 from April 2005. This means pensioners no longer have to live on as little as £69 a week as they did in 1997. Pension Credit also rewards 1.9 million pensioners who have saved for their own retirement, and has ended the unfair penalty on many savers of a 100 per cent marginal deduction rate on their savings.

Women pensioners, who in the past have not been able to build up an entitlement to a full basic state pension, have been among those to benefit the most from Pension Credit. Although only 48 per cent of women currently receive a full basic state pension, twice as many women receive Pension Credit as men.

Claiming Pension Credit is a much simpler process than previous application processes. The application form is relatively short and straightforward and can be completed largely over the telephone with the help of an advisor, who then sends it to the claimant to sign and return. From age 65, provided their circumstances do not change, most applicants have their entitlement fixed for five years.

Fairness for tomorrow's pensioners

5.62 The Government is committed to providing a clear and sustainable framework for retirement provision within which individuals can make effective choices about how much to save and when to retire, as set out in the Pensions Green Paper in 2002. Since then, the measures in the Green Paper have been developed and taken forward through legislation and the publication of *Informed choices for working and saving.*[12] The Government's policies aim to deliver:

- *a guarantee of a decent minimum income in retirement* – provided by the state, and below which no pensioner need live;
- *transparency* – the Government's Informed Choice programme is helping people to make informed and effective choices about working and saving for their retirement;
- *simplicity* – the Government is simplifying the tax regime for pensions, and ensuring that people have access to simple and flexible savings products;
- *security* – the Pension Protection Fund and a new pro-active regulator will improve protection for members of occupational pension schemes; and
- *opportunities for extended working lives* – the Government is combating age discrimination and enhancing the rewards for those choosing to defer taking their state pension, providing people with greater opportunity and rewards for working longer if they wish to do so.

[12] *Simplicity, security and choice: Informed choices for working and saving*, Department for Work and Pensions, February 2004.

5.63 The Government establised the Pensions Commission in 2002 to keep under review the regime for UK private pensions and long-term savings, and assess how effectively the current voluntarist approach is developing over time. On the basis of this assessment, the Commission will make recommendations to the Secretary of State for Work and Pensions on whether there is a case for moving beyond the current voluntarist approach. The Pensions Commission published its interim report *Pensions: Challenge and Choices* in October 2004. The Government welcomes this report, which furthers understanding of the challenges posed by an ageing population, and looks forward to the Commission's second report on policy recommendations in Autumn 2005. The interim report makes several recommendations on data adequacy, which the Government accepts. The Government will respond to the long-term savings issues raised by the Commission. The nature of any response will be guided by the imperative of maintaining long-term fiscal sustainability.

A decent mimimum income for all

5.64 The Government is committed to guaranteeing a decent minimum income in retirement. From April 2005, the guarantee element of the Pension Credit will stand at £109.45 for single people and £167.05 for couples. The Basic State Pension will rise to £82.05 for single pensioners from April 2005, representing a rise of 7 per cent in real terms since 1997. In addition, the Government reformed the State Earnings Related Pension Scheme (SERPS) by introducing the State Second Pension in April 2002. This increased the rights built up by those on low and moderate earnings, as well as by disabled people and carers. Someone earning half median earnings, around £11,000 per annum, will be able to accrue a weekly State Second Pension of around £70 at retirement in 2050, in today's earnings terms; roughly double what would have been built up under SERPS.

Informed choice

5.65 Beyond the foundation provided by the Government, it is for individuals and families to decide for themselves what income they wish to receive in retirement. The Government is working with employers and the pensions industry to provide timely, accurate and tailored information that will enable people to make informed choices about their retirement provision. Measures include:

- issuing nearly 3 million forecasts in 2003-04. 1.3 million of these were combined forecasts, which contained information relating to both state pension accruals and current private pension saving. The Pensions Act 2004 provides the Government with a reserve power to require that pension schemes provide these combined forecasts, should evidence show that they make a significant difference to savings levels. The 2004 Spending Review set DWP a PSA target to ensure that by 2007-08 over 15 million individuals are regularly issued with a pension forecast;

- a web-based retirement planner, which DWP will deliver by the spring of 2006. This will enable people to consider the impact on their retirement income of varying savings behaviour or working longer than currently planned; and

- piloting the use of information and advice in the workplace. The Pensions Act 2004 provides reserve powers to require employers to ensure that their employees have access to a decent standard of pension information.

5.66 *Informed Choices for working and saving* also sets out ways by which individuals could maximise the opportunities to save available to them in the workplace. The Government is exploring automatic enrolment in employers' pension schemes. The Pensions Commission confirmed that such approaches could increase take up significantly.

Pension tax incentives

5.67 Individuals need clarity around the tax treatment of their pension saving. The existing eight taxation regimes create complexity, each with its own set of rules. Following an announcement in Budget 2004, Finance Act 2004 legislated for a single universal regime for tax-privileged pension savings, which will come into effect in April 2006. As well as providing individuals with greater flexibility and choice over their retirement savings, tax simplification will benefit employers and pension providers through a reduction in administrative costs. The Government is responding to representations made on the Finance Act 2004 legislation, and will introduce a package of supplementary measures in Finance Bill 2005. There will also be further modifications, including a new transitional rule to allow certain funeral expenses currently paid by occupational schemes to continue to be paid tax free.

5.68 The Government has implemented reforms to ensure that savings pays. Pension Credit provides the Savings Credit reward to 1.9 million pensioners who have saved for their own retirement, and has ended the unfair penalty on many savers of a 100 per cent marginal deduction rate on their savings. The Financial Services Authority has concluded that, as a result of the Savings Credit, "*for most people, most of the time, it will pay to have saved*".[13]

Stakeholder pensions

5.69 In addition to information and transparency, individuals need access to simple, good value products. The introduction of 'Stakeholder' pensions has ensured that value-for-money, flexible private pension arrangements are available to all. The review of the charge cap in June 2004 should further extend the reach of these products. Stakeholder pensions are one element of the Stakeholder suite described earlier in this chapter.

Pension protection

5.70 The Government has a role in ensuring that there is appropriate regulation of the pensions and savings industry. To rebuild confidence in saving, the Government acted to ensure that victims of personal pensions mis-selling were compensated where this was appropriate. The Government has introduced legislation through the Pensions Act 2004 to establish the Pension Protection Fund (PPF). This is the UK's first scheme for ensuring that individuals in defined benefit pension schemes receive a meaningful proportion of their expected pension income if their sponsoring employer becomes insolvent. At the same time, the Government has introduced legislation to strengthen and refocus the Pensions Regulator, enabling it to take a risk-based approach and use its resources more effectively. In addition, the Government is providing a package of assistance for those people who have lost out due to their pension scheme being wound up, when the sponsoring employer became insolvent, prior to the introduction of the PPF.

Enabling longer working lives

5.71 The Pensions Commission's analysis confirmed that working longer will be an important part of the response to increased life expectancy. Of those aged between 50 and state pension age, the employment rate has risen from 65 per cent in 1997 to 70 per cent now. Furthermore, there are now nearly 1 million people over state pension age in employment. Chapter 4 sets out the Government's employment strategy, which contains measures to further improve the employment opportunities of older workers. The Government does not believe it is right to force people to work longer and has no plans for a crude increase in the state pension age, but it is providing greater choice and flexibility for those who wish to do so, including:

- measures which mean that it will be possible to draw an occupational pension while remaining with the same employer;
- ensuring that from April 2005, those who choose to defer taking their state pension will be rewarded, either with weekly payments that increase by 10.4 per cent for each year of deferral or, alternatively, by a taxable lump sum. Tax will be applied to the lump sum at the marginal rate and it will not affect any

[13] *FSA Factsheet: Stakeholder Pension and Decision Trees*, Financial Services Authority, April 2004.

age related allowance due. Claimants will be able to self declare their appropriate tax rate and the tax will be deducted before the payment is made; and

- legislation, which the Government will bring into force in 2006, to implement the age discrimination strand of the European Employment Directive.

SUPPORTING COMMUNITIES, CHARITIES AND GIVING

5.72 The voluntary and community sector (VCS) plays a central role in creating a fair and enterprising society with a culture of volunteering and giving. The Government has provided a wide range of tax reliefs and special provisions to support the VCS, which are now worth more than £2.4 billion a year, and provides additional support through a number of programmes and initiatives. The Government sees enhanced consultation and engagement with the VCS as key outcomes from implementation of the O'Donnell Review recommendations for the integration of Inland Revenue and HM Customs and Excise and the strengthened capacity for tax policy development at HM Treasury. The Government is committed to further action to support the work of the VCS in:

- developing stronger local communities;
- taking a greater role in public service delivery, described in Chapter 6;
- engaging people in volunteering and mentoring; and
- engaging the corporate sector in meeting community needs.

Volunteering and giving

5.73 The Government will launch the 2005 Year of the Volunteer at a 'Local Heroes Ceremony' in January. Through the Year of the Volunteer, the Government will work with the VCS and corporate sector to promote the universal benefits of volunteering. All private and public sector employers, including Government departments, should consider their contribution to creating a culture of volunteering, spreading best practice, and raising overall levels of voluntary activity. In May 2004, the Home Secretary and Chancellor launched a Commission, led by Ian Russell, Chief Executive of Scottish Power, to examine how to achieve a step change in youth volunteering and engagement, building on the valuable contribution young volunteers already make in our communities. The Commission published its consultation document in October 2004, seeking views on how to engage more young people in volunteering, enhance the range and quality of volunteering opportunities and give the achievements of young volunteers greater recognition. The consultation period closes on 31 December 2004 and the Commission will report in spring 2005 on a new national framework.

5.74 The Government strongly supports the impact volunteer mentors can have on improving the life chances of others, particularly young people. A new National Mentoring and Befriending Body, supported by the Home Office and to be launched during 2005, will raise the profile of mentoring and ensure that quality standards are maintained and strategic links to Volunteer Centres are developed. It will be supported by regional mentoring and befriending bodies and a series of local mentoring projects with a track record in delivery. Building on this, the Government will work with schools, the business sector and the VCS to explore the potential for greater corporate involvement in mentoring through the Corporate Challenge.

5.75 The Chancellor and Home Secretary will host a Volunteering Conference in January 2005 with representatives from the VCS and business. The Conference will discuss the Russell Commission, mentoring, and finance issues such as existing funding and the use of existing tax incentives.

Corporate Community Involvement

5.76 High quality, mutually beneficial links between local businesses and their communities provide effective frameworks for the giving of both time and money. In the 2004 Spending Review, the Government announced it would look to business to take forward a national campaign during 2005, as part of the business-led Corporate Challenge, to promote Corporate Community Involvement via an increase in employer support for Payroll Giving, employee volunteering and corporate charitable activity. The Campaign will provide an opportunity to highlight how corporate community involvement can contribute to reducing poverty, promoting an inclusive society and raising economic productivity.

5.77 The Government is committed to ensuring that the generous set of tax incentives available to encourage corporate giving is understood and used. The *Guide to Tax Incentives for Corporate Giving*, to be published shortly, will explain this set of incentives; helping to boost corporate tax efficient giving in the 2005 Corporate Challenge National Campaign.

Payroll Giving

5.78 In 2004, around 530,000 employees gave £85 million to charity through Payroll Giving, with one in five employees having access to a Payroll Giving scheme. The Government believes that employees should benefit from the opportunity to make regular charitable donations provided by Payroll Giving. Following the announcement in Budget 2004, the Home Office has launched an £8.3 million scheme to improve access to Payroll Giving and encourage more of the UK's 12 million employees in small- and medium-sized enterprises (SMEs) to give to charity. The scheme works in two parts: SMEs will receive a grant of up to £500, depending on their size, when they establish a scheme; and the Government will match each employee's donation pound-for-pound, up to a maximum of £10 per month for six months, from when the employee signs up.

Gift Aid

5.79 Changes to Gift Aid announced in Budget 2000 have achieved a considerable increase in the number of charities and donors using Gift Aid. In 2003-04, nearly 56,000 charities claimed tax repayments of £586 million on Gift Aid donations, compared with 25,000 charities claiming tax of £222 million on donations in 2000-01.

5.80 In the 2003 Pre-Budget Report, the Government announced changes to the Gift Aid scheme so that certain heritage and conservation charities could not turn admission charges into donations on which Gift Aid could be claimed. These admission schemes do not encourage greater giving to charity, which is the essential purpose of the Gift Aid scheme. It is also unfair that only certain charities have been able to use Gift Aid in this way. After detailed discussions with the charity sector, an approach has been established which upholds the principles of Gift Aid, while recognising the unique position of charities dependant upon visitor support. To encourage additional Gift Aid donations and support for charities, **the scope of the statutory exemption, which allows for the right of free admission to be disregarded as a benefit, will be expanded to allow more types of charities reliant on visitor support to benefit**. The Government will discuss with the charity sector how the broader scope of the exemption will be defined. In addition, the exemption will be amended so **Gift Aid will apply where the donation is at least 10 per cent more than the normal admission charge, or where the donation results in the unlimited right of admission for a period of not less than 12 months**. The Government will introduce these changes in April 2006 to allow time for charities to make the necessary preparations to operate the new scheme.

Unclaimed assets

5.81 As set out in Budget 2004, the Government believes that it is right in principle that more should be done to reunite assets with their owners and it welcomes the continued efforts of the British Bankers' Association, the Building Societies' Association and National Savings and Investments in trying to do so. Where assets and owners cannot be reunited, the assets should be reinvested in society, as long as the original owners' entitlements to reclaim are preserved. The Government asked the industry to expand the scope of action beyond investment banking into retail banking and the wider financial sector. Following the Budget, the Government has held constructive discussions with the industry to take this forward and will report on progress in due course.

Football Supporters' Trusts

5.82 The Government is keen to support Football Supporters' Trusts in the important work they do for the community. Following a review launched in the 2003 Pre-Budget Report, **Inland Revenue will now work with Supporters Direct to provide guidance and dedicated support for Football Supporters' Trusts to set up charities or Community Amateur Sports Clubs to run their community activities, and to help them take advantage of the range of tax reliefs available to such bodies.**

DELIVERING A MODERN AND FAIR TAX SYSTEM

5.83 A modern and fair tax system encourages work and saving, keeps pace with developments in business practices and the global economy and provides the foundation for the Government's objective of building world-class public services.

Protecting tax revenues

Tackling non-compliance

5.84 For such a system to be effective, everyone needs to pay their fair share of taxes and receive the tax credits they are entitled to. Tax avoidance and tax or tax credit fraud undermine the ability of the tax system to deliver its objectives, imposing significant costs on society. The Government has always made clear its determination to tackle such non-compliance, to ensure the tax system is fair and is seen to be fair.

5.85 Since 1997, the Government has taken a series of steps to crack down on those who abuse the system. These have included structural reforms that make the system less vulnerable, closing loopholes in the law and improving the way HM Customs and Excise and Inland Revenue deliver their compliance functions. However, economic and social change, including globalisation, is providing new opportunities for those determined to avoid or evade their obligations. Continual vigilance and action are therefore needed.

A modern organisation

5.86 The integration of HM Customs and Excise and the Inland Revenue, described further in Chapter 3, and the strengthened capacity for tax policy development at HM Treasury, represent a natural next step in developing a strategic approach to improving compliance. A modern organisation, using modern compliance tools, will be well placed to rise to the continuing challenge from non-compliance. This approach will be based on two key principles of fairness and customer focus, ensuring activities are effectively tailored to the needs and behaviours of different customers.

5.87 A key part of this approach will be to encourage customers to comply voluntarily as the best way of improving compliance. Reducing the costs faced by compliant taxpayers will be a priority. However, the Government is also determined to take vigorous action against those who choose not to comply. The compliant majority should not pay the price for others who deliberately flout their obligations to pay a fair share. Intensifying efforts to combat avoidance and fraud will therefore also be a central feature of the approach.

Tackling avoidance schemes

5.88 Tax avoidance schemes are often sophisticated and aggressive in nature and thrive in an environment of secrecy. Such schemes represent an unacceptable attack on the integrity of the tax system. In Budget 2004, the Government introduced disclosure rules to tackle tax avoidance schemes for both direct taxes and VAT. These rules are already achieving their purpose of allowing earlier and more targeted action against avoidance schemes. The Government welcomes the generally positive reaction of the business community to the disclosure rules and intends to continue to use disclosures received to counter avoidance and to ensure improved design of tax policy in the future.

Avoidance of tax on remuneration

5.89 **The Government is taking action in this Pre-Budget Report to remove the ability to avoid Pay As You Earn (PAYE) and national insurance contributions (NICs) liability on certain remuneration arrangements**. This follows action by the Government in recent years against a variety of schemes, particularly ones designed to avoid tax and NICs on bonuses received by higher paid employees. To prevent exploitation of similar loopholes, **the Government has also announced in a statement issued alongside the Pre-Budget Report that it is prepared to bring forward legislation to counter any schemes of this type which are developed in the future. If necessary, such legislation would be effective from today**.

Other direct tax avoidance measures

5.90 In addition, the Government is taking action to close a number of loopholes currently being exploited to avoid tax, including:

- **stopping the uncommercial use of options to avoid tax on capital gains or to generate capital losses;**
- **closing down the use of stripped corporate bonds to avoid income tax; and**
- **a number of measures to counter avoidance in the corporate and financial sectors including abuse of the Controlled Foreign Companies rules, schemes involving annual payments and relief for foreign taxes, artificial arrangements to avoid tax on profits from debt securities, and abuse of the life company taxation rules.**

Film tax

5.91 **The Government is closing a number of avoidance schemes that exploit the tax reliefs for UK film production.** The Government remains committed to promoting a sustainable British film industry, and confirmed this commitment by launching, on 21 September, details of a new tax credit for British qualifying films with production budgets up to £20 million. The new tax credit has been welcomed by the industry, and the Government is engaged in discussions with industry representatives to increase its understanding of the industry and to develop the detail of the operation of the credit. In light of the steps taken against film tax avoidance both today and in recent years, and of the development of the new tax credit for low budget British films, the Government will consult with the UK Film Council and the industry in an early review of the tax relief that is used by large budget British films, that will conclude at the end of January 2005.

Tackling VAT losses

5.92 In April 2003, the Government launched a VAT compliance strategy to tackle revenue shortfalls across the VAT system and to improve the service that Customs offers to VAT registered businesses. In 2003-04, the first year of the strategy, the shortfall of revenue fell sharply to 12.9 per cent of theoretical liabilities from 15.8 per cent in the previous year. Further details are available in *Measuring and Tackling Indirect Tax Losses – 2004* published today by HM Customs and Excise. Further measures to tackle VAT losses announced today include:

- **blocking an off-shore scheme that seeks to avoid VAT incurred on settling UK insurance claims; and**
- **ensuring fair VAT recovery on share issues.**

Tackling tobacco smuggling

5.93 Tobacco smuggling undermines the Government's health objectives, involves serious and widespread criminality, and costs over £2.5 billion a year in lost tax revenue. Since the introduction of the tobacco strategy in 2000,[14] the illicit cigarette market share has fallen to 15 per cent, down by more than a quarter from its peak.

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

5.94 The Government is concerned about the continuing significant smuggled share of the hand-rolling tobacco market, and is looking to see how the lessons learnt from the success of the strategy for tackling tobacco smuggling, can be applied to tackle smuggling of hand-rolling tobacco. As a first step, Customs will be working with tobacco manufacturers to reduce the supply of hand-rolled tobacco to smugglers, and making an impact on passenger smuggling gangs.

Combating alcohol fraud

5.95 The Government is committed to taking action to tackle alcohol fraud that is both tough and proportionate. Since Budget 2004, the Government has worked closely with the spirits industry to develop the details of the duty stamps system to be introduced in 2006 to combat spirits fraud.

5.96 Updated estimates published today provide encouraging signs that Customs have made progress in tackling spirits fraud. This progress does not remove the need or case for further measures, but emphasises the importance of implementing those measures in a way that keeps the compliance costs for the legitimate trade to a minimum. Therefore, in addition to freezing spirits duty for the remainder of the Parliament and meeting the additional printing and distribution costs entailed by duty stamps, the Government:

- **has decided, based on industry proposals, to make targeted exemptions from the duty stamps regime;**
- **has decided to adopt the industry's proposal to allow duty stamps to be incorporated into bottle labels, and, subject to further work with the industry on detailed stamp design, is inclined to allow additional flexibility in the format of stamps; and**
- **believes there is a case for not attaching a financial liability to duty stamps, and will work further with the industry to examine the implications of this for the impact of duty stamps on both fraud and compliance costs before making a final decision.**

5.97 As a result of incorporating these features into the planned duty stamps system, overall compliance costs – at the time of the Budget estimated by the industry at £23 million start-up and £54 million a year ongoing – could be reduced to £7 million start-up and £5 million a year ongoing based on the industry's estimates. This means duty stamps remain a proportionate measure, including in the context of updated estimates of the level of spirits fraud. Further details are set out in a business brief published by Customs today.

Oils fraud

5.98 The UK oils strategy has reduced the illicit diesel market share in Great Britain from 8 per cent in 2000 to 6 per cent in 2003. This comprehensive strategy is focused on stopping large-scale commercial and criminal fraud through a combination of law enforcement activity and better controls of the sale and distribution of the oils involved. HM Customs and Excise has already put in place a new assurance regime that has made the supply chain for red diesel and kerosene more transparent, making it easier to identify and take action against fraudsters. To tackle the risk that they may shift to misusing other oils, especially aviation turbine fuel and marine gas oil, Customs will explore with the trade options for increased fraud proofing of these products. Budget 2004 announced the narrowing of the differential between main road fuels and rebated oils by one penny per litre, though this was defered in July as part of the wider fuel duty decision. The Government today confirms that it will implement the narrowing of this duty differential, as discussed in Chapter 7, in support of the UK oils strategy and with the aim of further reducing the illicit market share.

Protecting the UK tax base

5.99 The Government is determined to defend the corporation tax system robustly against legal challenges under EU law. Discussions with business on the wider issues raised by legal developments are continuing. The Government will also continue to monitor the impact of international accounting standards on the corporation tax base.

Modernising the tax system

Income tax and NICs

5.100 The income tax personal allowances for those aged under 65 will increase in line with inflation in 2005-06. The NICs threshold and limits will also increase in line with inflation. There will be no change in NICs rates for employers and employees, or the profit-related NICs paid by the self employed. Annex B provides further details of the changes to the rates and allowances within the tax and benefit system announced in this Pre-Budget Report.

Residence and domicile

5.101 The Government is continuing to review the residence and domicile rules as they affect the taxation of individuals, and is considering various aspects of this issue in respect of the responses to the background paper published at Budget 2003.[15] The Government remains determined to proceed on the basis of evidence and in keeping with its principles. It would welcome further contributions to the debate, which will then be taken forward by the publication of a consultation paper setting out possible approaches to reform.

Small businesses

5.102 The Government remains committed to providing targeted support to small businesses, including appropriate tax incentives to support its growth and productivity objectives. However, in some areas, the pursuit of these objectives through the tax system may be constrained by the ability to match definitions for tax purposes with the underlying characteristics of firms. **The Government is today publishing *Small companies, the self-employed and the tax system: a discussion paper*, and welcomes the views of smaller firms and their advisers on the strategic issues raised**.

Leasing

5.103 As part of the Government's continuing commitment to modernise the corporation tax system, it has considered the tax treatment of leased plant and machinery. **Following a period of constructive consultation, the Government has decided to align the tax treatment of leasing with that of other forms of finance**. Detailed proposals are contained in the Technical Note on Corporation Tax Reform,[16] published today, and consultation will continue on the details of the new regime. The Government intends to legislate for this in Finance Bill 2006. Leasing is an important source of finance for small businesses, who typically use shorter leases. The Government has therefore brought forward proposals to ensure that such leases remain outside the new regime.

Pooled investment schemes

5.104 In the light of the new FSA regulations and the introduction of Qualified Investor Schemes, the Inland Revenue issued a technical paper in July 2004 discussing possible changes to the tax regime for Authorised Investment Funds (AIFs). A summary of responses is available on the Inland Revenue website. Following this, **the Government intends to bring forward a modernising package including a number of technical changes**, for example clarifying the taxation for unit trusts that have multiple classes of units and introducing a measure that applies the taxation arrangements for AIFs only to those funds where each investor holds less than 10 per cent of the fund. The Government also continues to examine the scope for simplifying and modernising the taxation of pooled investment schemes and it welcomes and invites a more strategic approach from the industry on whether radical reform similar to that under way for pensions is viable.

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

[16] *Corporation tax reform: technical note*, Inland Revenue, December 2004.

Accrued Income Scheme

5.105 Following the positive responses to the consultation published at Budget 2004,[17] the **Government has decided to proceed with simplification of the Accrued Income Scheme**. There will be further consultation on the detail with a view to legislation.

Shari'a compliant financial products

5.106 The Government recognises that individuals and businesses wish to have access to financial products that comply with Shari'a Law. The Government welcomes the progress that has been made in developing suitable products and the contribution that these developments will make to the financial sector, and to the opportunities available for both business and personal customers. **The Government is consulting on how to encourage further innovation and ensure that tax does not create an impediment to the development of new products in this area, and is considering legislative options for the 2005 Finance Bill**.

Travellers' allowances

5.107 The Government supports cross-border shopping and is against excessive restrictions being applied to travellers who bring goods into the country for their own use. Travellers may currently bring goods (excluding alcohol, tobacco and perfume) up to a total value of £145 from outside the EU into the UK, without being required to pay tax or duty on arrival. This limit applies to all EU Member States and would require unanimous agreement in order to be changed. The last review of the EU travellers' allowance took place in 1994. **The Government believes that the £145 limit is now out of date, and has proposed to the European Commission that it be raised, in order to better support cross-border shoppers**.

TACKLING GLOBAL POVERTY

5.108 The UK is committed to eliminating poverty in the long-term and achieving the internationally agreed Millennium Development Goals (MDGs), which include halving poverty, combating HIV/AIDS, malaria and other diseases and achieving universal primary education by 2015. As set out in Box 5.3, the Government will use the UK's Presidencies of the G7/8 and EU in 2005 to press for further international action.

5.109 The United Nations (UN) has warned that, although progress is being made globally on reducing poverty, most developing countries are not expected to meet more than three of the seven MDGs by the target year of 2015.[18] 2005 is the target year for the first MDG of eliminating gender disparity in primary and secondary education, and this aim will be missed.

The challenge of 2015

5.110 One of the major reasons for the lack of progress is the need for large-scale and sustained investment in health, education, sanitation and economic development, which underpin all these goals. The UK is leading the way in pushing for increased resources for development to overcome this gap in funding. In addition to higher UK aid flows, the Government has proposed the International Finance Facility (IFF), described further in Box 5.4. Alongside action to increase funding, the UK is pushing for further and deeper debt relief, and supporting established mechanisms for reducing poverty such as improving trade conditions. To meet the MDGs it is crucial that *aid, trade and debt relief* are all tackled together. For example, aid is needed to help poor countries build up the investment in the infrastructure and capacity that they need to respond to new trading opportunities.

[17] *Options for the reform of the Accrued Income Scheme*, HM Treasury and Inland Revenue, March 2004.

[18] *Human Development Report 2003*, United Nations Development Programme, 2003.

The Commission for Africa

5.111 The Government attaches particular importance to the eradication of poverty in Africa. The Commission for Africa (CfA) was established in February 2004 by the Prime Minister to determine which policies have been effective and where more can be done to support Africa's development, in particular by the international community. There are seventeen Commissioners – nine from Africa – representing government, business, development institutions and civil society. It is for Africa to shape its own future, and the Commission will work in support of African processes and institutions, particularly The New Partnership for Africa's Development (NEPAD) and the African Union, to achieve the most comprehensive assessment possible. The findings of the Commission will feed into the UK's Presidencies of the G7/8 and EU.

Box 5.3: Mobilising international support for development in 2005

In 2005, the UK will put development at the top of the international agenda through the Presidencies of the G7/8 and the EU. No countries, or regions of the world, should be left behind in the general increase in global growth and prosperity. On current rates of progress, Africa will not reach any of the internationally agreed Millennium Development Goals (MDGs) by the target date of 2015. There are three main areas in which the Government will be using the Presidency to push for action, all three of which are needed to meet the MDG targets:

***Aid:* donor governments must continue to progress towards the target of spending 0.7 per cent of GNI on aid. To have the maximum impact on achieving the MDGs, the UK will press for this aid to be front-loaded through the International Finance Facility (IFF), described in Box 5.5. The IFF would release significant resources in areas such as education, health and trade infrastructure between now and 2015.**

***Debt relief:* the UK will use its Presidency to continue to spearhead international action to relieve the debt burden of the world's poorest countries. In 2005, the UK is seeking G7/8 and EU commitment to finance 100 per cent of the debt service owed by poor countries to multilateral institutions. The international community should also agree 100 per cent relief on debts owed by poor countries to the IMF. This relief should be financed through better use of IMF gold reserves.**

***Trade:* the UK is seeking an ambitious outcome to the Doha Development Agenda in the WTO, and a reform of the EU's Common Agricultural Policy that will benefit poor countries, and will be pushing for action to better enable developing countries to benefit from access to rich country markets. Developing countries must be able to carefully design and sequence trade reforms within their own development and poverty reduction strategies, with support through additional finance. The Government will press for investment in the infrastructure and capacity poor countries need in order to respond to new trading opportunities, and will consider how to provide transitional assistance to help countries adapt and reap the benefits of more open global markets while ensuring the most vulnerable people are protected.**

5.112 In parallel to the work of the Commission, the UK will continue to support African-led peacekeeping operations, especially in their efforts to end the current humanitarian crisis in Darfur. The UK is determined to provide the fullest possible assistance to achieve a lasting peace in Sudan, and is the second largest bilateral contributor. The Government has allocated £62.5 million for humanitarian assistance in response to the Darfur crisis between September 2004 and March 2005. The 2004 Spending Review set aside a further £150 million for humanitarian and emergency relief in Sudan over the next three years, to be called on at any time.

5.113 The UK recognises the importance of an African-owned peace and security agenda, and that African peacekeeping provides a cost-effective alternative to UN interventions. Enhancing the capacity of African-led peacekeeping will be a priority for the UK G7/8 and EU Presidencies, including continuing support for the G8's Africa Action Plan and working with NePAD. Building the capacity of the African Union, as a major regional body for managing African Peace Support Operations, will be a key strategy for delivering this enhancement to African peacekeeping in 2005 and beyond.

Overseas aid

5.114 The UK is fully committed to achieving the UN target for overseas aid of 0.7 per cent of Gross National Investment (GNI). The 2004 Spending Review announced that by 2007-08, total UK aid will rise to nearly £6.5 billion a year, representing 0.47 per cent of GNI, a real terms increase of 140 per cent since 1997. This substantial increase will allow the UK to continue to be a world leader on development, and demonstrates the UK's commitment to helping the world's poor and working towards the MDGs. The Government aims to sustain the rate of aid growth it achieves in 2007-08, which would mean that total UK overseas development assistance would reach 0.7 per cent of GNI by 2013. If the proposal for the IFF is agreed, the equivalent of 0.7 per cent of GNI could be achieved in 2008-09.

5.115 Reflecting the importance of Africa to achieving the MDGs, UK bilateral aid to Africa will rise from £1 billion per year to at least £1.25 billion per year by 2007-08. Over the next three years, the UK will spend at least £1.5 billion on HIV/AIDS related programmes to counter the growing threat of the pandemic. To mark the 20th Anniversary of the Live Aid concert in 2005, the Chancellor has announced that the Government will make a special donation to the Band Aid Charitable Trust to cover the cost of VAT collected on the new Band Aid single and Live Aid DVD. The Government will do all it can to support the work of Band Aid and ensure that all proceeds from sales of the new single and DVD go to support the vital work of the Band Aid Trust in the poorest countries of Africa.

Debt relief

5.116 The Government has been a champion of the cancellation of debt through the Heavily Indebted Poor Countries (HIPC) Initiative. The Initiative is providing over $70 billion of debt service relief, allowing savings to be used for country-owned poverty reduction strategies which encourage pro-poor growth and work towards the MDGs. An extension of the Initiative for two years was agreed in October 2004 which will enable a further ten countries to receive debt relief, making possible a further debt write-off of more than $30 billion.

5.117 Recognising that the HIPC initiative cannot guarantee debt sustainability in all cases and that countries are still facing significant debt burdens, the UK proposes that donors should go further and match up to 100 per cent bilateral debt relief with up to 100 per cent multilateral debt relief. This should be achieved through the provision of extra funding and the revaluation or sale of IMF gold to guarantee increased resources for poverty reduction. The Government will continue to call on other donors to join the UK in paying for their share of multilateral debt relief, and will urge the IMF to consider anew all options for financing its share of 100 per cent debt relief.

5.118 In the absence of international agreement to provide 100 per cent multilateral relief, the UK will pay its share of the debt service owed to the World Bank and African Development Bank's concessional financing arms on behalf of eligible countries from January 2005. The UK has widened the criteria to include both post Completion Point HIPCs and low-income countries with suitably robust public expenditure management systems, and the 2004 Spending Review set aside funding for this purpose. This debt service relief will be guaranteed up to 2015 for all eligible countries to ensure resource support for achieving the MDGs. It is estimated that relieving the IMF debts of unsustainable HIPCs would cost the IMF around $7 billion. G7 Finance Ministers have been asked to report by the end of the year on ways to strengthen debt sustainability in the world's poorest countries.

Box 5.4: The International Finance Facility (IFF)

Fiscal constraints mean that many international donors will not reach the UN aid target of 0.7 per cent of Gross National Income in the short term. An estimated extra $50 billion is needed annually to meet the MDGs. The IFF is designed to deliver the necessary funding to achieve the MDGs ahead of 2015 by frontloading aid to allow developing countries to invest in sustainable long-term poverty reduction strategies. The IFF is not a replacement for progress towards the 0.7 per cent target, on which the UK remains focused. Funding for debt relief should reinforce, not replace, funding to build a skilled work force and the infrastructure and capacity to trade. As a stable financing vehicle, the IFF would provide the critical mass of additional and predictable funding needed to make lasting progress in all these areas. Alongside sustainable debt relief and achieving agreement on global trade, the IFF has the capacity to provide a lasting solution to the needs of the developing world through raising the resources needed to tackle the causes as well as the symptoms of poverty. Given the urgency to act now, the UK is taking immediate steps towards finalising the technical details of the proposal ahead of the launch, and the IFF will play a key part of the UK's Presidencies of the G7/8 and EU in 2005.

The World Bank and IMF have stated that the IFF is the most advanced proposal to frontload aid, and that it is technically feasible. France is a strong supporter of the IFF, and Italy has recently announced that it will support the IFF and work jointly with the UK and other international partners towards its implementation. Working groups from various countries have agreed that the IFF will provide stable and predictive development financing.

The UK – together with France and the Global Alliance for Vaccination and Immunisation – is finalising the details for an IFF for immunisation (IFFIm) that will demonstrate the principles of frontloading. This proposal could save up to 5 million lives ahead of 2015 and make a significant contribution to the MDGs. It is expected that the IFFIm will be launched in the first half of 2005.

Trade

5.119 The Government believes that trade and investment are key to reducing poverty in developing countries by promoting long-term economic growth, as set out in *Trade and the global economy*, published by the Treasury in May 2004. Subsidies and trade barriers prevent poor countries from selling their goods. Every year agricultural protectionism in developed countries costs the world's poorest countries over £50 billion. The Government is committed to reducing these barriers, in particular by reforming the Common Agricultural Policy and by delivering a Doha Development Agenda in the World Trade Organisation that is favourable to developing countries. It is important that developing countries are able to carefully design and sequence trade reforms within their own development and poverty reduction strategies. For example, they must be equipped with the infrastructure and capacity to realise the potential benefits of open trade. To achieve this, richer countries should be ready to support – with additional finance – investment in health, education, infrastructure and protecting the most vulnerable citizens. Investment in social programmes using the front-loaded resources provided by the IFF will ensure that developing countries have the essential building blocks for production and trade.

Health

5.120 It is vital to invest in the health of people in the developing world to reduce mortality rates and increase life expectancy; and also to increase productivity and drive economic growth. Underlying this is the need to support the development of health systems that are responsive to the needs of poor people, particularly women and youth, as well as tackling diseases that solely or disproportionately impact on poor countries.

5.121 Malaria kills one million people every year, 750,000 of them African children under five. Recent positive results with field trials and other research suggest that a licensed vaccine could potentially be ready in three to four years time. In order to speed up progress, the UK Government is ready, working with other Governments, to enter into legally binding contracts to buy a fixed quantity of vaccines at an agreed price. Such *advanced purchase agreements,* which are only binding if the vaccines are successfully developed, will encourage pharmaceutical companies to invest in research with confidence that there will be a market for their products and can ensure that the vaccine will be available at affordable prices.

5.122 With AIDS killing three million people every year and threatening to wipe out decades of progress in the developing world, developing an AIDS vaccine is clearly of critical importance. The UK will explore the use of advance purchase agreements to create the right incentives for pharmaceutical companies, while also recognising the need for direct investment in research as it is still at an early stage. As an example of an area where the returns to investment are potentially very high – with early research suggesting that for every year we bring forward the discovery of an AIDS vaccine, two million lives would be saved – this would be a priority for spending through the IFF and the UK will work with our international partners to increase the resources available. The UK will continue to support work on other HIV prevention approaches, in particular developing microbicides. In addition, the Government recognises the importance of coordinating research efforts and, as agreed by the G8 at the 2004 Sea Island Summit, will push forward with the establishment of the Global HIV Vaccine Enterprise – a virtual consortium to accelerate research into vaccine development through enhancing coordination, information sharing and collaboration globally.

Post-conflict support for Iraq

5.123 The UK's commitment to find a fair and sustainable solution to Iraq's debt was achieved in November 2004, when the Paris Club of creditor countries agreed to forgive 80 per cent of Iraq's external debts. The residual debt was rescheduled on generous terms. The UK's share of this debt relief amounts to approximately $1.4 billion. Full implementation of the Paris Club deal and comparability of treatment from non-Paris Club creditors should deliver approximately $100 billion of debt reduction to Iraq. The UK continues to work alongside its international partners, including the United Nations and the International Financial Institutions, to support the reconstruction of Iraq. The UK supported the agreement in September 2004 of a $436 million IMF Emergency Post-Conflict Assistance programme for Iraq. Through DFID's programmes in Iraq, the UK is working to strengthen the capacity of Iraqi government institutions, including fiscal and economic policy-making capacity within the Ministry of Finance.

6 DELIVERING HIGH QUALITY PUBLIC SERVICES

The Government's goal is to deliver world class public services through investment and reform, while ensuring efficiency and value for money. The 2004 Spending Review set departmental Public Service Agreement (PSA) targets and spending plans for the three years to 2007-08, within the overall envelope for public spending set in Budget 2004 and consistent with the fiscal rules.

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

- **additional resources to fund the ten year strategy for childcare, as outlined in detail in Chapter 5;**
- **a further £520 million assigned to the special reserve for 2004-05 for military operations in Iraq and the UK's other international obligations, and additional resources for counter-terrorism and resilience; and**
- **taking action to reduce pressures on council tax in 2005-06 by £1 billion by releasing an extra £125 million of resources for England alongside a reduction in ring fencing and other obligations and £512 million from departmental reallocations.**

The 2004 Spending Review agreed stretching efficiency targets for all departments, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services. The Pre-Budget Report details the progress departments have already made in delivering efficiencies, including:

- **savings on branded and generic medicines for the NHS of £1 billion per year from 2005-06;**
- **value for money gains of £2 billion in central civil government procurement; and**
- **a total of around 4,000 posts moving out of London and the South East by the end of 2004-05.**

The Pre-Budget Report outlines further work to implement more efficient management in the public sector, including the publication of Sir Michael Lyons' recommendations on asset management, calling for detailed asset disposal plans.

Finally it outlines the next steps in the Government's continued public sector reform programme, focusing on devolving decision-making closer to the front line and providing greater personalisation of services.

6.1 The Government's goal is to deliver world class public services, including high-quality education and training, a modern and reliable transport network, and an effective and responsive health service, through sustained investment and reform. World-class public services are central to delivering the Government's objective of building a flexible economy and fair society, well-placed to prosper in the global economy both now and in the future. Efficiency is central to this objective, to allow sustained improvements in performance into the long term. The Government aims to:

- deliver resources to the front line, ensuring that the best value for money is achieved for the taxpayer;
- provide sustained investment in the Government's long-term priorities, to achieve clear, outcome-focused goals for performance; and
- work within long-term planning horizons, set most recently in the 2004 Spending Review, on the basis of sound public finances and a stable economy.

INCREASED RESOURCES FOCUSED ON PRIORITIES

2004 Spending Review

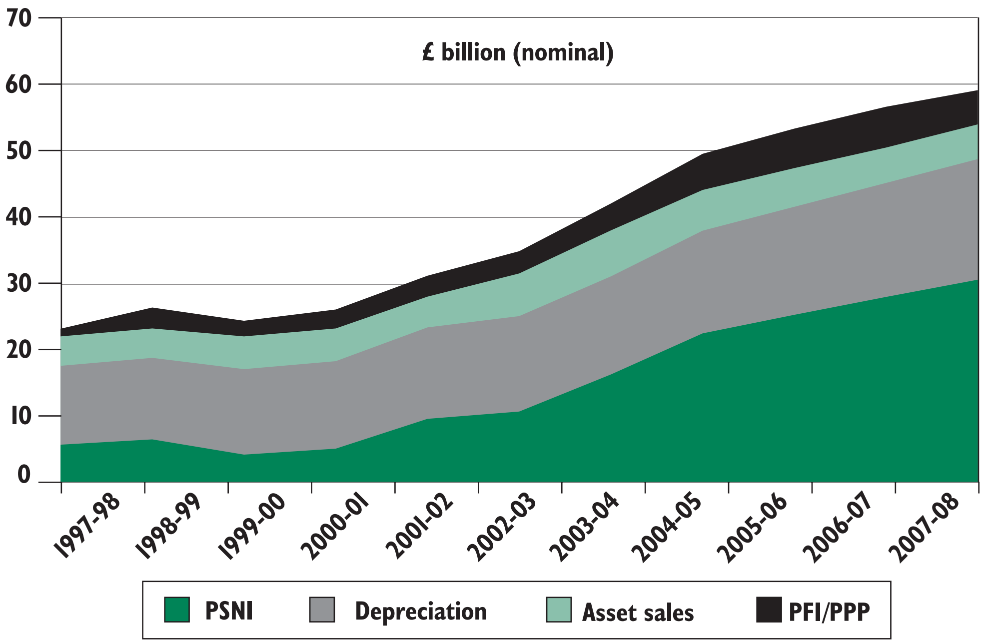
6.2 In the 2000 and 2002 Spending Reviews, the Government delivered sustained and significant increases in investment in its priorities, while ensuring stability by continuing to meet its strict fiscal rules. The 2004 Spending Review set priority outcome targets in departmental Public Service Agreements (PSAs), alongside spending plans for 2005-06 to 2007-08 that lock in these increases, while providing for further investment in priority public services. The 2004 Spending Review plans provided for:

- current spending to increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;
- public sector net investment (PSNI) to rise from 2 per cent of GDP to 2¼ per cent by 2007-08, to continue to address historic under-investment in the UK's infrastructure while meeting the sustainable investment rule; and
- agreed efficiency targets for all departments, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

Public capital investment

6.3 The Government is addressing the legacy of underinvestment in the UK's infrastructure by reforming the public spending framework to ensure prioritisation of investment, and by providing for increasing public capital spending. To date, the Government has delivered significant increases in capital investment in public services with net investment increasing to an estimated £21.7 billion in 2004-05. Although estimated investment this year, mainly in local authories and public corporations, is below the Budget 2004 forecasts, resources will be carried forward to future years to ensure delivery of the Government's aggregate investment plans. Total investment in public services, which includes gross capital spending by the public sector, including that financed by asset sales, and estimated investment scored to the private sector undertaken through Public Private Partnerships (PPPs), is set to rise to almost £60 billion by 2007-08, as shown in Chart 6.1.

Chart 6.1: Total investment, 1997-98 to 2007-08

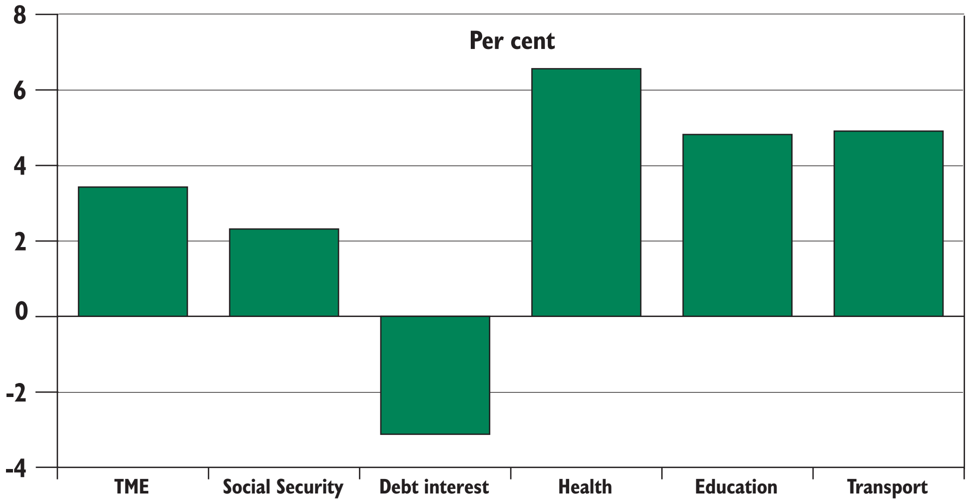


Source: HM Treasury.

6.4 It is important that these historic increases in investment in public assets are effectively planned, delivered and managed. To reinforce this, the Government commissioned Sir Michael Lyons to report on how to further improve public sector asset management and his report, *Toward Better Management of Public Sector Assets*, is published today alongside the Pre-Budget Report. Sir Michael's report is described later in this chapter. His recommendations will be taken forward and reflected in Departmental Investment Strategies.

6.5 This step change in funding for public service priorities is affordable as a result of prudent management of the economy and the public finances, which have enabled the Government to continue to contain growth in social security and debt interest payments, as illustrated in Chart 6.2.

Chart 6.2: Releasing resources for priorities – real annual average growth rates, 1997-98 to 2007-08



Source: HM Treasury.

Provision for priorities

6.6 The Pre-Budget Report announces further resources directed to the Government's priorities. In particular it announces:

- additional resources to fund the ten year strategy for childcare, as outlined in detail in Chapter 5;
- further resources for military operations in Iraq and the UK's other international obligations, and for counter-terrorism and resilience; and
- taking action to reduce pressures on council tax in 2005-06 by £1 billion by releasing an extra £125 million of resources for England alongside a reduction in ring fencing and other obligations and £512 million from departmental reallocations.

Special reserve

6.7 The Government has to date provided £4.4 billion to meet the extra costs of the military conflicts in Afghanistan and Iraq and other international obligations. In this Pre-Budget Report, as a prudent allowance against continuing commitments, **the Government adds £520 million to the special reserve for 2004-05** – raising the overall provision to nearly £5 billion by April 2005.

6.8 Since 11 September 2001, the Government has given increased priority to improving the UK's ability to respond to the terrorist threat. In total, annual spending on counter-terrorism and resilience across departments will be over £2 billion in 2007-08, compared with £1.5 billion in 2004-05 and less than £1 billion before 11 September 2001. Since the Spending Review, the Government has allocated, in total, a further £105 million to this priority: to the Office of the Deputy Prime Minister for civil resilience; for counter-terrorism measures in the Home Office; and to strengthen HM Customs and Excise's work on improving security at ports.

Funding local services

6.9 The Government is committed to achieving stability and sustainability in the funding of local authorities, so that they can play a full part in delivering high quality public services. The 2004 Spending Review announced a number of commitments to strengthen the ability of local government to contribute to public service delivery, including the introduction of full three-year settlements for local authorities and real terms annual increases in funding between 2005-06 and 2007-08 averaging 2.7 per cent for revenue and 4.8 per cent for capital.

6.10 However, the Government accepts that many of the problems in the current local government finance system in general, and council tax in particular, can only be solved in the longer term. The independent inquiry into local government finance, headed by Sir Michael Lyons, has been established to take a fundamental look at how this system can be reformed and will report by the end of 2005.

6.11 Since the 2004 Spending Review, the Government has been working closely with local authorities and others to ensure that local government is able to deliver public service improvement across all the key areas for which it has responsibility, including schools, children's services, adult social services, housing, planning, waste disposal and many others, without imposing unacceptable rises in council tax.

6.12 To this end the Government has taken action to reduce pressures on council tax by £1 billion in 2005-06. This will be achieved both through an increase in resources provided by central government and by changes to increase flexibility, reduce ring fencing and reduce obligations for local government. **Direct grant will be increased by more than £600 million above the grant set for 2005-06 in the 2002 Spending Review settlement. To fund this, Departments have reallocated £512 million of existing funding from central programmes to local authorities. An additional £125 million in new funding for England has also been allocated to local government**. Alongside this additional money, the Government will be implementing measures to reduce local authorities' need to raise council tax by one third of one billion pounds, for example reducing by £75 million the amount that local authorities will be obliged to passport to schools and setting upper limits for some recycling targets.

6.13 This increased funding and flexibility means that local authorities will be able to deliver better public services alongside council tax rises significantly lower than last year's 5.9 per cent. The Government will be prepared to take even tougher capping action in 2005-06 than last year to ensure that rises in council tax are acceptable for all people, including pensioners and others on low or fixed incomes, in all areas.

[1] *£125 million will be transferred from the Exchequer to local government revenue support grant, with an additional £24 million going to Scotland, Wales and Northern Ireland under the Barnett formula.*

DELIVERING RESOURCES TO THE FRONT LINE

6.14 The Government's vision is to create modern and efficient public services. The Government is committed to securing efficiency improvements that will either directly increase the output and quality of public services, or will free up major resources that can be better spent on front-line services. This will be achieved by transformational change in key areas so that the public services:

- work across departmental boundaries and maximise the opportunities for securing good value across the public sector when procuring goods and services;
- promote the use of electronic services across government making transactions with government departments more accessible for people;
- share corporate services such as IT, Human Resources (HR) and finance functions where it makes sense to do so;
- have fewer staff in support services and more staff on the front line; and
- have a better regional balance of activity with fewer non-front line staff in high cost locations.

6.15 Following Sir Peter Gershon's independent review of public sector efficiency,[2] the 2004 Spending Review published targets for government departments to deliver efficiency gains, in aggregate, in excess of £20 billion by 2007-08. Local government is expected to contribute at least £6.45 billion of these efficiency gains. At least half of these savings must be cashable, which will allow resources to be recycled to fund priorities at the front line. Other efficiency gains will lead to increases in public sector outputs including improvements in quality.

6.16 Achieving this transformational change means that workforce restructuring is necessary. Alongside an overall increase of 250,000 public sector staff delivering front-line public services, there is a planned gross reduction of around 84,000 civil service posts, with net reductions of around 70,000; and the relocation of over 20,000 posts out of London and the South East in line with the recommendations of Sir Michael Lyons' review.[3]

6.17 Reducing administration costs is integral to driving economy and efficiency. To meet this commitment, the 2004 Spending Review set administration budgets for each department at or below the 2005-06 nominal level for 2006-07 and 2007-08 (representing a real terms reduction of at least 5 per cent) with the exception of the Security and Intelligence Agencies and the Foreign and Commonwealth Office where additional spending is necessary on vital security needs.

Progress on the ground

6.18 Since the 2004 Spending Review there has been good progress both by departments in delivering efficiencies and in cross-government action to support efficiency. Detailed long-term plans are being developed for the whole spending review period up to 2008 and departments have published Efficiency Technical Notes, explaining how efficiency gains will be measured. Box 6.1 describes some of the efficiencies departments are implementing already, in advance of the period covered by the 2004 Spending Review.

[2] *Releasing resources to the front line. Independent Review of Public Sector Efficiency*, Sir Peter Gershon CBE, July 2004.

[3] *Well placed to deliver? – Shaping the pattern of Government service*, Sir Michael Lyons, March 2004.

6.19 On relocation, around 4,000 posts will have moved out of London and the South East by the end of 2004-05. Plans are on track that will result in over 10,000 posts – more than half the announced total target for 2010 – relocating by the end of 2007-08.

6.20 There has also been progress in the broad areas of efficiency identified by Sir Peter Gershon, including procurement, electronic government and the use of benchmarking to reduce the costs of corporate services such as IT:

- the Office of Government Commerce (OGC) has reported £2 billion of value for money gains in central civil government procurement for 2003-04. Around £500 million has been saved through collaboration between departments and as a result of direct negotiation between departments and suppliers. Nearly £600 million of procurement savings have been made between the Home Office, Department for Work and Pensions (DWP) and the Inland Revenue. OGCbuying.solutions, the Ministry of Defence and the NHS Purchasing and Supplies Agency have agreed to co-ordinate their purchase of energy which will yield estimated annual savings of between £5 million and £10 million. Further action by the Government to improve value for money in procurement is set out in Box 6.2;
- a recent Defra IT-outsourcing contract used benchmarks to secure efficiency savings of at least £25 million per year by 2007-08; and
- the successful introduction of bar-coded transactions at the Post Office means some 40 million licensing transactions are processed electronically each year. This has significantly improved the accuracy of vehicle records and reduced DVLA processing costs.

Box 6.1: Departmental progress on efficiency

The Department of Health (DoH) has negotiated a price cut with the drugs industry of 7 per cent, providing savings of £370 million per year on branded medicines in England. This will be channelled back into front-line NHS services by local Primary Care Trusts. Further savings on generic medicines will increase total savings for the NHS of £1bn per year from 2005-06 available for allocation to front-line health services. DoH has also announced savings in its arms-length bodies: savings of £140 million in 2005-06, rising to £500 million by 2007-08; staffing reduced by around 5,000 and another 750 posts released for front-line service delivery by 2007-08.

The Department for Work and Pensions has relocated 2,050 posts and has reduced workforce numbers by over 6,000 – well on course to deliver the ambitious targets set in the 2004 Spending Review.

The Ministry of Defence has consolidated army junior entry training in North Yorkshire, resulting in 1,230 posts relocating out of the South East, and has reduced HQ numbers by around 300 staff. It is also on track to deliver over £400 million in savings through improved Defence Logistics available for allocation to front-line defence services.

The Department for Transport (DfT) will deliver efficiency gains of around £140 million in 2004-05 as a result of the Highways Agency improving its procurement regime and the DVLA implementing electronic service delivery. On top of its existing efficiency programme, and as part of implementing the reform agenda set out in the recent Rail White Paper, the DfT is legislating to streamline the public sector organisations involved in the delivery of rail services – including abolishing the Strategic Rail Authority (SRA). Further detailed design work remains to be carried out, but these reforms will reduce by about half, from around 600, the current public sector posts covering rail in the DfT, the SRA and their associated bodies.

The Inland Revenue and HM Customs and Excise are on track to meet their workforce targets, with reductions of 836 staff and relocation of 274 posts during 2004-05.

The Department for Education and Skills has reduced its workforce by 450; the **Department of Health** is on track to reduce its HQ staffing by over 700 by the end of 2004-05; and the **Department for Environment Food and Rural Affairs** has already delivered a reduction of 120 staff this year. **The Office for Standards in Education (Ofsted)** has announced plans for a workforce reduction of 500, with the relocation of 324 posts to Manchester, Nottingham and Bristol, by 2007-08.

The Police Service is on track to deliver total efficiency improvements of £190 million in 2004-05 through improved procurement and more effective use of officers' time.

The Department of Trade and Industry has moved 85 posts out of London, and the **Department for International Development** has moved 45 posts with a further 40 to follow during 2005.

National Savings and Investments will continue to build on the efficiency gains achieved so far through their partnership with Siemens Business Service, as announced by Siemens on 13 August 2004.

Local Government is expected to release £30 million of resources this year through e-enabling service delivery and securing unit cost savings in e-payment mechanisms and e-procurement. This builds on £20 million of cashable savings achieved last year.

Box 6.2: Procurement

The Government is committed to achieving value for money in public sector procurement to support the delivery of high quality public services through a range of initiatives led by the Office of Government Commerce (OGC). In addition to supporting the Government's productivity agenda, the initiatives set out in Chapter 3 are a key driver of value for money in procurement. In particular, the implementation of the Kelly Review of competition and capacity planning in procurement markets will drive forward improvements including:

- **improved dialogue between the public and private sectors, which will help Government better frame its requirements to ensure value for money;**
- **opening up the supply chain to develop flexible and innovative procurement solutions; and**
- **reinforcing the existing drive to improve departmental client capability through the development of departmental Centres of Excellence and improving skills in programme and project management.**

Building on OGC's success in promoting value for money improvements in central civil government procurement, including the achievement of £2 billion in value for money gains for 2003-04, the Government has decided that OGC's remit should be extended into the wider public sector from April 2005. OGC is currently engaged with stakeholders in key sectors, particularly at the local level, to identify the best way of working together to address challenges in project delivery, improving procurement performance and achievement of value for money targets. Engagement plans with each sector will be agreed with stakeholders by 1 April 2005, with OGC geared up to deliver its contribution at the same time.

Developing the efficiency agenda

6.21 The Government, building on Sir Peter Gershon's review of efficiency, is taking further steps to identify and implement more efficient business planning and management in the public sector.

Asset management

6.22 Securing the efficient delivery of public services depends on effective management of public sector assets. In the light of the estate implications of the efficiency and relocation reviews, the Chancellor asked Sir Michael Lyons to undertake a study of the management of public sector assets, including disposals, and to make proposals to improve asset management planning in the public sector which would help generate efficiency savings as well as contribute to the Government's objective of £30 billion worth of asset disposals by 2010.

6.23 **The report, *Toward Better Management of Public Sector Assets,* is published alongside the Pre-Budget Report**. The report concludes that the objective of £30 billion of public sector asset sales by 2010 is achievable but challenging and requires the Government to strengthen the management of assets by departments and others. The Government welcomes the report and will take forward the implementation of Sir Michael's recommendations that:

- the Government should review the linkage between investment and asset management at a strategic level to ensure a national framework which balances future capital investment with exploitation and maintenance of existing assets;

- departments should develop asset management strategies driven by their business plans which are the responsibility of finance directors and considered at board level;
- departments must show how they will contribute to the Government's objectives for asset management, including achieving £30 billion of asset disposals by 2010;
- the Government should review and where appropriate strengthen incentives for improved asset management;
- there should be improved asset management planning at local level with local government taking a lead role and departments and other agencies being required to engage locally;
- the Government should strengthen public sector property coordination in London and the effective use of workspace; and
- the Government should consider the establishment of a task force drawn from both the public and private sectors, to advise ministers, provide external challenge to departments on asset management, and explore the scope for further engagement with the private sector.

Financial Management Review

6.24 Efficient delivery of public services requires effective management of departmental spending on the basis of good information. There has been significant progress in the last five years in improving the management of resources in government, including the introduction of full resource accounting and budgeting and the establishment of the current public expenditure framework. At the same time, the Efficiency Review made clear that further work was needed to ensure departments are in a position to manage their resources in the most efficient way. To this end, Mary Keegan, Head of the Government Accountancy Service, is leading a department-by-department review of the effectiveness of financial management within government.

Government Offices' Review

6.25 Government Offices (GOs) represent the Government in the regions, working with local partners to administer or influence funding streams on behalf of departments. The 2004 Spending Review announced a reduction in the GOs' administration budget from the nominal 2005-06 level by 2.5 per cent a year in cash terms, as part of the drive for greater public sector efficiency. In the light of this, and of new roles and changing departmental demands on the GOs such as negotiating Local Area Agreement Pilots, HM Treasury is working with the Office of the Deputy Prime Minister (ODPM) and other departments to examine ways of improving the efficiency and effectiveness of the Government Office network. This work is expected to be completed early next year.

Atkinson Review

6.26 Public sector performance – both against efficiency targets and in delivering against the Government's priorities – must be judged on a clear and consistent basis. As described in Box 6.3, it is important to have robust measures of both efficiency and productivity in the public services. Reflecting this, Sir Tony Atkinson, Warden of Nuffield College Oxford, was asked by the National Statistician in December 2003 to undertake an independent review of the future development of measures of government output, productivity and associated price indices. Sir Tony published an interim report in July 2004, and will publish a final report in January 2005. The Office for National Statistics (ONS) have made a commitment to implement a response to the final report following its publication.[4] Further material on the potential impact of the Atkinson Review on the measurement of government output is provided in Annex A.

[4] *Office for National Statistics: Performance Management Framework*, Office for National Statistics, July 2004.

Box 6.3: Measuring efficiency and productivity in the public services

Improving the efficiency and productivity of the public sector are important components of the Government's objective of excellent and equitable public services. Both efficiency and productivity are concerned with the relationship between public sector inputs and outputs. They can both be improved by reducing the amount of inputs, while maintaining the same level of service provision, or by producing additional outputs – either greater quality or quantity – for the same level of inputs. There are currently two complementary processes respectively developing ways of improving efficiency and measuring productivity:

- **the Government's efficiency programme follows the conclusions of Sir Peter Gershon's independent review of public sector efficiency, which focused on releasing *"major resources out of activities which can be undertaken more efficiently into front line services that meet the public's highest priorities"*. As part of Spending Review 2004, departments agreed efficiency targets, alongside outcome-focused PSAs and departmental budgets, to ensure that significant resources can be released to front-line activities, and to deliver further improvements in public sector performance. In delivering these targets, departments will focus on processes in areas that can be simplified or streamlined; and**
- **the Atkinson Review was commissioned by the National Statistician to advise on ways of measuring public services' output and productivity for the National Accounts, focusing mainly on four major areas of spending – health, education, public order and safety, and social protection. National Accounts measures of output and productivity need to be as complete as possible, measuring output across all relevant spending.**

Improvements to the service received by users as a result of the Government's efficiency programme, may come in ways that will be captured by current National Accounts measures of output, for example, more out-patient appointments. However, they may also come through other effects such as better communication skills among pupils as a result of spending more time with teachers. These effects are harder to measure and will not necessarily be fully captured in the current National Accounts. Consequently, efficiency savings arising from Sir Peter Gershon's review of efficiency may have impacts in terms of improvements for users which are not reflected in the National Accounts measures of productivity.

Both measures are important, and alongside PSA targets, which incorporate equity objectives not relevant to National Accounts, they form a range of indicators that are necessary to inform policy decisions and to help ensure public accountability and transparency. Improving measurement and making measures publicly available is therefore an important part of the Government's commitment to accountability in the provision of public services. Nevertheless, it is clear that no single indicator, however well measured, can ever fully describe the performance of complex public services.

Workforce reform

6.27 Plans set in the 2004 Spending Review, including from resources freed up by efficiency gains, will allow for up to 250,000 more public service staff to deliver frontline services in key areas like education, healthcare and criminal justice by 2008. This will include: an estimated 143,000 more front-line health workers, such as nurses, GPs and consultants; over 33,000 more criminal justice workers in prisons, the police and youth justice; and about 55,000 more early years and childcare workers.

6.28 At the same time, savings from past investment in IT of around £6 billion, designed to streamline functions such as finance, HR and ICT across departments and delivery of transactions by departments like DWP and the new integrated revenue department, meant that in the 2004 Spending Review the Government could set out plans for gross reductions of around 84,000 administrative and support posts by April 2008, on the basis of the levels of activity and policy commitments set out at the time. 13,500 posts will be reallocated to the provision of front-line services to the public by the civil service.

A new deal for civil servants

6.29 The Government will ensure that departments act as responsible employers in taking forward the staffing implications of the Efficiency Programme. It has put in place a new service, the Efficiency & Relocation Support Programme, to provide information, advice and support for those civil servants affected by the changes. Over the next few months, the Government will ensure that wider public service job and retraining opportunities are communicated to these staff down to local levels. Jobcentre Plus is working to ensure that vacancies are accessible to facilitate the deployment of surplus staff. The Northwest Regional Network has been established to broker vacancies across the region. This will open up opportunities within the wider public sector and will be rolled out nationally. Affected staff in the region are being made aware of these opportunities.

Sickness absence

6.30 The 2004 Spending Review commissioned the Secretary of State for Work and Pensions to review the causes of long-term sickness absence across the public sector, and the Cabinet Office to examine options for tackling short-term absence, while recognising the right to sickness absence and support for the genuinely sick. The review, which will be published by the Secretary of State for Work and Pensions and the Minister for the Cabinet Office next week, highlights the potential saving from better management, and picks out good practice from across the economy. It concludes that good absence management depends on:

- leadership from top-level managers;
- real-time data on absence, and triggers for intervention and audit of management action;
- line managers having the skills and support to deal with case management, referral and return to work; and
- regular and supportive contact for those who are absent due to sickness.

6.31 The civil service is taking a lead in acting on these conclusions. Departments and agencies will draw up detailed plans for absence management. Each department will answer an annual Parliamentary Question on its absence record. **The Cabinet Secretary will ensure that Permanent Secretaries, Agency Chief Executives and departmental boards take responsibility for the management of absence in their organisations and account for progress through existing performance review mechanisms**. The civil service will also pilot innovative approaches to tackling absence, including the wider use of occupational health professionals to certify absence and offer support. The civil service will instigate further work looking at the issues of job and workplace design in relation to absence. A detailed delivery plan will be drawn up, agreed with stakeholders and published by Budget 2005.

Local pay

6.32 In the civil service, departments are being asked to analyse the case for more local pay variation through the pay remits process and through revisions to pay and workforce strategies. In the wider public sector, all of the Pay Review Bodies (PRBs) have been given a clear locus to investigate the role that local pay could play in addressing specific recruitment and retention issues. They will make recommendations to Ministers in the New Year.

DELIVERING PROGRESS AND REFORM

6.33 In addition to the focus on improved efficiency, broader reform of the public services is needed to ensure they can meet the Government's long-term objective of building a flexible economy and fair society. The investment delivered in the last three spending reviews has translated into significant improvements in public service outcomes, as set out below. As in previous Spending Reviews, to ensure these improvements continue, extra investment provided in the 2004 Spending Review is linked to reforms to enhance further service delivery and ensure that public resources are focused where it counts – on the patient, the pupil and the citizen. The next steps in public service reform build on existing strong foundations to enable continuing improvement in public services. The 2004 Spending Review announced measures to:

- strengthen further the achievement of national objectives;
- increase devolution and flexibility for front-line professionals and communities;
- enable front-line staff to develop a new professionalism; and
- achieve more personalised public services.

Strengthening national objectives

6.34 As part of the 2004 Spending Review, the framework of PSAs was strengthened and refined to reflect the conclusions of the Devolving Decision Making Review, published alongside Budget 2004.[5] In particular, the Government has strengthened PSAs by:

- focusing even more closely on outcomes, removing input targets and giving the front line maximum scope to determine how to deliver outcomes most effectively at the local level in consultation with stakeholders and the public;
- introducing PSA 'standards' in particular areas of public service delivery. PSA standards highlight areas where the Government's ambitions for delivery expressed in previous PSA targets have been achieved but where performance data will continue to be monitored and reported to ensure that high levels of performance are maintained;
- increased consultation with a wide range of stakeholders, particularly the front line, on the phrasing and measurement of targets;
- greater use of evidence and analysis to ensure that the targets are informed by delivery expertise and best practice; and
- reducing the burdens on front-line staff by the removal of 500 Service Delivery Agreements (SDAs) that previously set targets below PSAs and increasing the freedom to set local priorities alongside national targets, for example through reformed local PSAs.

6.35 Progress against PSA targets will continue to be made public regularly through Autumn Performance Reports, Departmental Reports and web-based reporting.

6.36 Improvements to the PSA framework will be matched by reform of inspection. The Government will work to ensure that independent audit and inspection continues to challenge the public services to improve further, by taking greater account of the experiences of those who use the services under assessment. It will work to rationalise further inspection and regulation regimes to maintain public confidence without unnecessary burden to public service providers.

[5] *Devolving decision making: 1 – Delivering better public services: Refining targets and performance management*, HM Treasury, March 2004.

Devolving decision-making

6.37 The Government is clear that robust national standards work best as part of an overall framework of devolution and local accountability. A devolved approach to public service delivery can help deliver excellent and equitable public services that are better suited to different local and regional needs and individual circumstances. In line with the findings of the Devolving Decision Making Review, the Government has been giving local and regional services greater flexibility to enable them to meet better central priorities and decide on local ones. Devolution and local decision-making empower public service staff and professionals, allowing services to be tailored to meet local needs and encouraging innovative approaches to delivery. For example:

- recently announced police reform proposals will reduce bureaucracy for the police to enable them to be more responsive and accountable to their local communities and neighbourhoods;
- the Government will increase autonomy for schools by providing them with three year financial settlements and establishing a New Relationship with Schools, freeing secondary schools from unnecessary bureaucracy through a single point of contact; and
- the Government is also developing the relationship between central and local government, strengthening local PSAs, developing the Safer and Stronger Communities Fund and piloting Local Area Agreements.

6.38 The second Devolving Decision Making Review, also published alongside Budget 2004, set out the case for more devolved decision-making, including to strengthen the capacity of regional institutions to meet their specific economic challenges.[6] Building on this approach the 2004 Spending Review:

- devolved additional responsibilities for business support, business-university collaboration, enterprise in disadvantaged areas and rural socio-economic development to the Regional Development Agencies (RDAs);
- established greater flexibility for RDAs through a new, strategic 'tasking framework' linking RDA outputs in their Corporate Plans more closely to key regional and national priorities. The new framework for 2005-08 will be made public shortly, with Corporate Plans being published early next year;
- was informed by a strong input from the English regions through the Regional Emphasis Documents (REDs). The Treasury published an overall response to the REDs in July 2004, and will publish a response to each RED later this year; and
- announced the intention to enhance further regional input into decision-making.

6.39 Alongside the Pre-Budget Report, the Government is now consulting the regions and others on how best to involve them in key decisions through indicative regional funding allocations and longer-term planning assumptions for transport, housing and economic development. (Box 6.4 outlines the proposals further.) On the basis of this consultation, the Government will detail this further step in Budget 2005.

[6] *Devolving decision making: 2 – Meeting the regional economic challenge: Increasing regional and local flexibility,* HM Treasury, March 2004.

Box 6.4: Regional funding allocations for transport, housing and economic development

The Government recognises that choices for each region on transport, housing, planning and economic development cannot be taken in isolation. The Government also believes that these choices are best taken when informed by regional stakeholders. Building on proposals from the regions in the Regional Emphasis Documents, the 2004 Spending Review announced that the Government would examine new ways to integrate transport, economic and spatial development strategies in each region, within a framework of indicative funding allocations for each region.

The Government is setting out proposals for consultation alongside the Pre-Budget Report to establish regional transport funding allocations for the first time, and to supplement the regional transport, economic development and housing funding allocations set over the 2004 Spending Review period with guidance on long term planning assumptions for the regions beyond the spending review period.[a] These regional funding allocations and longer term planning assumptions will give regions a far stronger base on which to plan. By submitting proposals consistent with these assumptions regions will have a stronger voice in the next Spending Review.

[a] *Devolving decision making: A consultation on regional funding allocations*, HM Treasury, DfT, DTI and ODPM, available at www.hm-treasury.gov.uk

New professionalism

6.40 More streamlined achievement of national objectives and greater devolution of decision-making will empower frontline professionals to exercise a greater role in their own improvement and to deliver more personalised services. The Government aims to engender a new professionalism that gives frontline professionals the capacity to take advantage of greater freedoms and flexibilities, motivated by their public service ethos. To achieve this, as well as providing more resources to the frontline, the Government is:

- taking steps to foster stronger local leadership through setting up institutions such as the National College for School Leadership and the NHS Leadership Centre; and
- enabling frontline professionals to learn from each other through greater collaboration and the spread of best practice across local government, the NHS and schools.

Personalisation

6.41 The Government is committed to delivering pubic services that are excellent for everyone. Each individual has unique needs and circumstances. Delivering fair outcomes therefore requires differentiated services that can be responsive to each individual's needs and circumstances. The Government's goal is to provide flexible public services that are personalised to individuals and can ensure fairer outcomes. The 2004 Spending Review and departmental five-year plans set out how the Government will ensure greater personalisation through increased choice and more flexible access to a greater range of services, delivered in a more integrated fashion and with more opportunities for user and citizen involvement. For example:

- in the health service key steps include ensuring a maximum wait of 18 weeks from GP to hospital treatment and more integration of health and social care for elderly people in health and social services;
- as described in Chapter 4, DWP is continuing to increase personalisation through tailored pathways to work and support for particular groups, such as claimants of incapacity benefit;
- future reform to 14-19 education and services for young people will aim to provide more diverse services that are both more joined-up and delivered according to the needs of children, young people and parents; and

- the recent police reform white paper provides for police to be more visible, responsive and engaged with their local communities and neighbourhoods. Greater transparency and stronger democratic accountability will enable communities to have greater involvement in what their local police do.

Voluntary and community sector

6.42 Voluntary and community organisations are often well placed to help deliver public services, especially where their close understanding of local communities and of the needs of particular groups of the population enables them to provide more responsive and personalised public services. The Voluntary and Community Sector (VCS) Review reported interim findings at the time of the 2004 Spending Review, and reached several key conclusions:

- the sector can offer many clear advantages in public service delivery and reform but is limited by access to financial capital and poor levels of understanding within the public sector;
- there is potential for a greater or more effective role of the sector in particular in health care services for older people, homeless hostel provision, correctional services, ethnic minority employment, and parenting support and adult learning. Departments are publishing actions plans in each of these areas; and
- effective involvement of the sector relies on strong partnerships with local public sector bodies. There are many examples of good practice, but there is more to be done to learn from these, in a range of areas.

6.43 The full findings of the VCS review will be published in the new year through three publications: *Working Together, Better Together*, a summary pamphlet recording the findings of the review; *Exploring the role of the third sector in public service delivery and reform*, a discussion document on the development of this field; and *Effective Local Partnerships*, a leaflet setting out a practical checklist for local practitioners entering into partnership arrangements with the voluntary and community sector. The Government will host a third sector summit early next year with a series of seminars to discuss how the role of the VCS in public service delivery can be taken forward.

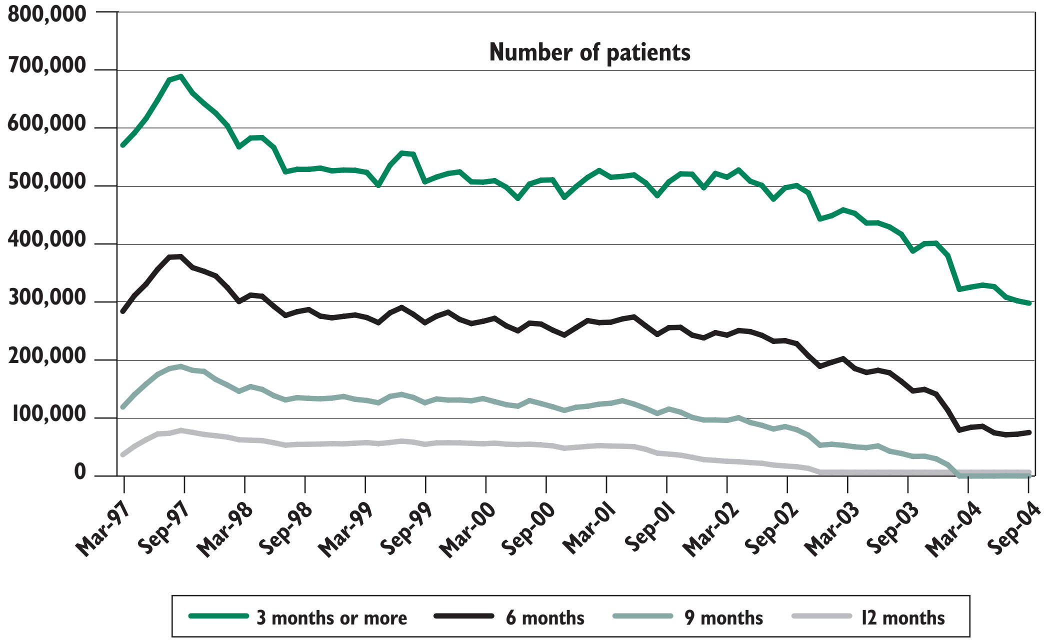
6.44 The Local Community Sector Taskforce, set up as part of the 2004 Spending Review, will take forward the development of regional Compacts between the VCS and RDAs in public service delivery and community participation, and will assist the VCS in managing the effects of the wind down of the Single Regeneration Budget. The Taskforce will report to the Deputy Prime Minister and the Chancellor and is made up of representatives from Government departments, the RDAs and the VCS.

6.45 The Government's commitment to developing the capacity for the VCS has already been demonstrated through the £125 million Futurebuilders fund, which aims to improve public service delivery through long-term investment in the VCS in England. The Fund has so far received more than 600 applications and the first investments will be announced in early 2005.

Delivery and reforms on the front line

6.46 The Government's approach to improving public service performance – matching investment with a clear framework of delivery and reform – is being put into practice across the public services, producing real progress in standards and outcomes. The 2004 Spending Review set out how the public services will build on these advances, outlining the agenda for further reform, efficiency gains, and improvements in service delivery.

Chart 6.3: Cutting waiting times



Source: Department of Health. Figures for April and May 2002 were not available following the abolition of Health Authorities.

Health

6.47 In Budget 2002, the Government announced an annual average real increase in NHS funding of 7.2 per cent over five years, linked to far-reaching reform. This has helped deliver significant improvements in service standards and outcomes. Compared to 1997-98, there are now 450,000 more operations per year, while maximum waiting times for an operation have been halved from 18 months in 1997 to nine months in April 2004, and more than 300,000 fewer patients are waiting for treatment. Premature deaths from heart disease and cancer have also fallen sharply – by over 23 per cent and 12 per cent respectively since the period from 1995-97.

6.48 Over the 2004 Spending Review period, the Government's priority will be to lock in the reforms set out in the NHS Plan,[7] building on the successes already achieved while driving through further fundamental reforms. The challenge is to deliver more personalised health care to patients at a time and place of their choosing, while improving primary and preventative care to tackle the underlying causes of ill health and health inequalities. Key measures to meet these challenges are:

- greater priority for disease prevention, tackling health inequalities and improved chronic disease management;
- a new PSA target to deliver a maximum wait from GP referral to hospital treatment of 18 weeks by the end of 2008. NHS patients will also have the right to choose from at least four or five different healthcare providers from the end of 2005, and from 2008, from any provider that meets NHS standards and can do so within the NHS's national maximum price; and
- a focus on adult social care, protecting and promoting independence for the elderly and the vulnerable and supporting social inclusion. Investment will be delivered in social services worth £1.8 billion more a year by 2007-08 than in 2004-05.

[7] *The NHS Plan: a plan for investment, a plan for reform*, Department of Health, July 2000.

Childcare, Children's Services and Youth Services

6.49 The Government is committed to working toward affordable, quality childcare available to all and is investing record amounts in childcare and early years. In the 2004 Spending Review, funding for Sure Start was increased by £769m in 2007-08 compared to 2004-05. The Government has published *Choice for parents, the best start for children; a ten year strategy for childcare*, alongside this Pre-Budget Report, to build on this investment and improve childcare services. The strategy is described in detail in Chapter 5. The Government will also bring forward a green paper on youth and young people within the next few months, outlining its vision of integrated and improved youth services, building on the ongoing reforms to children's services set out in *Every Child Matters*.[8] The Children Act, which received Royal Assent in November 2004, will provide the legal basis to implement recommendations and associated statutory Guidance on children's services. This includes Guidance that will place a duty to cooperate on local authorities and other key stakeholders.

Funding for sport

6.50 The independent review of funding for sport, led by Lord Carter, will make recommendations on improving the efficiency and effectiveness of investment in sports facilities and participation. Box 6.5 describes the provisional interim findings of the Carter Review.

Box 6.5: The Carter Review of funding for sport

In July 2004, the Chancellor and the Secretary of State for Culture, Media and Sport asked Lord Carter to review the coordination of national sports effort and resources. Lord Carter's report will be published in Spring 2005.

The Government's strategy for sport was set out in Game Plan[a]. Achieving increased participation in sport depends on educating and persuading potential users, coaching, efficient and effective structures and funding, and on the provision of quality sports facilities for communities. Investment in new facilities for schools is being provided through the Government's Building Schools for the Future programme and by the National Lottery. As well as investment in facilities, the Government has announced a new cross-government public health campaign to raise awareness of the benefits of including physical activity in everyday life.[b]

The review is examining the scope for involving private and public sectors together in a new National Sports Foundation. A foundation could act as a sponsorship clearing house for sports projects and act as a catalyst for the untapped energies of sports organisations by developing their capacity to involve local communities and private management expertise in the running of grassroots facilities.

[a] *Game Plan: a strategy for delivering Government's sport and physical activity objectives*, Strategy Unit, December 2002.
[b] *Choosing Health: Making healthy choices easier*, Department of Health, November 2004.

Education

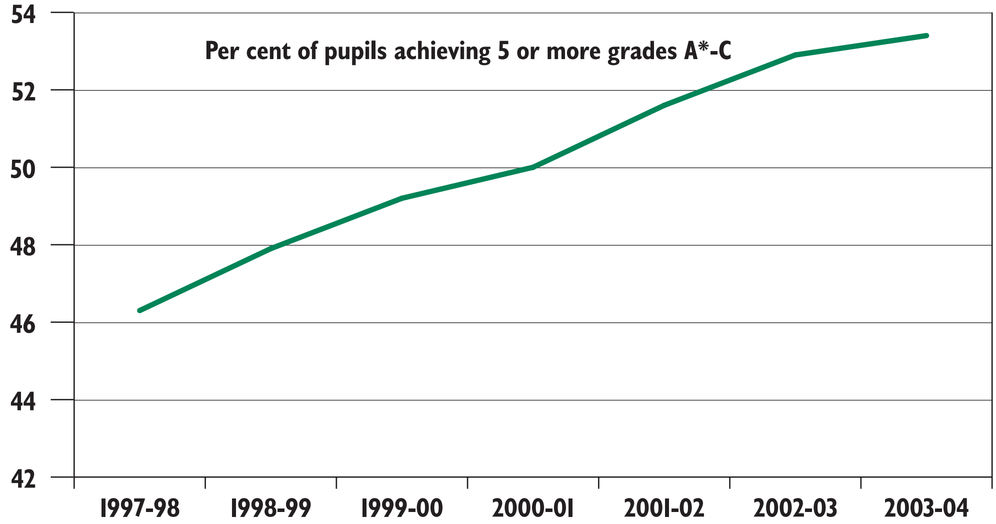
6.51 The 2004 Spending Review provided for education spending in England to grow by an annual average of 4.4 per cent in real terms, building on the sustained high investment and improving standards in education since 1997. For example, 53.4 per cent of 16 year olds achieved five or more A* to C grade GCSEs in 2004, compared to 45 per cent in 1997. The Government has reached its target to help 750,000 adults gain basic skills by 2004 and there are over 250,000 young people currently learning through apprenticeships.

[8] *Every Child Matters*, September 2003.

6.52 The Department for Education and Skills (DfES) recently published its *Five Year Strategy for Children and Learners*,[9] which sets out the next steps in the Government's work to drive improvements at all levels of the education system. Personalisation and devolved decision making will be central to those reforms, which aim to narrow the attainment gap between schools and between individual pupils. In addition to the Five Year Strategy the Government:

- will publish a white paper in the new year outlining its response to the final report of the Working Group on 14-19 reform, chaired by Mike Tomlinson. The Government has welcomed the report, which outlines plans for a reformed curriculum structure; and
- to ensure the FE sector is able to meet the challenge of 14-19 reform, delivering the aims of the Skills Strategy and Success for All, in both the medium and long term, a review will be undertaken by Sir Andrew Foster – Chair of the joint DfES/Learning and Skills Council Bureaucracy Review Group and Deputy Chairman of Royal Bank of Canada.

Chart 6.4: Improving GCSE performance



Source: Department for Education and Skills

Transport

6.53 Long-term planning is vital for transport infrastructure. *The Future of Transport White Paper* published by the Department for Transport (DfT) in July 2004 sets out a long-term strategy for reform of the transport system backed by a sustained programme of investment over the next 15 years.[10]

6.54 As described above in Box 6.4, the DfT's regional agenda is an important element of this strategy, designed to make regional transport spending more transparent and to help regions to develop integrated, prioritised and affordable strategies for transport, land use and economic development. This will be complemented by a Transport Innovation Fund (TIF), to support the cost of regional and local transport schemes that contribute towards national productivity growth and innovative approaches to integrating different transport modes. DfT will administer the TIF, and will publish details of how the Fund will work in practice at the time of Budget 2005.

[9] *Five Year Strategy for Children and Learners*, Department for Education and Skills, July 2004.

[10] *The Future of Transport: a network for 2030*, Department for Transport, July 2004.

6.55 DfT is making positive progress in delivering against its PSA targets, in particular:

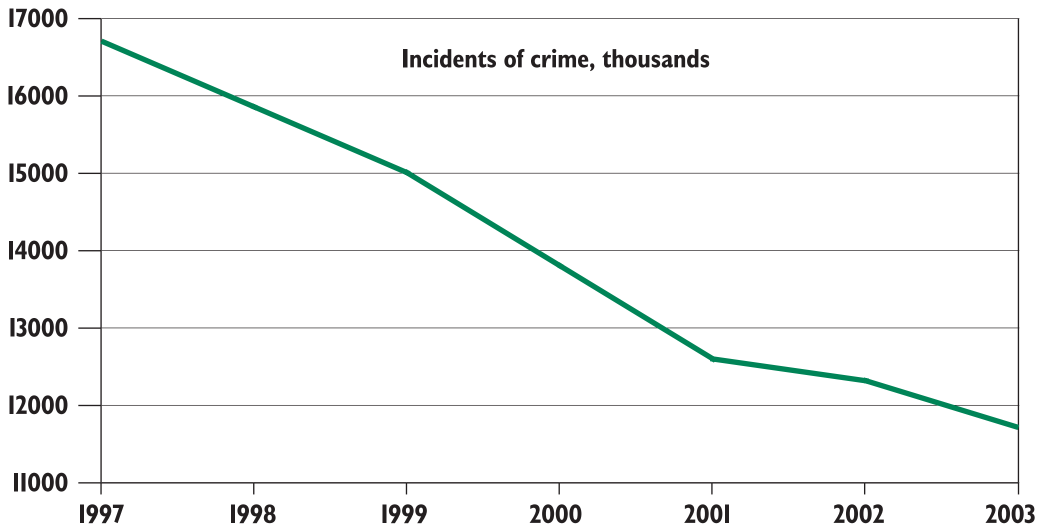
- on road safety, total road deaths fell by 22 per cent and child road deaths fell by 40 per cent in 2003 compared to the 1994-98 baseline;
- the use of local public transport has risen, with good progress toward the target of a 12 per cent rise in combined bus and light rail patronage from 2000-2010. Combined patronage has risen by 4 per cent over the first two years of the period; and
- rail performance is gradually improving, with the proportion of trains arriving on time increasing by 2 percentage points between 2002-03 and 2003-04. DfT set out a comprehensive reform package in the recent Rail White Paper.

Criminal Justice

6.56 The Government has made significant progress in its aim of building a safe, just and tolerant society with stronger local communities, including by:

- cutting overall crime by 30 per cent since 1997, with falls in domestic burglary and vehicle crime of 39 per cent and 40 per cent, respectively; and
- reforming the police to raise performance and increase community engagement, backed up by investment leading to record numbers of police officers and the introduction of Community Support Officers (CSOs).

Chart 6.5: Tackling crime



Source: British Crime Survey. Figures for 1998 and 2000 are interpolated. Figures for 2001-2003 are for the 12 months from the year beginning June.

6.57 The 2004 Spending Review builds on this investment and success, providing for an increase in spending on crime, justice and communities of £3.5 billion in 2007-08 compared to 2004-05. It also set stretching new targets for the Home Office, Department of Constitutional Affairs and Crown Prosecution Service to sustain progress and reform, including:

- a 15 per cent reduction in crime and increasing the number of crimes for which an offender is brought to justice to 1.25 million by 2007-08;

- increasing neighbourhood policing, including providing 20,000 CSOs by 2008; and
- addressing the underlying causes of crime in communities, including through youth intervention programmes and simplified local funding arrangements, and reducing further the harm caused by illegal drugs.

Housing

6.58 The Government has made significant progress in tackling homelessness. There are now two-thirds fewer people sleeping rough than in 1997, and the inappropriate use of bed and breakfast accommodation for homeless families with children has been ended. In addition, the Government has improved the condition of the social housing stock, with over a million homes brought up to the Decent Homes standard, with the aim of making all social housing decent by 2010.

6.59 The 2004 Spending Review announced a 50 per cent increase in new social house-building by 2007-08 compared to 2004-05, and an extra 10,000 homes a year funded through a £430 million increase in direct investment, an expanded Private Finance Initiative (PFI) programme, and significant efficiencies. It also announced extra investment to regenerate areas suffering from low housing demand, with funding of over £450 million a year by 2007-08 compared to £150 million in 2004-05. The 2004 Housing Act is opening up provision of new social housing to a wider range of suppliers and managers and the £200 million set aside to be competed for in 2005-06 will increase significantly over the subsequent two years. As set out in Chapter 3, the Government is taking forward the recommendations of the Barker Review of housing supply for reforms of the planning system.

6.60 The ODPM will shortly be publishing its 5-Year Strategy for housing and sustainable communities, including a pilot for transforming deprived estates into mixed communities and providing support for first-time buyers.

Royal Mint

6.61 The Government is committed to ensuring public service professionals have the flexibility to meet their priorities. In light of this, **the Government intends to transform the Royal Mint from a trading fund into a Government-owned company**. This will provide a more appropriate corporate governance structure and the opportunity for the Mint to improve its performance.

Local Government

6.62 Building a coherent relationship between central, regional and local government is at the heart of the Government's commitment to deliver high quality public services and improve the effectiveness of local government in their leadership and delivery of services to all communities.

6.63 To support this, the Government is strengthening the conversation between central and local government. The second generation of local PSAs provide an increased focus on addressing local priorities and building more effective local partnerships. Local Area Agreements are also being piloted to provide increased consultation and negotiation between central and local government on their respective priorities, within a single framework for ring-fenced local funds.

6.64 The Comprehensive Performance Assessment (CPA) introduced in 2002 gives local people a much better understanding of how well their council serves them and their community. Performance improved substantially between 2002 and 2003, with over half of county and single tier councils as well as around half of district councils now rated excellent or good across the full range of services.

6.65 The 2004 Spending Review provided substantial increases in resource and capital investment for local authorities. Alongside this, local government will be responsible for delivering at least £6.45 billion of efficiency gains by 2007-08. At least half of these savings will be cashable, releasing further resources to front-line activities.

6.66 To improve certainty and financial planning the 2004 Spending Review announced the Government's commitment to introduce three-year revenue and capital settlements for local authorities. A consultation document setting out the Government's proposals will be published later this month. This will invite views from local authorities and other stakeholders on announcing three-year revenue and capital settlements for 2006-07 and 2007-08 by Autumn 2005.

Conclusion

6.67 This chapter has shown how, through investment, efficiency and reform, the Government is transforming the quality of public services, consistent with the fiscal rules.

7 PROTECTING THE ENVIRONMENT

The Government is committed to delivering sustainable development and a better environment and to tackling the global challenge of climate change. It is using a range of economic instruments and other measures to protect the environment, while taking account of the need to meet social objectives and deliver sustainable economic growth. This Pre-Budget Report reviews progress and announces new steps and decisions, including:

- **the forthcoming launch of the UK climate change programme consultation** and prioritisation of climate change as a key theme for the UK's presidencies of the G8 and EU;
- **the launch of a joint Energy Efficiency Innovation Review with Defra,** supported by a new R&D fund aimed at accelerating energy-efficient technology;
- **continuation of the freeze on the main road fuel duties** in response to the sustained volatility in the oil market;
- **narrowing of the duty differential between rebated oils and main road fuels by one penny per litre** to help tackle oils fraud and a **consultation on vehicles using rebated oils;**
- **a package of measures to support the development of biofuels**, including a consultative process and feasibility study on a Renewable Transport Fuels Obligation;
- **plans to align the VAT fuel scale charge with the company car benefit charge** to provide consistent tax incentives for less polluting cars, subject to informal consultation with businesses; and
- **restoration from April 2006 of the company car tax diesel supplement on new diesel cars** registered from January 2006, to reflect the mandatory introduction of Euro IV emissions standards.

INTRODUCTION

7.1 The Government is committed to promoting sustainable development. Economic, social and environmental progress must go hand-in-hand, and policy should take account of the inter-relationship between these different objectives. Good environmental policy should promote not stifle enterprise and innovation, for example, by facilitating the development of innovative environmental technologies and encouraging investment. The key environmental challenges that the Government seeks to tackle are:

- *tackling climate change*, and reducing emissions of greenhouse gases to minimise their environmental costs;
- *improving air quality* to ensure that air pollutants are maintained below levels that could pose a risk to human health;
- *improving waste management*, so that resources are used more efficiently and wastes are reused or recycled to deliver economic value; and
- *protecting the UK's countryside and natural resources*, to ensure they are sustainable economically, socially and physically.

7.2 Meeting these challenges requires effective policy, particularly in four key sectors: energy, transport, waste and agriculture. Policy on energy use by business and households and on reducing emissions from transport is key to tackling both climate change and air quality, while effective waste management and good agricultural policy affect a range of important environmental targets.

Global challenge of climate change

7.3 The Government recognises that many environmental issues need to be tackled on a global level. *Long-term global economic challenges and opportunities for the UK*, published alongside this Pre-Budget Report, explains how global economic developments will place increased pressure on world resources and on the environment in the decades ahead. In particular, climate change may have a significant impact on global economic growth in the long term, and requires concerted international action to tackle it.

7.4 There is strong evidence that the climate is changing. Average global temperatures increased by 0.6°C during the twentieth century and the ten warmest years on record have all occurred since the beginning of the 1990s. The *Third Assessment Report* of the Intergovernmental Panel on Climate Change, published in 2001, stated that there was new and stronger evidence that most of the warming observed over the last 50 years was attributable to human activities. This conclusion has been strengthened by more recent work, including that by the European Environment Agency[1] and the Hadley Centre.

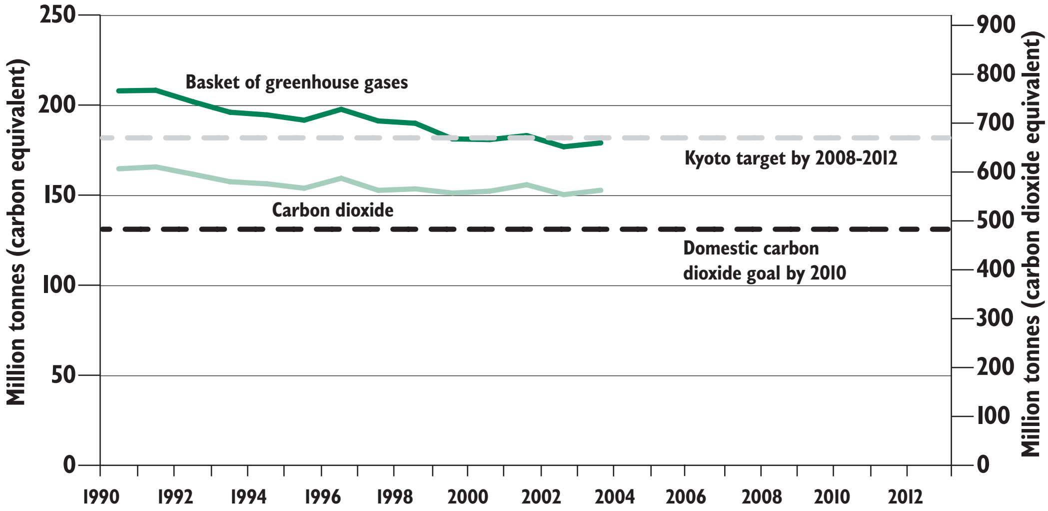
7.5 The UK climate has also changed, with annual average temperature rising by about 1.0°C over the last century. The impacts of climate change are likely to be wide ranging, affecting many parts of the UK's environment, economy and society. In the long term, potential impacts include: bad weather damaging roads and railways and leading to disruption; interruptions in the energy supply; more flooding; higher costs for building repairs and refurbishment; water shortages and weather-related health effects. Claims for storm and flood damage in the UK have doubled to over £6 billion between 1998-2003 compared to the previous five years. The Association of British Insurers estimates this could triple by 2050.[2]

7.6 Other areas of the world are expected to be affected even more severely. Many developing countries such as Bangladesh and India are likely to be vulnerable to rising sea levels, while central Africa may face bigger increases in temperatures than the global average. Developing countries will be less able than others to mitigate and adapt to these climatic changes. Climate change is therefore likely to put increased pressure on food and water resources, energy supplies and human settlements in already vulnerable areas, which may contribute to migration, instability and conflict.

7.7 The Kyoto Protocol commits the UK to reduce its greenhouse gas emissions to, on average, 12.5 per cent below 1990 levels between 2008 and 2012. The Government also has a national goal to move towards a 20 per cent reduction in carbon dioxide emissions below 1990 levels by 2010. Chart 7.1 sets out progress against goals on greenhouse gas emissions. Provisional data for 2003 show that UK emissions of greenhouse gases fell by 13.9 per cent between 1990 and 2003, and carbon dioxide emissions fell by 7.2 per cent during this period. Emissions in 2003 were higher than those in 2002 due in part to the high price of gas and subsequent increase in the use of coal in electricity generation. However, recent projections contained within the UK's National Allocation Plan, part of implementing the EU Emissions Trading Scheme (EU ETS), show emissions are set to resume their downward trend.

[1] *Impacts of Europe's changing climate – An indicator-based assessment*, European Environment Agency, 2004.

[2] *The changing climate for insurance*, Association of British Insurers, June 2004.



Source: National Environmental Technology Centre
Note: Figures for 2003 are provisional

Other environmental challenges

7.8 The Government faces a number of other environmental challenges besides climate change. The policies of the Government and the Devolved Administrations on improving air quality are set out in the Air Quality Strategy for England, Scotland, Wales and Northern Ireland and its first addendum.[3] These strategies set health-based air quality standards for nine key air pollutants and target dates for their achievement across the UK between 2003 and 2010. The Government expects to see significant reductions in levels of carbon monoxide, benzene and 1,3-butadiene. However, as indicated in Defra's 2003 Departmental Report there are some areas of the country (mostly at some urban and roadside locations) where, despite large falls, it will be highly challenging to meet targets for reductions in the levels of nitrogen dioxide and particulates. To tackle these pollution hotspots and achieve further general air quality improvements, the Government is reviewing the Air Quality Strategy.

7.9 The rate of improvement in the biological and chemical quality of UK rivers since 1990 has slowed in the last few years and is showing signs of levelling off. New ways of assessing water quality to be introduced under the Water Framework Directive will require the UK to set environmental quality standards for a wider range of chemicals in lakes, estuaries, coastal waters and groundwater, as well as rivers, and will introduce measures to ensure those standards can be met, including on diffuse pollution from agriculture and the built environment.

7.10 Effective management of waste is also critical to an environmentally sustainable economy. The Government is committed to meeting the requirements of the Landfill Directive which aims to prevent, or to reduce as far as possible, the negative environmental effects of landfill and has also set targets for the recycling of household waste. The 2002 World Summit on Sustainable Development committed the international community to promote a ten-year framework in support of sustainable patterns of consumption and production.

A strategy for environmental policy

7.11 To help meet these challenges, the Government is committed to ensuring that sustainable development is integrated into policymaking and to do this using a range of policy instruments. In the Spending Review 2004, every department was asked to consider the economic, social and environmental implications of their policy priorities and objectives, and to integrate these into their spending programmes and policies. The Government has incorporated sustainable development into the Public Service Agreements (PSA) to ensure that they adequately reflect social, economic and environmental concerns.

[3] Available at www.defra.gov.uk/environment/airquality.

7.12 As described further in Box 7.1, the Government is taking a number of steps to tackle the global challenge of climate change and is making this issue a key priority for the UK's presidencies of the G8 and EU in 2005. **The Government will be launching a consultation on the review of the climate change programme on 8 December.**

Box 7.1: Tackling the global challenge of climate change

The Government recognises that the global challenge of climate change needs to be tackled multilaterally and that, if left unchecked, in the medium to long term it may become a significant threat to continued global economic growth. The Government has already set itself challenging targets to reduce its emissions of carbon in recognition that taking mitigating actions now will lessen the risks to future generations both in the UK and beyond.

To enable progress at the international level, the Government has decided to make climate change a central theme of its G8 and EU Presidencies in 2005, described further in Chapter 2. Building on the success of the UK Emissions Trading Scheme, the Government has also helped implement the first international carbon trading scheme, the EU Emissions Trading Scheme (EU ETS), which is due to be up and running next year. This reflects the Government's commitment to secure multilateral action to tackle this global issue while protecting economic competitiveness.

At a domestic level, the Government will be launching a consultation on the review of the climate change programme on 8 December. This review will provide a comprehensive assessment of the efficacy and cost-effectiveness of existing and potential measures to meet our climate change objectives. Following the review, the Government intends to produce a revised climate change programme in the first half of 2005.

7.13 The Government uses a range of policy instruments to tackle failures of the market to take environmental costs into account including spending measures, regulatory measures, and voluntary approaches. The primary focus of this chapter is economic instruments. The Government is committed to the use of economic instruments where they are appropriate and cost effective and has introduced a number of such measures to help meet environmental targets.

7.14 The principles underlying the Government's use of economic instruments to meet environmental objectives were first set out in the Statement of Intent on environmental taxation in Budget 1997. *Tax and the environment: using economic instruments,* published by the Treasury in 2002, describes the framework by which decisions on the use of economic measures are made.[4] The Government will continue to refine its approach to the use of economic instruments, and will build on the success of measures such as the climate change levy (CCL) and the company car tax reforms, to enable environmental goals to be achieved at least cost to business and the consumer.

ENERGY USE IN INDUSTRY AND HOUSEHOLDS

7.15 The 2003 Energy White Paper set out four goals of the Government's energy policy covering the environment, energy reliability, affordable energy for the poorest, and competitive markets for businesses, industries and households.[5] The environmental aim is to put the UK on a path to cut carbon dioxide emissions by some 60 per cent by around 2050. This challenge will require step changes in both the source of energy, with a greater need for lower-carbon and renewable production of electricity, and in the efficiency with which energy is used. The case for improving energy efficiency has also been underlined by the recent

[4] *Tax and the environment: using economic instruments*, HM Treasury, November 2002.

[5] *Our energy future – creating a low carbon economy*, DTI, 2003. Available at www.dti.gov.uk.

increases in world gas and oil prices. Energy efficiency measures in both business and households are frequently cost-effective, improving productivity and reducing bills, but there are a number of barriers to their uptake. Reducing these barriers will require a range of policy responses, including the use of economic instruments such as the CCL and the EU ETS, regulatory measures and other approaches. **In support of this, Defra and HM Treasury will be jointly undertaking an Energy Efficiency Innovation Review to examine how technological, policy, financial and organisational innovation, whether by Government, business or consumers, can best contribute to a longer-term step-change in energy efficiency.**

Climate change levy

7.16 The CCL and its associated measures seek to encourage businesses to use energy more efficiently and to reduce emissions of carbon dioxide. The CCL is broadly revenue neutral for business and the service sector, with revenues recycled back to business by means of a 0.3 percentage point reduction in employer national insurance contributions, introduced at the same time as the levy, and through support for energy efficiency and low carbon technologies via the Carbon Trust.

7.17 The levy package was forecast to reduce emissions by the equivalent of at least 5 million tonnes of carbon a year by 2010, of which 2 million tonnes of carbon was attributable to the levy alone. The Government has commissioned an independent assessment of the levy and its role in tackling climate change. Early indications are encouraging and suggest that the CCL alone should deliver estimated annual savings of around 3.5 million tonnes of carbon (MtC) by 2010 – well above the 2MtC forecast at the time of the levy's introduction. The results also show that it has encouraged the installation of new renewables and combined heat and power capacity, because generation from these sources is exempt from the levy. **The Government will publish the completed evaluation for Budget 2005**.

Climate change agreements

7.18 Climate change agreements allow energy-intensive sectors to obtain 80 per cent relief from the CCL if they agree to increase energy efficiency and reduce emissions. Following consultation, Budget 2004 announced new eligibility criteria to widen the entitlement to relief, to be introduced once EU state aids approval is obtained. Applications have been received from several sectors of business for these new agreements, and negotiations to establish the environmental targets that the sectors will need to meet are continuing. State aids clearance from the EU is still awaited.

EU emissions trading scheme

7.19 The Government continues to prepare for the introduction of the EU ETS in 2005 and recently announced its proposals on the total number of greenhouse gas emission allowances to be allocated to UK industry as part of the first phase. The allocation strikes a balance between the concerns of business about potential competitiveness impacts and the UK's leadership on climate change. The industrial (non-generating) sectors will receive an allocation based on their projected requirements in the first phase. Overall, the emissions cap represents a reduction in business-as-usual emissions projections equivalent to 5.2 per cent, and will take the UK beyond its Kyoto commitment. In the first two phases, the EU ETS will contribute to the Government's domestic goal of moving towards a 20 per cent reduction in carbon dioxide emissions on 1990 levels by 2010.

Renewable energy

7.20 In January 2000, the Government announced a target for renewable sources to supply 10 per cent of UK electricity in 2010, subject to the costs being acceptable to the consumer. The key policy mechanism being used to meet this target is the Renewables Obligation, which requires all licensed electricity suppliers to supply a specific and growing proportion of their electricity from certified renewable sources each year. In line with the commitment in the 2003 Energy White Paper the Government has recently commenced a review of the obligation. The key consideration of the review will be to ensure the delivery of the 2010 target, while maximising value for money for consumers.

Investment in energy-saving technologies

7.21 Enhanced capital allowances (ECAs) for investments in approved energy-saving technologies were introduced in 2001 and currently cover more than 7000 approved products. Administration of the ECA scheme is managed by the Carbon Trust, an independent not-for-profit company funded principally from recycled CCL revenues. Budget 2004 announced the addition of further technologies to the ECA scheme, worth £5 million in 2005-06. The Government is committed to the development of the scheme and continues to consider the case for additional technologies.

7.22 As described further in Chapter 3, looking to the challenges and opportunities posed by the UK's commitment to a future low carbon economy, **the Government will help focus the growing public and private investment in this area by investing in a £20 million fund to help foster a new partnership to accelerate energy-efficient technology, run by the Carbon Trust.**

Household energy efficiency

7.23 Although energy-efficient products are often cost-effective options, demand for them from households and businesses is limited. Economic instruments can provide useful signals, encouraging consumers to purchase such goods and manufacturers to invest in their production. Following consultation, the Government introduced a package of measures to promote household energy efficiency in Budget 2004, and work has been continuing since then to build on this.

7.24 For the private rented sector, Budget 2004 announced the Landlord's Energy Savings Allowance, which is now in place. It also confirmed the Government's intention to consider the introduction of a Green Landlord Scheme. Work on the Green Landlord Scheme is under way, with the aim of identifying further effective ways to improve household energy efficiency in the short and longer term. This includes targeting particular areas of improvement within households and raising the overall energy efficiency levels of properties. The Government will discuss this further with key stakeholders ahead of an announcement on the scheme in Budget 2005.

7.25 The Government continues to support investment in renewable energy and other energy-efficient products too. A reduced rate of VAT for ground source heat pumps was introduced in Budget 2004, and the Government has also stated its readiness to introduce a reduced rate of VAT on micro combined heat and power boilers, with any decision being dependent on the outcome of the ongoing field trials. In addition, the Government will continue to negotiate with its European partners to extend the categories of permitted reduced VAT rates to include energy-saving materials for DIY installation and energy-saving products, although in the short term these negotiations are unlikely to deliver an opportunity for reduced VAT rates to be used to promote energy efficiency, beyond the existing provisions.

7.26 Besides using economic instruments, the Government has also recently set a firm target for the next phase of the Energy Efficiency Commitment (EEC) (2005-08), under which energy suppliers are required to achieve targets for installing energy efficiency measures in the household sector.[6] The Department for Environment, Food and Rural Affairs (Defra) consulted between May and August 2004 on a proposal that would roughly double the level of activity of the current EEC and deliver savings of around 0.7 million tonnes of carbon a year by 2010. In October 2004, Defra announced an additional £3 million for an Energy Savings Trust information campaign to support the Energy Efficiency Commitment. In July the Government also gave the green light to an industry Code for Sustainable Buildings which will establish higher standards for energy and water efficiency as well as waste and use of materials. The Code will be completed by the end of 2005 for national rollout in 2006. Changes to building regulations are also expected to deliver a 25 per cent improvement in energy efficiency from 2005 by raising insulation standards.

[6] The EEC and other measures to promote household energy efficiency were set out in *Energy efficiency – the Government's plan for action*, Defra, April 2004.

Energy Products Directive

7.27 The Energy Products Directive (EPD) came into force on 1 January 2004 and provides an EU framework for the taxation of energy products, increasing the existing minimum rates of duty on hydrocarbon oils and introducing minimum rates of duty for the taxation of other energy products, including electricity, natural gas, coal and other solid fuels. The minimum rates in the EPD do not affect any of the UK's existing rates or exemptions for hydrocarbon oils duty or CCL, but will require increases to rates in some other Member States, which will provide environmental benefits across the EU. The UK currently holds derogations on private pleasure boats, private pleasure aircraft and waste oils. These are due to expire on 31 December 2006. The Government will discuss the derogations with stakeholders before their expiry date.

A CLEAN AND EFFICIENT TRANSPORT SYSTEM

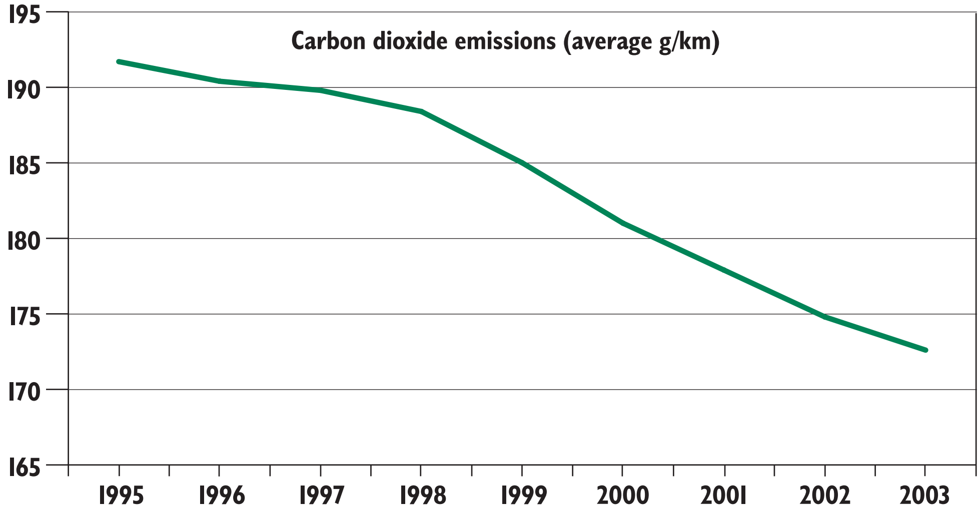
7.28 Transport is the second largest source of carbon dioxide emissions in the UK and so has an important role to play in tackling climate change. A safe, clean and efficient transport system is also key to sustaining economic growth. The Government recognises the importance of efficient transport in boosting productivity, extending mobility and helping to create a more inclusive society. However, it recognises that these benefits must be achieved while minimising the impact of transport on the environment, now and in the future.

7.29 Over recent years, demand for travel has increased, providing additional challenges to the Government's transport and environmental objectives. The Government's long-term goal is to support the switch to a low-carbon economy, including zero-emissions transport. The recent Department for Transport (DfT) White Paper[7] considers the factors that will shape travel over the next 30 years, with the aim of creating a transport network that can meet increasing demand for travel, while achieving environmental objectives. Reflecting the environmental impact of transport, DfT now shares key PSA targets on climate change and air quality with Defra and DTI.

7.30 The Government has already taken a number of measures to improve the efficiency of the transport system, including support for the take-up of the most efficient fuels and vehicles, and the promotion of more environmentally-friendly forms of travel. Since March 2001, for example, all cars registered have been subject to a graduated vehicle excise duty scheme based on carbon dioxide emissions. Although growth in the transport sector led to an increase in total transport emissions in 2003, average carbon dioxide emissions from new cars in the UK have fallen in recent years, as shown in Chart 7.2. Emissions from new cars are expected to fall further with the continued impact of the voluntary agreement between the European Commission and car manufacturers, underpinned by environmentally-focused vehicle taxes. The agreement commits car manufacturers to reduce carbon dioxide emissions to an average of 140 grams per kilometre by 2008.

[7] *The future of transport*, DfT, July 2004. Available at www.dft.gov.uk.

Chart 7.2: Carbon dioxide emissions from new cars

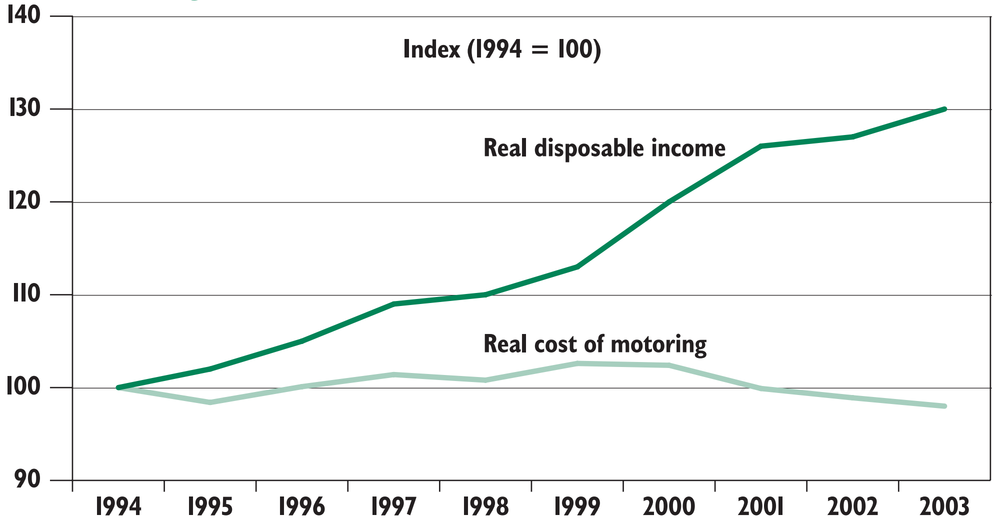


Source: DVLA

Costs of motoring

7.31 The cost of motoring has remained broadly constant for a quarter of a century, with a slight fall in recent years as a result of lower purchase prices and vehicle efficiency improvements, as shown in Chart 7.3. Over the same period, household disposable income has increased significantly, with average motoring costs therefore accounting for a smaller share of disposable income. This trend is set to continue in coming years as vehicles continue to become more fuel efficient.

Chart 7.3: Index of household disposable income and cost of motoring



Source: Office for National Statistics
Note: Overall cost of motoring includes purchase, maintenance, petrol and oil, and tax and insurance

Fuel duty **7.32** In July 2004, the Government announced it would review the planned inflation-based increase in fuel duties, which was intended to take effect from 1 September 2004, and report back at the Pre-Budget Report. Volatile world oil prices have meant higher UK pump prices than would have otherwise been expected in recent months. **Today, the Chancellor, in response to the continued volatility in the oil market announces the continuation of the freeze on main road fuel duties for this financial year.** It remains the Government's policy that in future years, fuel duties should rise at least in line with inflation, as the Government seeks to meet its target of reducing polluting emissions and funding public services. Given this continuation of the freeze on main road fuel duties, the differential for sulphur-free fuel will not be introduced. **The Government remains committed to the introduction of cleaner and more environmentally-friendly fuels and will aim to implement the duty differential for sulphur-free fuels when market conditions allow.**

Rebated oils **7.33** Budget 2004 announced an increase in duty on rebated oils of 2.42 pence per litre from 1 September. This was one penny per litre above the planned inflation-based increases for main road fuels and would therefore have narrowed the duty differential between rebated oils and the main road fuels to address the problem of oils fraud. In July 2004, as part of the wider fuel duty review, the Government deferred this increase until Pre-Budget Report. Today, **the Government confirms that it will implement the narrowing of the duty differential by one penny per litre between rebated oils and main road fuels.** This is part of a package of measures that aim to reduce further oils fraud in the UK.

7.34 **As a further step in its anti-fraud strategy, the Government also today publishes a consultation document on the categories of vehicles that are eligible to use rebated oils.**[8] This consultation invites views on how best to ensure that rebated oils are used only by appropriate vehicles, thereby helping to tackle oils fraud, protecting revenues and reducing damaging emissions. More detail on the Government's oils fraud strategy is provided in Chapter 5. The Government believes that there are measurable environmental benefits to be gained from the introduction of lower-sulphur rebated oils and will continue to keep under review the option of introducing a duty differential to encourage the take-up of these more environmentally-friendly fuels.

Alternative fuels **7.35** In the 2003 Pre-Budget Report, the Government published its Alternative Fuels Framework, setting out the rationale for Government support in this area and placing environmental benefit at its core. The framework includes a commitment to a three-year rolling guarantee on the fuel duty differentials for all alternative fuels, in recognition of the need for long-term certainty in the market. The Government continues to use this structured approach to underpin further investment in this growing industry – an industry which it sees as playing a significant contribution to the future security of supply for fuel.

Biofuels **7.36** As Box 7.2 explains, the Government recognises that biofuels can offer significant environmental benefits. The DfT consulted on the Government's biofuels policy and strategy for implementing the EU Biofuels Directive during the summer of 2004. The consultation asked for views on a wide range of issues, including appropriate biofuels sales targets for the UK to set under the Directive, and appropriate mechanisms to achieve these. Today, the DfT publishes a summary of the consultation responses.[9]

[8] *Hydrocarbon oil duty: consultation on changes to excepted vehicle schedule*, Customs and Excise, 2004.

[9] Available at www.dft.gov.uk.

Box 7.2: Promoting cleaner road fuels

***Long-term global economic challenges and opportunities for the UK*, published alongside the Pre-Budget Report, explains that pressure on global resources such as oil is likely to intensify as demand in developing countries grows. The volatility of the oil market has emphasised the challenge that faces all Governments to deliver security of fuel supply and tackle the environmental damage caused by fossil fuels. The Government remains committed to using the tax system, including duty incentives, to reduce the environmental impact of road transport and, in successive Budgets, has successfully used fuel duty differentials to encourage the take-up of less environmentally-damaging fuels. Between 1997 and 1999, the rate of fuel duty for ultra-low sulphur diesel was steadily cut relative to conventional diesel. Within two years, these duty incentives succeeded in converting the entire diesel market to the cleaner fuel. A similar duty incentive was also used to encourage the switch to ultra-low sulphur petrol. The Government remains committed to the introduction of cleaner and more environmentally-friendly fuels and will aim to implement the differential for sulphur-free fuels when market conditions allow.**

The Government recognises that biofuels can offer significant environmental benefits through reduced emissions of greenhouse gases and local air quality improvements, and believes they offer a cost-effective option for reducing emissions from road transport. They may also, in the future, contribute to security of fuel supply. The duty differential of 20 pence per litre for biodiesel has helped the biodiesel market to grow over the past few years and it now accounts for around 24 million litres of fuel sold each year. From 1 January 2005, a similar duty differential for bioethanol will also be introduced. The Government is also taking forward a package of further measures to support the development of biofuels in road transport. The package is set out in detail below.

7.37 **To further encourage the introduction of biofuels, the Government is announcing a consultative process and feasibility study on a possible Renewable Transport Fuel Obligation (RTFO).** An RTFO would require a specified proportion of aggregate fuel sales to come from renewable sources and would draw on the experience of the obligation for renewable electricity. The Energy Act 2004, includes primary legislation enabling the introduction of an RTFO in the future, which would be subject to its cost-effectiveness and feasibility. The Government is keen to discuss details of how an obligation would work with interested stakeholders and will set out next steps shortly. The consultative process and feasibility study will commence shortly and will seek to establish the cost-effectiveness, administrative feasibility, regulatory burdens and compatibility of an RTFO with other Government objectives.

7.38 Budget 2004 announced discussions with stakeholders on the possibility of extending the duty differential approach to inputs-based production of biodiesel as a means of encouraging the use of biomass in conventional fuel production. As a result of these discussions, **the Government today announces work towards a pilot project to examine the potential for using duty incentives for inputs-based production, and will hold a tendering process after Budget 2005.** The pilot project will be launched in 2005 and is expected to start in 2006. The Government will be working closely with stakeholders to take this forward.

7.39 The Government believes that enhanced capital allowances for the cleanest biofuels plants could encourage these more environmentally-friendly fuels. Following the launch of a stakeholder discussion document in October,[10] the Government will continue detailed discussions to develop an effective and efficient scheme, and intends to set out details at the Budget.

[10] *Enhanced capital allowances for biofuels – a stakeholder discussion document*, HM Treasury, 2004. Available at www.hm-treasury.gov.uk.

Road fuel gases

7.40 Budget 2004 announced that the duty differential for natural gas (NG) would remain at its current rate and the duty differential for liquefied petroleum gas (LPG) would be reduced by one penny per litre in 2004-05 from 1 September 2004, and by a further penny per litre in both 2005-06 and 2006-07, towards a level more commensurate with the environmental benefits of the fuel. The reduction in duty differential for this year has also been deferred as part of the wider continuation of the freeze on main road fuel duties. The Government remains committed to offering support to those LPG and NG vehicles that offer the best environmental performance. **To give further support to these vehicles, the Government today announces its intention to simplify the alternative fuel discounts for company car tax at Budget 2005.**

Company car tax

7.41 Budget 1999 reformed the company car tax system from 6 April 2002 to encourage the take-up of more environmentally-friendly cars by basing it on carbon dioxide emissions. In April 2004, the Inland Revenue published the first stage of the evaluation of the scheme which found that there had been considerable success in reducing business mileage and lowering carbon dioxide emissions as a result of more fuel-efficient cars. The Inland Revenue will continue to evaluate the scheme to ensure that it meets the Government's environmental aims.

Company car tax – diesel supplement

7.42 **The Government announces today that from 6 April 2006, the waiver of the 3 per cent diesel supplement for diesel cars that meet Euro IV emissions standards will cease for cars registered on or after 1 January 2006.** The waiver was introduced to encourage early take up of Euro IV technology and has achieved that purpose. Euro IV emissions standards will become mandatory for all new diesel cars registered from 1 January 2006. The waiver will be retained for the life of diesel cars that meet Euro IV emissions standards and were registered before 1 January 2006. This is consistent with the principles of regulatory certainty. Reflecting the environmental benefit gained from the early introduction of these vehicles, it also continues to reward those who made the additional investment to purchase Euro IV standard vehicles, prior to standards being made mandatory.

Capital allowances for business cars

7.43 As part of the wider Corporation Tax reform, the Government is considering options for modernising the capital allowances regime for business cars. The Government will be evaluating the possibility of encouraging greater take-up of low emissions cars with, for example, allowances graduated by carbon dioxide emissions, and will be consulting stakeholders as part of the ongoing Corporation Tax reform programme.

Company car fuel

7.44 The company car fuel benefit charge was reformed in 2003 to follow the emissions basis of the company car tax system. This provides consistency of tax treatment and reinforces the environmental benefits of the scheme. The Inland Revenue has commenced work to evaluate the new scheme. **In addition, the Government today announces, subject to Commission approval and informal consultation with businesses, that the VAT fuel scale charge will be aligned with the company car benefit charge.**

Lorry road-user charge

7.45 Road haulage plays an important role in a productive economy. The Government is committed to ensuring that all lorries using UK roads contribute on a fair and equal basis towards the cost that they impose. The Government is therefore progressing its plans for a Lorry Road-User Charge (LRUC), accompanied by offsetting tax cuts, to be made through a fuel duty repayment scheme. It is due to be phased in from 2007-08.

7.46 The third progress report on LRUC, which moved the scheme into the procurement phase, was published alongside Budget 2004.[11] In May 2004, the Government launched the procurement process and in August HM Customs and Excise announced the shortlist of bidders that would go through to the next stage. The Government is currently assessing the responses to its preliminary Invitation to Negotiate (ITN), and expects to issue final ITNs to shortlisted bidders in January 2005. **The Government will shortly be issuing a discussion paper, which will consider various details of how the charge might operate in practice.**

[11] *Modernising the taxation of the haulage industry – lorry road-user charge: progress report three*, HM Treasury, March 2004.

National road-user charge

7.47 Congestion is a serious and growing problem in the UK, with high economic and environmental costs, and traffic levels are forecast to grow by around 40 per cent between 2000 and 2025. Unpredictable and rising journey times raise costs for individuals and businesses, and have an adverse effect on UK productivity and economic growth. Congestion also creates localised air-quality hotspots, often in highly-populated urban areas. The Government is committed to tackling this situation and is developing new measures of congestion, to identify better the underlying problems and provide a better focus for policy interventions. DfT will publish new PSA targets for inter-urban and urban congestion by July 2005, and will also publish regular projections of congestion.

7.48 The policy response to congestion can be summarised in terms of two approaches: better management of supply (including better network management and physically increasing capacity); and better management of demand (including road-pricing schemes, provision of alternative transport modes and land use planning policies). While there is a case for increasing road capacity at key points on the road network, there is a need to balance road users' needs with wider environmental issues and to make more effective use of the existing road system. In this context, there are early indications from London and the new M6 toll road that road-charging schemes can help to reduce congestion, as described in Box 7.3.

7.49 In July 2004, DfT published a feasibility study that considered how and when a national road-pricing scheme might be delivered.[12] The study concluded that a national distance-based charge, with local variations in the charge rate to reflect congestion levels, could cut congestion by up to a half as well as reducing environmental costs. It found that the technology is becoming feasible and could be available for the mass market in ten years time. In the Future of Transport White Paper, the Government welcomed the feasibility study and committed to taking a number of actions in response to its recommendations.[13] A full response to the feasibility study will be published in due course, setting out in more detail how the Government will take forward these actions.

Box 7.3: The impact of road-charging schemes on congestion

Introduced in February 2003, the London congestion charge is a cordon-based charge covering eight square miles of central London. Motorists pay £5 a day to drive within the charged area on weekdays. The scheme has been successful at reducing congestion and emissions within the charged area. Transport for London (TfL) reported a 30 per cent average reduction in congestion and a 15 per cent reduction in the volume of traffic within the charged area. These traffic changes are estimated to have reduced traffic-related emissions of carbon dioxide in the area by 19 per cent. TfL research shows that traffic flows around the edge of the charging zone have increased only marginally and that the direct impact on business activity appears to have been small. An extension to this scheme is currently being considered. Durham city centre has also operated a cordon-based charge since October 2002, where drivers are charged £2 to access a small part of the city centre. The city of Edinburgh is currently considering a cordon-based charge for possible introduction in 2006 and is due to conduct a referendum in early 2005.[a]

The M6 toll road, which was privately financed and opened in December 2003, offers an alternative to the M6 motorway through the West Midlands conurbation, which is often subject to heavy congestion. In a survey after the first three months of operation,[b] the Highways Agency found that the road was carrying 40,000 vehicles a day on weekdays and around 30,000 vehicles a day at the weekend. This survey also found that traffic had fallen by around ten per cent on weekdays, by around 15 per cent on Saturdays and by 20 per cent on Sundays. Journey times had consequentially fallen on the non-toll M6 motorway, with estimates of journey time improvements of up to 16 minutes on weekdays.

[a] *Impacts monitoring second annual report*, Transport for London, April 2004.

[b] *M6 toll traffic monitoring study*, Highways Agency, July 2004.

[12] *Feasibility study of road pricing in the UK, DfT,* July 2004. Available at www.dft.gov.uk.

[13] *The future of transport*, DfT, July 2004. Available at www.dft.gov.uk.

Aviation **7.50** The UK Air Transport White Paper,[14] published by DfT in December 2003, recognised that greenhouse gases emitted from aircraft engines make a significant and growing contribution to climate change. In the EU, aviation accounted for 3 per cent of total carbon dioxide emissions in 2001, an increase of 68 per cent from 1990 levels. Forecasts suggest that the UK's combined domestic and international aviation emissions could account for up to a quarter of the UK's total contribution to climate change emissions by 2030.[15] The White Paper set out the Government's approach to tackling the global impact of aviation on the environment, and announced new measures such as increased use of scale charges for noise and local air quality, and expanded noise compensation and mitigation schemes.

7.51 The Government believes that a well-designed emissions trading regime is potentially the most cost-effective way of ensuring that aviation contributes towards the goal of climate stabilisation. This would put an overall limit on the carbon dioxide emissions from aviation and would ensure that the emissions reductions required to achieve this take place cost-effectively. This is one of the UK's key priorities for the Presidency of the EU in 2005, with the aim of aviation joining the EU ETS from 2008.

7.52 The Government is holding bilateral discussions with major EU Member States to gather support for the UK's initiative and to consider the design issues that would need to be resolved. The UK has already had significant success at international level, leading the way with European counterparts to oppose an amendment at the recent International Civil Aviation Organisation assembly which would have restricted action to tackle aviation's environmental impacts at national and European level.

IMPROVING WASTE MANAGEMENT

Waste strategy **7.53** Efficient use of resources and the effective management of waste are essential features of an environmentally sustainable economy. Over recent years the Government has taken a range of steps to develop more sustainable waste management practices and reduce the UK's reliance on landfill. Next year the Government will be conducting a review of Waste Strategy 2000 to evaluate progress made and inform future policy decisions across all waste streams.

Landfill tax **7.54** The landfill tax encourages efforts to minimise the amount of waste generated and to develop more sustainable waste management techniques. It contributes to the achievement of the Government's waste strategy targets through the diversion of waste away from landfill. Total waste received at sites registered for landfill tax fell by nearly 20 per cent in the period from 1997-98 to 2003-04. As announced in Budget 2003, the standard rate of landfill tax will be increased by £3 a tonne in 2005-06 to £18 a tonne, and by at least £3 a tonne in the following years to reach a medium- to long-term rate of £35 a tonne. There are early indications that this announcement has encouraged reductions in disposals of active waste to landfill – such disposals are down by over 4 per cent compared with the year before the announcement was made.

Recycling landfill tax revenue **7.55** Budget 2003 announced that future increases in the standard rate of landfill tax would be introduced in a way that is revenue neutral to business as a whole and to local government. In line with this commitment, the 2004 Spending Review announced that a spending programme, rising to £146 million a year in England by 2007-08, will be used to support business in improving resource efficiency.[16] Box 7.4 provides more detail on the Business Resource Efficiency and Waste programme announced by Defra on 22 November 2004. Following the announcement in the Spending Review the Government will also consult key stakeholders on the potential for a new enhanced capital allowance scheme for waste and associated resource efficiency technologies. The additional funding for the Environment, Protective and Cultural Services block grant in the Spending Review included provision to ensure that the increases in landfill tax from 2005-06 are revenue neutral to local government.

[14] *The future of air transport*, DfT, December 2002. Available at www.dft.gov.uk.

[15] This includes the radiative effect (or 'radiative forcing') of condensation trails generated by air traffic in the upper troposphere.

[16] Funding for the devolved administrations was determined in the Spending Review in accordance with the established devolution funding arrangements.

Box 7.4: Business Resource Efficiency and Waste Programme

The Business Resource Efficiency and Waste (BREW) programme in England has been developed in consultation with business to help them become more resource efficient. A steering committee of business representatives will monitor and advise the programme as it develops. The programme is worth £43 million in 2005-06 rising to £146 million in 2007-08.

In November 2004, Defra announced the 2005-06 allocation of funds. This included an expansion of independent advice to businesses on ways to minimise waste, support for the development of new markets for waste and, through co-funding of the DTI Technology Strategy, support for research and development aimed at waste minimisation and energy efficiency. Funding of £2 million in 2005-06 will be allocated to the Environment Agency to boost their efforts to tackle illegal dumping of waste, ensuring a level playing field for business.

Landfill tax credit scheme

7.56 The Landfill Tax Credit Scheme (LTCS) redresses some of the environmental costs of landfill by improving the environment in the vicinity of landfill sites. Projects benefiting from LTCS funding include the reclaiming of land, improvements to local community facilities and repairs to places of worship. In 2003, the landfill tax credit scheme was reformed and extended to include habitat creation projects in support of biodiversity. In addition, a number of changes have been made to the running of the scheme: simplifying administration and streamlining processes, introducing a small grants scheme, and introducing better information systems. Value for money indicators are also being developed. Budget 2004 announced that the value of the scheme would be increased in line with inflation so that it is worth £48.3 million in 2004-05. The Government recognises the important contribution made by the LTCS and has received positive representations from stakeholders on the value of the projects funded by the scheme. The Government will announce the value of the scheme for the coming year in Budget 2005.

Incineration

7.57 In the 2002 Pre-Budget Report, the Government announced that it would review the case for a tax on incinerated waste following independent assessment of the evidence on the health and environmental effects of waste management options. In May 2004, the Government published this assessment[17] and concluded that on the evidence of the studies so far, the disposal of municipal solid waste has at most a very minor effect on health and that, in particular, the risks to human health from incinerating waste are small compared to other day-to-day risks. The evidence on environmental impacts suggests that the significant adverse environmental effects of waste management are limited to those that are already being tackled, such as methane emissions from landfilling waste.

7.58 Defra has today published a second report[18] providing an independent assessment of the costs of the impacts identified in the first report. In addition, HM Customs and Excise has published a summary paper,[19] which brings together key findings of these two reports and attempts to value the impacts of different disposal options. The paper highlights the wide range of uncertainty to which the figures are subject and the difficulties in trying to rank the disposal options.

7.59 International comparisons demonstrate the relatively small role that incineration plays in waste management in the UK. In 2001, Germany incinerated 22 per cent, France 32 per cent and Denmark as much as 60 per cent of waste, compared to the UK's 7 per cent.[20] Environmental standards that incinerators have to meet have been significantly tightened over recent years and are set to become even tighter.

[17] *Review of environmental and health effects of waste management: municipal solid waste and similar wastes*, Defra, 2004.

[18] *Valuation of the external costs and benefits to health and the environment of waste management options*, Defra, 2004.

[19] *Combining the Government's two health and environment studies to calculate estimates for the external costs of landfill and incineration*, HM Customs and Excise, 2004.

[20] *e-digest of environmental statistics*, Defra, 2004. www.defra.gov.uk/environment/statistics/index.htm.

7.60 The Government has a legal commitment under the landfill directive to reduce reliance on landfill and, to help to achieve this, is increasing the standard rate of landfill tax. Incineration has a part to play in meeting this commitment, in particular by dealing with the residual waste that will be left even after achieving the much higher levels of recycling and reuse that the Government is aiming for. Taking into consideration all these factors, including existing barriers to incineration, the Government is not convinced that there is a strong case for the introduction of a tax on incinerated waste. The Government is continuing to explore barriers to new waste management technologies, such as mechanical and biological treatment, and ways of facilitating their introduction, including the potential role of enhanced capital allowances.

Improving local waste management

7.61 Defra will be announcing in the next few weeks the allocation of £45 million to local authorities in 2005-06 from the reform of the Waste Minimisation and Recycling Challenge Fund. The funding will be used to support local authorities in introducing more sustainable waste management practices; to assist the introduction of the landfill allowance trading scheme; and to help deliver £299 million of efficiency gains on waste services announced in Spending Review 2004. To facilitate best practice the Government aims to ensure that one of the planed local authority regional centres for excellence being established will have specific responsiblity for waste. It is also essential that the planning system is equipped to assist delivery of the necessary waste disposal facilities where and when they are needed to support the UK's waste objectives. Defra and ODPM will shortly issue a joint consultation on revised policy guidance to facilitate strategic and spatial planning for waste management.

PROTECTING THE UK'S COUNTRYSIDE AND NATURAL RESOURCES

7.62 Sustainable development requires that economic growth is not pursued at the expense of the environment, but works to protect, preserve and improve it, while supporting economically and socially stable communities. The Government is committed to ensuring that the UK's natural resources are used efficiently and responsibly.

Agriculture

7.63 Over 75 per cent of land in the UK is used for agricultural purposes, so farming practices have a significant impact on the UK's environment. Good agricultural practice can help preserve and improve the natural environment. However, agriculture can also be the source of a range of environmental problems, including water pollution from the inappropriate use of fertilisers and pesticides and climate change through the impact of methane, carbon dioxide and nitrous oxide emissions.

Diffuse water pollution

7.64 **The Government is today publishing a summary of responses to the consultation on catchment-sensitive farming[21] that was launched in June 2004.** The Government is taking immediate steps to work with stakeholders on early voluntary action and supportive approaches and will continue to work on improving the evidence base to inform policy in this area. The Government will consider using other measures where required to tackle diffuse water pollution and meet the Government's commitments under the Water Framework Directive. The Government is mindful of the cumulative impact of forthcoming measures in the agricultural sector and will continue to work with stakeholders in 2005 to develop an effective package of measures for further consultation in due course.

[21] *Summary of responses to the joint Defra-HM Treasury consultation on 'Developing measures to promote catchment-sensitive farming'*, Defra, December 2003.

Pesticides **7.65** An industry voluntary initiative on measures to reduce the environmental damage caused by the agricultural use of pesticides has been in place since April 2001. To cover the potential case that the voluntary initiative might fail to deliver the required environmental benefits within a reasonable timescale, the Government has continued to keep the options for an economic instrument under review. A study of key design issues for potential economic instruments carried out on behalf of Defra was published in September 2004.[22] In particular, it examined the design of a workable banded tax that would differentiate between pesticides on the basis of risk and encourage switching toward less environmentally-hazardous products.

7.66 The voluntary initiative is due to come to an end in 2006 and the Government will evaluate the success of the scheme and its environmental impact to assess which further actions are required beyond 2006. The Government continues to believe that, if fully implemented, the voluntary initiative is the most effective way of reducing the environmental pollution associated with pesticides. However, to judge the initiative a success the Government is conscious that the targets specified must be challenging and rigorous and that the initiative must be delivering good environmental outcomes. The initiative must be able to develop stretching and meaningful environmental targets and to demonstrate clearly the benefits to biodiversity and water quality. The national targets proposed for biodiversity need to be refined and progress may have to be demonstrated at a local level.

Water **7.67** In October 2004, the Government issued its final guidance on improvements to environmental and drinking water quality to the industry regulator, Ofwat, as part of the wider Periodic Review process. Ofwat is today announcing five year price limits for the period from April 2005-10, and water companies will invest around £5 billion to ensure compliance with the UK's statutory obligations and deliver a further package of quality improvements. Quality investment proposals have been closely scrutinised by Government. In 2003, the Government introduced 100 per cent first-year enhanced capital allowances for business investments in qualifying water efficiency technologies. The scheme currently supports six technologies. The Government is committed to the continued development of the scheme.

Aggregate extraction

Aggregates levy **7.68** The aggregates levy was introduced in April 2002. In the light of independent research, the levy was set at a rate of £1.60 per tonne on primary aggregate commercially exploited in the UK. Revenue from the aggregates levy is recycled to businesses through a cut in employer national insurance contributions, and through the aggregates levy sustainability fund, which supports projects seeking to minimise the impact of quarrying on local communities. Box 7.5 provides a brief overview of progress and shows there are strong indications that the levy is achieving its objectives. Further details will be published by Budget 2005.

Northern Ireland relief scheme **7.69** Budget 2004 announced that the Government intended to extend the scope and duration of the relief that applied on aggregates used in Northern Ireland because the levy was not achieving its environmental objectives there. EU state aids approval has now been received and the extended relief came into effect from 1 April 2004. It is now fixed at 80 per cent of the full rate until 31 March 2011. To benefit from the extended relief, aggregate businesses in Northern Ireland have to agree to implement environmental improvements to their operations. There has been unqualified support from the aggregates industry in Northern Ireland with more than 160 applications to join the extended scheme. HM Customs and Excise have been co-operating with other law enforcement agencies to ensure that those paying tax are not disadvantaged by competing with those operating outside the law. Since 1 January 2004, 15 new registrations for aggregates levy have been made in Northern Ireland as a result of enforcement action.

[22] *Review of key issues related to economic instruments to reduce the environmental impact of pesticide use*, Defra, April 2003.

Box 7.5: The aggregates levy

The aggregates levy aims to reduce the amount of primary aggregate being extracted directly from quarries and to encourage alternatives, including the use of recycled aggregates and by-products from other industrial processes. The early indications are that it is proving successful in achieving these aims:

- **production of primary aggregate in Great Britain fell by 3 per cent between 2002 and 2003, to its lowest level since 1982. Between 2001 and 2003 production fell by 8 per cent. The fall in aggregate production is against a backdrop of buoyant construction activity and GDP growth;**
- **in England, a study produced by the Symonds Group[a] shows that the estimated production of recycled aggregates increased by over 3 million tonnes between 2001 and 2003. In a survey of expanding recycled aggregate businesses, the levy was the most frequent reason given for growth since 2001; and**
- **sales of by-products such as china clay waste and slate waste used as aggregate have risen significantly as a result of the aggregates levy exemptions granted to these products. The national production of slate for 'fill and other' uses increased by 65 per cent in 2003, compared with the pre-levy year 2001.**

[a] *Survey of arisings and use of construction, demolition and excavation waste as aggregate in England in 2003*, Symonds Group, October 2004.

Sustainable land use

Sustainable housing

7.70 Discussed further in Chapter 3, the Government's strategy for housing places key housing, planning and regeneration policies in the context of wider requirements for sustainable communities, including employment, quality public services, transport, a safe and healthy local environment, and sound local government. The Barker Review also recognised the need for housing policy to balance the environmental and social implications of housing development against the risks to macroeconomic stability and long-term affordability of not delivering a substantial increase in housing supply.

Contaminated land tax credit

7.71 As part of a package of measures to promote urban regeneration, Budget 2001 introduced the contaminated land tax credit to provide business with incentives to clean up contaminated land. The Barker Review recommended that the Government should consider the extension of the tax credit to land that has lain derelict for a period of time, but that this should encourage genuine new investment in brownfield remediation, and not simply subsidise development that would take place in any case. The Government continues to examine options to extend the credit in an efficient way, taking into account the Barker recommendation. **Research into the effectiveness of the contaminated land tax credit is under way and, depending on the outcome of that research, the Government will consult next year on extending the credit.**

ENVIRONMENTAL APPRAISAL OF POLICY MEASURES

7.72 The Government is committed to appraising the environmental impact of Budget measures, and aims to ensure that policy design, appraisal and evaluation take account of costs and benefits, the precautionary principle and the need to internalise costs by making the polluter pay. The Government constantly monitors the environmental impact of its policies to ensure they achieve their desired effect: evaluations of several key measures, such as the climate change levy and aggregates levy are under way and the findings will be published in 2005. These will help to build a more comprehensive picture of the effectiveness of environmental taxes and will inform the review of the climate change programme and a further stock take of the evaluation of environmental tax policy for the Budget.

7.73 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 that have a significant effect on the environment or which serve an environmental purpose. To increase transparency and public reporting of key performance indicators, the environmental appraisal tables are also available on the Treasury website. The tables will be updated regularly to reflect continuing monitoring of environmental indicators and further evaluation of specific schemes.

Table 7.1: The Government's policy objectives and Budget measures

Policy objective	Sustainable development indicator[1] and recent trend data	Recent Government measures
Tackling climate change and improving air quality.	*Emissions of greenhouse gases* UK greenhouse gas emissions were 13.9 per cent below 1990 levels in 2003.[2] *Days when air pollution is moderate or higher* The number of days with moderate or higher air pollution increased from 20 to 50 in urban areas and from 30 to 61 in rural areas between 2002 and 2003.[3] *Road traffic*[4] Between 1998 and 2003, total motorised traffic volume rose by 6.9 per cent, however, road traffic intensity (vehicle kilometres per GDP) fell by 6.0 per cent between 1998 and 2003.	*Government measures* • Climate change programme, DETR, November 2000. • UK Emissions Trading Scheme, Defra, August 2001. • Energy Efficiency Commitment, Defra, April 2002 and April 2004. • Renewables Obligation, Defra, April 2002 and December 2003. • Energy White Paper, DTI, 2003. • Energy Efficiency – the Government's Plan for Action, Defra, April 2004. • Air Quality Strategy, DETR, January 2000, and Addendum, Defra, February 2003, and review, Defra, 2003-04. • Implementation of Integrated Pollution, Prevention Control regime, Defra, 2002. • Continued support for local air quality management system. • Negotiation and implementation of EU air quality directives and international agreements 2003-04. • Ten Year Plan for Transport, DETR, July 2000, and review, DfT, 2003-04. • Powering Future Vehicles, DfT et al, July 2002. • Air Transport White Paper, DfT, December 2003. *Specific Budget measures* • Climate change levy (CCL) package. • Green Technology Challenge. • Road fuel duty and differentials. • Reforms to car, lorry, van and motorcycle VED. • Company car tax and fuel scale charge reform, and authorised mileage allowance payments. • Duty rate for rebated fuels. • Landlord's energy saving allowance. • Reduced VAT on installation of energy-saving materials and renewables.
Improving waste management.	*Household waste and all waste arisings and management* Household waste increased from 22.5 million tonnes in 1996-97 to 25.8 million tonnes in 2002-03. However, over the same period the proportion of household waste being recycled increased from 7.5 per cent to 14.5 per cent.[5]	*Government measures* • Waste Strategy 2000, DETR, May 2000. • Waste Implementation Programme, Defra, 2002. • Reform of the Waste Minimisation and Recycling challenge Fund. *Specific Budget measures* • Landfill tax and landfill tax credit scheme. • Business Resource Efficiency and Waste programme.
Regenerating Britain's towns and cities.	*New homes built on previously developed land* In 2003, 66 per cent of new housing was on previously developed land, increasing from around 54 per cent in 1990.	*Government measures* • Urban White Paper, DETR, November 2000. • Package of measures to tackle abandoned vehicles. *Specific Budget measures* • Capital allowances for flats over shops. • Contaminated land tax credit. • 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* Farmland birds almost halved between 1977 and 1993. However, declines have lessened in recent years and 2003 populations were virtually unchanged from 1993. Woodland birds fell by about 30 per cent between 1974 and 1998. Since then, however, populations have remained broadly constant. *Chemical river quality and biological river quality*[6] In 2003 about 95 per cent of rivers in the UK were rated as having good or fair chemical quality and approximately 96 per cent of UK rivers were of good or fair biological quality.	*Government measures* • Regulations transposing the Water Framework Directive came into force 2 January 2004. • Rural White Paper, DETR, November 2000. • Strategy for sustainable farming and food, Defra, December 2002. *Specific Budget measures* • Aggregates levy and aggregates levy sustainability fund. • Pesticides voluntary initiative.

[1] *Achieving a better quality of life – review of progress towards sustainable development, Defra, March 2004 – latest data from www.sustainable-development.gov.uk.*
[2] *The six main greenhouse gases are: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perflourocarbons and sulphur hexaflouride (provisional figure).*
[3] *Air quality headline indicator for sustainable development: 2003, Defra (provisional figures).*
[4] *Provisional data from DfT.*
[5] *Municipal Waste Management Survey, 2002-03, Defra.*
[6] *New measures of water quality will be needed under the EU Water Framework Directive; the Environment Agency is currently characterising water bodies to help establish these.*

Table 7.2: The environmental impacts of Budget measures

Budget measure	Environmental impact[1]
Climate change levy package.	Forecast savings of at least 5 million tonnes of carbon per year by 2010.[2]
Landlord's energy saving allowance for energy efficiency.	Reductions of carbon dioxide emissions.
VAT reduction for energy saving materials and domestic installation of renewable energy technologies.	Reduction of carbon dioxide emissions.
Enhanced capital allowances for energy-saving and water efficiency technologies.	Reductions in energy and water use by business.
Road fuel duty and differentials.[3]	The non-revalorisation of fuel duties is expected to have resulted in higher carbon emissions that would otherwise have been the case, although this is expected to have been partially offset by higher oil prices. The shift to ultra low sulphur petrol from ordinary unleaded is estimated to have reduced nitrogen oxided emissions by 1 per cent, carbon monoxide emissions by 4 per cent and emissions of volatile organic compounds by one per cent per year between 2001 and 2004. The shift to ultra low sulphur diesel 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 increased use of biodiesel and the introduction of bioethanol will help reduced carbon dioxide emissions. The road fuel gas differential will result in a reduction in emissions of particulates and nitroge oxides.
Rebated fuels.	A narrowing of the differential with main road fuels will reduce levels of fraud, which will deliver environmental benefits through increased use of less polluting fuels.
Reforms to car, lorry, van and motorcycle VED.	Reductions in emissions of carbon dioxide and local air pollutants.
Company car tax system.	Estimated carbon dioxide emissions savings of 0.15 to 0.2 MtC in 2004. In the long run it is forecast that carbon dioxide savings will be between 0.5 and 1 MtC per year.[4]
Employer-provided van benefit.	This will remove the incentive to drive older, more polluting vans and reduce emissions over time.
Company car fuel benefit charge.	The programme of increases over five years in the fuel scale charge between 1997-98 and 2002-03 is estimated to have reduced the number of drivers in receipt of free fuel by around 300,000.[4] It is expected that the programme has reduced carbon dioxide and local air pollutant emissions due to fewer private miles travelled where fuel has been paid for by drivers and not their employers. Restructure of the fuel scale charge in 2003 to relate it to carbon dioxide emissions and to include the same discounts and premiums as in the company car tax system will further reduce emissions of carbon.
100 per cent first year allowances for cars with low carbon dioxide emissions, and hydrogen and natural gas refuelling infrastructure.	Reductions in emissions of carbon dioxide and local air pollutants.
Air passenger duty.	The freeze in rates will lead to a small increase in emissions of carbon dioxide and local air pollutants.
Landfill tax.	Encourages waste producers and the waste management industry to switch away from landfill disposal towards waste minimisation, re-use and other waste management options.
Landfill tax credit scheme.	A scheme supporting local community and environmental projects in the vicinity of landfill sites.
Aggregates levy and aggregates levy sustainability fund.	Reductions in noise and vibration, dust and other emissions to air, visual intrusion, loss of amenity and damage to wildlife habitats.
Capital allowances for flats over shops.	Bringing empty space over shops back into the residential market, helping to create greater urban diversity while reducing the pressure for new greenfield development.
Contaminated land tax credit.	Bringing forward remediation of contaminated land.
Stamp duty exemption for disadvantaged areas.	Regeneration and improved functioning of property markets in the UK'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.

[1] These estimates are subject to a wide margin of error.
[2] Based on the DTI energy model. There are a number of difficulties involved in estimating the emissions savings from the individual components of the climate change levy, including the need to avoid double counting. Of the 5 MtC (million tonnes of carbon) per year by 2010, the levy and exemptions account for 2.0 MtC, the negotiated agreements account for 2.5 MtC and energy efficiency measures account for 0.5 MtC. A related measure, the UK emissions trading scheme, involves 31 direct participants who have undertaken binding commitments to deliver emissions reductions of 1.1 MtC by 2006. Subject to revision dependent on final outcome of Cambridge Econometrics review.
[3] Using NETCEN emissions models – further detail on the methodology used is provided in NETCEN's January 2000 report, UK Road Transport Emissions Projections. Between 1977 and 1999, the fuel duty escalator is forecast to have reduced emissions between 0.1 MtC and 0.2 MtC per year by 2010.
[4] Based on Inland Revenue modelling.

A THE ECONOMY

UK GDP has grown strongly over the past year. As many of the key uncertainties that had substantially dampened international activity receded during 2003, business and consumer confidence rose around the world and supported a solid resumption of output growth and world trade. Indeed, global growth in 2004 is robust, despite higher oil prices, which have been driven to record nominal highs largely by exceptionally strong demand growth. Against these positive international developments, UK GDP accelerated from mid-2003, and annual growth has now remained above trend for four consecutive quarters. There is also now significant evidence of a rebalancing in the composition of UK demand growth: latest data reveal private consumption has grown at more moderate rates over recent years than previously thought, while business investment has picked up strongly. However, despite historically high rates of world economic growth over the past year, a number of risks continue to surround the international outlook, some of which have become more prominent since Budget 2004.

With the economy still judged to be below trend, sound domestic fundamentals allied with a still buoyant outlook for world trade should allow a further period of growth at above trend rates over the short-term forecast horizon, without generating inflationary pressures. However, underlying growth has been easing gradually since late 2003 – when quarterly growth was at its fastest for almost four years – and this pattern is expected to persist through next year as the economy moves back towards trend. In the 2004 Pre-Budget Report forecast:

- **UK GDP is expected to grow by 3 to 3½ per cent in both 2004 and 2005, unchanged since the 2003 Budget forecast, as remaining slack in the economy is absorbed. This masks a continued easing in underlying growth during the course of 2005 before the output gap closes by early 2006.**
- **Consumer Prices Index (CPI) inflation is expected to rise gradually back to target by mid-2006, helped by monetary policy anchoring inflation expectations, and as upward pressure from import prices, accentuated by the recent depreciation of sterling, feeds through.**

Global developments remain a key influence on the UK outlook, and challenging judgements will continue to be faced in setting monetary and fiscal policy.

INTRODUCTION[1,2]

A1 This annex discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2007. It begins with an overview of developments and prospects in the world economy. It then outlines the Government's latest assessment of the UK economy, followed by a more detailed discussion of sectoral issues and risks.

[1] The UK forecast is consistent with national accounts and balance of payments statistics to the second quarter of 2004 released by the Office for National Statistics on 29 September 2004, and output, income and expenditure data for the third quarter released on 26 November 2004. 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.

THE WORLD ECONOMY

Overview

A2 The global economy has shown considerable strength over the past year, with growth rates comparable to those last seen 20 years ago. World growth during 2004 is estimated to be around 5 per cent – almost double the growth rate of 2001 when a number of the world's major economies suffered a slowdown. The strength of world growth is the result of much improved developments in both advanced and emerging economies. The US, Japan, China and wider Asia have all experienced strong growth, as have some other advanced economies where domestic demand has been strong. Growth in the euro area has improved and is now at around trend rates, although this is still low in comparison with other G7 economies.

Table A1: The world economy

	Percentage changes on a year earlier unless otherwise stated				
		Forecast			
	2003	2004	2005	2006	2007
Major 7 countries[1]					
Real GDP	2¼	3½	3	2¾	2¾
Consumer price inflation[2]	1½	3	2¼	1¾	1¾
Euro area					
Real GDP	½	2	2	2¼	2¼
World trade in goods and services	5	9½	8½	7¾	7¼
UK export markets[3]	3¾	8¾	8	7¼	6¾

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

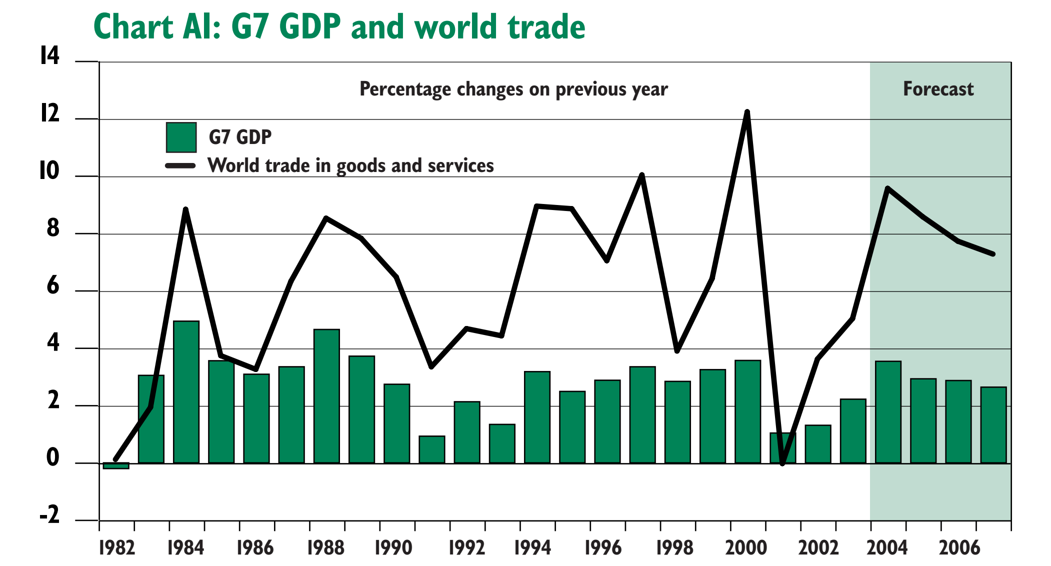
[2] *Per cent, Q4.*

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

A3 The recovery in advanced and emerging economies has contributed to a marked pick-up in world trade, from very low growth in 2001, with stronger intra-regional trade in Asia and Europe also contributing to strong growth. Some key economies, particularly Germany, Japan and much of emerging Asia, have been dependent on net exports to support GDP growth. This has led to a continuation of global imbalances, and highlights one of the risks to sustainable and balanced global growth going forward.

A4 However, a number of risks and uncertainties continue to surround the global economic outlook. High oil prices, global imbalances, household and corporate balance sheet adjustment, the need for fiscal consolidation in a number of countries and the possibility that inflationary pressures could build, present downside risks. These factors can influence growth directly, for example by lowering profit margins and household disposable income, and can also have secondary effects through confidence channels with a potentially larger impact on growth. On the upside, oil prices could decline more rapidly than expected and orderly monetary and fiscal adjustment could boost confidence, which would tend to strengthen growth.

A5 High and rising oil prices reflect the combined effects of a number of supply uncertainties, low stocks and rapidly rising demand. Whilst higher oil prices appear to have had some dampening effect on economic activity since the middle of 2004, the strength of world demand that has contributed to pushing up prices has remained robust.



A6 The strength of global growth, particularly in China, has also increased demand for raw materials, especially metals, pushing up primary commodity prices. This, together with high and rising oil prices, has fed through to a pick-up in headline inflation rates. However, due to relatively weak labour markets and continued spare capacity in many key economies, core inflation has been subdued to date.

A7 The improvement in global growth since 2003, and inflationary pressures stemming from higher commodity prices, have prompted a degree of monetary policy adjustment. This follows a prolonged period of historically low nominal and real interest rates. The shift in monetary policy will also have a positive impact in anchoring inflationary expectations before they begin to build. With monetary policy in most major economies focused on keeping inflation low and stable, the risks of any feed-through in the future remain low.

G7 activity

A8 Following a pick-up in G7 growth in 2003, economic activity has continued to strengthen in 2004, with a particularly marked acceleration in the early part of the year. This marks a significant improvement in global economic conditions compared with 2001 and 2002. G7 GDP growth is expected to be around $3^1/_2$ per cent in 2004 as a whole. In 2005, G7 growth is expected to settle back to around 3 per cent.

United States

A9 GDP growth in the US has been supported by strong private consumption as a result of monetary and fiscal stimulus during 2003 and early 2004, as well as solid house price growth and rising equity valuations which have boosted household wealth. Strong productivity growth has also contributed to robust GDP growth in the US, with GDP growing at 3 per cent in 2003. This has generated increased demand for imports, which has supported growth in a number of G7 and emerging economies.

A10 During mid-2004, private consumption growth moderated as high oil prices, rising interest rates, the expiry of temporary tax cuts and a weaker labour market all served to curb household spending. However, data released during the autumn show a recovery in private consumption and business investment growth. With levels of corporate profitability at historic highs, business investment growth should gain further strength in late 2004 and into 2005. US growth is recovering from the lull in mid-2004, and is expected to maintain a solid pace during 2005.

Euro area **A11** In the euro area, growth rebounded in the first half of 2004, and is expected to continue to grow at trend rates of about 2 per cent in 2004 and 2005. However, this is still low compared with other G7 and advanced economies. The recovery has been driven largely by a strong contribution from export growth, while domestic demand has made a much more limited contribution. However, this masks considerable variation across the member states. While Italy has experienced relatively modest growth, France and Spain have benefited from comparatively buoyant private consumption. In Germany, external demand has provided the main impetus to growth, while investment and consumption have been relatively weak. Looking forward, external demand should continue to support activity in the euro area, and a more widespread revival in investment and consumption should materialise over the next few years.

Japan **A12** After almost a decade of very weak growth, the Japanese economy appears to have picked up markedly in late 2003 and into 2004, although statistical uncertainties complicate the assessment. This turnaround has stemmed from demand for Japan's exports from Asia, particularly China, and the US, on top of a number of years of gradual reform and balance sheet adjustment. The sources of growth within the Japanese economy have started to broaden out, particularly towards private consumption, pointing to an improvement in the sustainability of growth over the medium term. In addition, after several years of deflation, the prospects for a return to inflation, albeit mild, are now more secure.

Emerging markets and developing economies

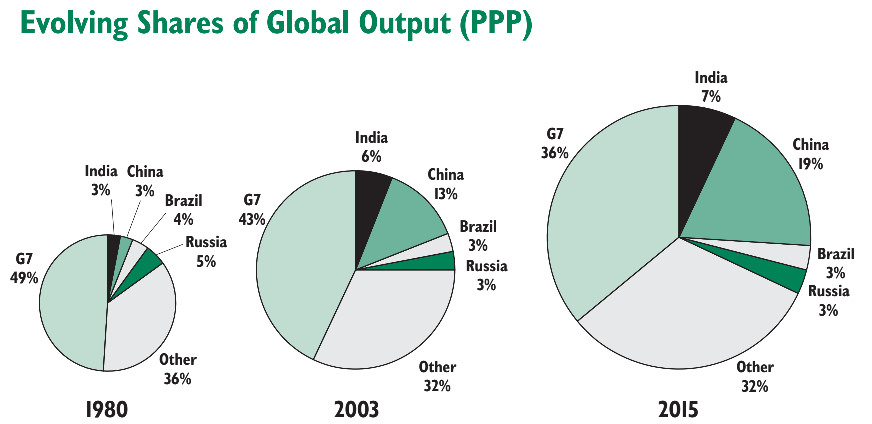
A13 Higher growth in the world's major economies has provided further support to activity in emerging market economies during 2004. In particular, Asian and Latin American economies have continued to benefit from buoyant US consumption, which has driven growth in demand for their exports. Trade between emerging markets has also become an increasingly important source of growth for these economies. In a number of countries, such as China and Brazil, these developments have helped to generate a pick-up in domestic demand and a general broadening of growth.

A14 Strong activity in emerging Asia has been largely underpinned by China, which has an increasingly significant role in shaping regional and global economic trends. Asia's prospects rely, in part, on the Chinese authorities' ability to moderate the current pace of growth to a more sustainable rate. Strong growth in India has been driven by expansion in the manufacturing and service sectors. Solid growth in Latin America has been aided by higher commodity prices, while the Middle East and Former Soviet Union countries have experienced strong growth on the back of higher than expected oil prices. Growth in Eastern Europe has also picked up, but has been somewhat constrained by lacklustre growth in Western Europe. Some African countries have experienced growth in 2004, but the picture is mixed. Concerted international action is required to ensure that all African countries can benefit from the global recovery and can participate fully in the world economy.

A15 The external financing environment for emerging markets remains generally supportive. During the second quarter of 2004 uncertainties relating to the onset and pace of monetary tightening in the US briefly caused emerging market bond spreads to widen but, as fears of a sharp rise in US interest rates receded, spreads returned to historically low levels. In addition, real interest rates have been relatively low. Financing conditions are likely to become more restrictive in the medium term as US interest rates continue to return to more neutral levels. However, emerging market debt now appears to be better structured and therefore more resilient to tightening global financial markets. Furthermore, a gradual and transparent withdrawal of monetary stimulus in the US should ensure a smooth transition towards higher interest rates and continued growth in emerging markets.

Box A1: Globalisation and emerging markets

***Long-term global economic challenges and opportunities for the UK*, published alongside the Pre-Budget Report, examines the changing nature of the global economy over the next decade. One of the key trends that it identifies is the rapid development of major emerging markets, particularly China and India.**



Source: IMF, Consensus Forecasts, HM Treasury.

Already, rapid growth in major emerging markets is driving a fundamental restructuring of the global economy. In 2004, world growth is forecast to be around 5 per cent, the strongest in around 20 years. Growth in emerging and developing countries is projected to be around 6½ per cent, compared to lower growth in advanced economies of around 3½ per cent. Emerging market growth is being driven by the re-emergence of China and India – together home to around a third of the world's population – as global economic powers. China and India are the second and fourth largest economies in the world respectively when measured on a purchasing power parity basis, and their shares of world GDP dwarf those of many of the smaller OECD countries when measured on the same basis. On such a basis, China alone contributed more to global GDP growth over 2001 to 2003 than the whole of the G7 combined.

Rapid development in China and India is due in part to market-based economic reforms. With liberalisation and the spread of markets, increasing numbers of Chinese and Indian workers are shifting into the more productive, traded economy – with the result that the world's production frontier has shifted outwards. Both countries now attract significant levels of foreign direct investment (FDI) – China has recently overtaken the US to become the world's largest FDI recipient. Moreover, rising skills and education levels are allowing these countries to compete increasingly in higher-skill sectors. Rapid growth has brought about significant poverty alleviation. On World Bank projections, the number of people living on less than one dollar per day in China and South Asia is expected to halve between 2000 and 2015.

Rapid growth in China and India is also having a profound impact on world commodity and manufactures markets. China is the world's largest user of steel, copper and iron ore and is contributing around a third of world oil demand growth. It is also the world's largest market for mobile phones. Together, China and India now account for 6½ per cent of world exports.

These developments have significant ramifications for the global economy. They create long-term challenges and opportunities for the UK economy. The Government's strategy for meeting them is summarised in Chapter 1, and described throughout this Pre-Budget Report.

World trade

A16 Growth in world trade picked up significantly in the second half of 2003 and during 2004, on the back of strong demand, particularly from the US, alongside robust growth in industrial production. In addition, stronger trade growth from emerging markets, particularly Asia, as well as improved export growth from the euro area and Japan, have boosted rates of trade growth. World trade has now grown from just above zero in 2001, the lowest in 20 years, to 5 per cent in 2003, and is expected to be around 9½ per cent in 2004. Increasing regional integration of production processes, reflecting the differing cost advantages of countries for different stages of the production process, together with rising consumption, have also contributed to greater intra-regional trade in Asia and wider Europe. Specifically, increasing comparative advantage in producing cheaper manufactures means that Asia is now a significant driver of world trade growth, underpinned by strong growth of final demand in North America and some European countries.

A17 Along with stronger world trade, UK export market growth has picked up in 2004 and is expected to be reasonably robust across the forecast horizon, albeit showing some moderation as world GDP and trade growth move towards trend rates. The improvement in UK export market growth reflects an improvement in growth since 2003 in the euro area, which is by far the UK's biggest export market, as well as demand growth in some other smaller economic regions that are important for UK exports, including Africa, Australasia, and the Middle East.

Oil and commodity prices

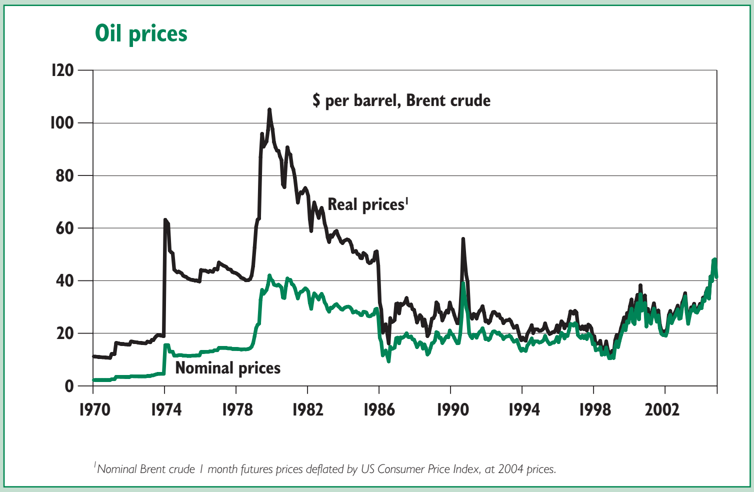
A18 Oil and non-fuel primary commodity markets have tightened over the past year, resulting in significant price growth. Rising demand for oil as the global economy has gathered pace, alongside disruptions and risks to supply, low stock levels, and low spare capacity have all contributed to tight supply and demand conditions and triggered upward pressure on prices, as discussed in Box A2. Price rises in non-fuel primary commodities, particularly materials and construction inputs, have principally been driven by strong demand from China and Asia resulting from their rapidly expanding industrial base.

A19 Brent oil prices started the year at around US$30 a barrel, but have since risen significantly, with peaks in October. Aside from supply uncertainties and disruptions, and low stocks which have continued since 2003, strong demand growth, disruption to production in the Gulf of Mexico and depleted spare capacity, have all added upward pressure to prices during 2004.

A20 With demand growth from Asia now representing a significant addition to more established demand from the major industrialised countries, and with the margin of spare supply capacity dwindling over the past couple of years, the oil market may be more volatile in the future than in recent years, as well as average prices being higher. While fundamentals suggest there is scope for some moderation in prices next year, the balance of risks to oil prices remains on the upside, with some associated risk to the outlook for global growth and inflation.

Box A2: Oil prices

Oil prices have risen significantly since the start of the year, reaching record nominal levels in October of over $50 per barrel for Brent, but have since fallen back somewhat. However, the situation is different to previous periods of high oil prices. Very strong global oil demand growth has been the principal driving force behind higher prices which, in real terms, are still well below the peak levels of the late 1970s and early 1980s.



With strong demand absorbing oil supplies, spare global oil production capacity and stocks are at low levels. The tight market has magnified market concerns over the continuity of supply from a number of key producers: Iraq (sabotage); Venezuela (political unrest); Saudi Arabia (terrorism); Russia (the financial position of Yukos); and Nigeria (strikes and social unrest). The economic effects of higher oil prices depend on the extent to which the increases derive from demand-side or supply-side factors:

- if oil price rises result from increased global demand for goods and services which in turn use oil as an input, then higher oil prices will be associated with a net increase in global GDP. While production costs will also rise, this will tend to choke off only some of the extra non-oil output, and oil production itself is also likely to rise; and
- if oil prices rise in response to a decrease in oil supply, the impact on global GDP is unambiguously negative, as higher production costs for non-oil goods and services constrain their supply.

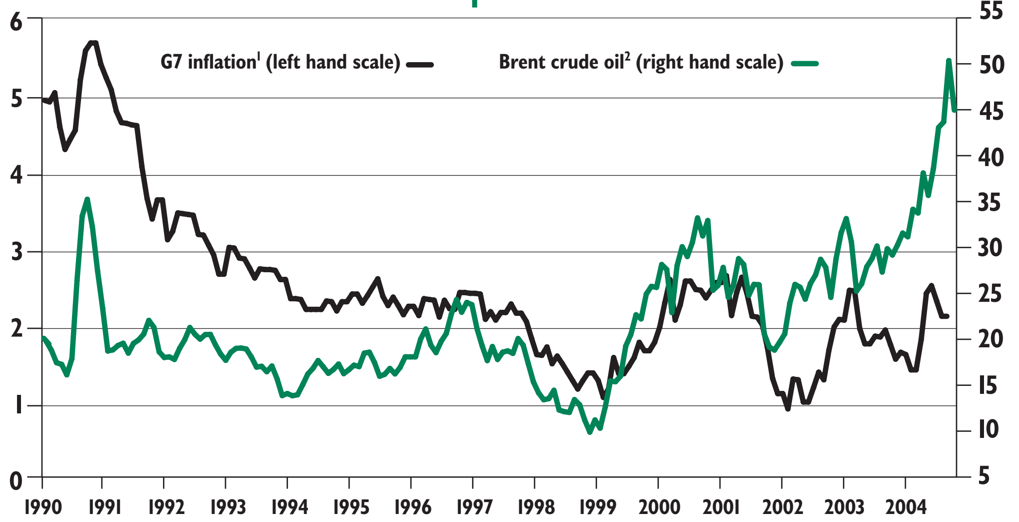
The impact of high oil prices on the global economy has so far been limited as strong world growth, particularly in Asia, has been a key driver of the rise in oil demand and therefore prices. Other factors have also helped: the oil intensity of world production has been decreasing since the 1970s; the real price of oil is still relatively low; and spare capacity coupled with weak labour markets in many advanced economies have so far offset the inflationary impact of the rise in oil prices. However, emerging economies have been more affected by oil price rises due to their higher energy intensity and lower energy efficiency.

Next year oil supply should continue to rise as producers respond to higher prices by expanding production capacity, while oil demand growth should moderate in the face of high prices. As a result, the market and most analysts expect oil prices to fall back, but only modestly and not to previous levels. However, the full impact of oil price rises is not yet clear, nor the extent to which business and consumer confidence may have been undermined. Sustained high oil prices therefore remain one of the primary risks to global growth and inflation in 2005.

G7 inflation

A21 During late 2003 and early 2004, the balance of concerns on inflation shifted from downside risks and the potential for deflation, to risks around mounting inflationary pressures. As the global economy has strengthened and commodity prices have increased, inflationary pressures have picked up, as reflected in the rise in headline inflation. However, core inflation has remained subdued and is still at historically low levels. This reflects weak labour markets in the US, Japan and the euro area containing wage pressures, and spare capacity in the G7 economies preventing price increases from being passed onto consumers. Deflation persists in Japan, though corporate price indices have started to pick up reflecting higher input prices. As a result of strong growth and signs that inflationary pressures have been building, some monetary authorities have already moved to contain inflationary expectations by raising interest rates. It therefore seems unlikely that inflation in the G7 economies will take hold.

Chart A2: G7 inflation and oil prices



[1] Consumer price index, percentage change on a year earlier.
[2] US dollars per barrel.

Forecast issues and risks

A22 A number of risks continue to surround the international outlook, some of which have become more prominent since Budget 2004. Most of the risks have both upside and downside potential. Near-term uncertainties include oil prices, which could be higher or lower then assumed, the possibility of a slightly quicker pace of monetary adjustment if inflationary pressures start to build more quickly, and sharp exchange rate fluctuations in response to US fiscal and current account deficits. Over the medium term, correction of global imbalances through exchange rate adjustment and growth realignment poses a risk to global growth, as does the need for fiscal consolidation and corporate and household balance sheet adjustment. However, resolving these problems through pro-active policy reform will make growth prospects more secure and sustainable.

A23 There are also a number of more region-specific risks to growth. For example, in the US, market reactions to the US fiscal and current account deficits could lead to sharper exchange rate adjustments. However, business investment growth could be stronger than projected given high levels of profitability. In the euro area, a continuation of narrowly based growth and relatively low trend growth rates could limit its contribution to G7 growth, but structural reform could lead to better utilasation of resources and therefore stronger trend growth. Japan's export led recovery and associated business investment growth could come under strain if China's path to more sustainable growth rates is more sudden than currently expected. However, with private consumption growth strenghtening and therefore growth broadening out, prospects for the sustainability of Japan's growth could improve faster.

A24 Global financial conditions are generally favourable, which is an important factor in supporting emerging market growth and progress on economic reform, but this could be unsettled, and bond spreads could rise, if monetary adjustment in the G7 has to move at a quicker pace or if exchange rate adjustments become more pronounced in response to current account imbalances, undermining emerging market growth.

UK ECONOMY

Overview of recent developments

A25 UK GDP growth so far in 2004 has been consistent with the Treasury forecast range of 3 to 3½ per cent for the year as a whole. This range was first published as the two-year ahead forecast in the 2002 Pre-Budget Report, and has since remained unchanged. The independent consensus has progressively come into line with it over the past year or so, having previously been significantly lower.

A26 During the global economic downturn that began in 2000, the Government's macroeconomic framework allowed the UK economy to remain resilient against the challenges and uncertainties arising from prolonged international weakness. In contrast to previous world slowdowns, low inflation and sound public finances allowed UK macroeconomic policy to respond swiftly to support output in the face of the significant weakening in global growth. The UK was the only G7 economy to avoid any quarters of negative growth between 2001 and 2003. The UK continues to experience its longest unbroken expansion since the introduction of quarterly national accounts data 50 years ago, with GDP now having grown for 49 consecutive quarters.

A27 UK GDP growth began to pick up sharply during the second quarter of 2003, as some of the previous major international uncertainties diminished and recovery in the world economy became more firmly entrenched. Business and consumer confidence rose from their early 2003 lows and, with UK domestic macroeconomic fundamentals remaining sound, rising confidence quickly translated into a pick-up in domestic demand growth in the second half of last year. Final domestic demand grew at its strongest rate for five years in the first quarter of 2004, at 1.2 per cent on the quarter, but has since moderated a little.

A28 As the world economy and UK domestic demand have strengthened, the independent Monetary Policy Committee (MPC) of the Bank of England has raised repo rates on five occasions since November 2003, with a cumulative increase of 1¼ percentage points, consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation at the target rate of 2 per cent for the CPI.

A29 Nonetheless, repo rates remain low by the standards of the past 50 years, currently standing at 4¾ per cent, and CPI inflation has been lower than expected and has remained below target, at around 1¼ per cent in recent months, despite rising oil prices. The credibility earned by the MPC has tended to anchor inflation expectations and reduce uncertainty about real interest rates and aggregate demand prospects in response to external shocks. This may at least partly account for an improvement in the short-term output-inflation trade-off through encouraging faster price adjustment in the face of tendencies for the economy to move away from trend, which may be an important factor in accounting for greater macroeconomic stability. Fiscal policy has supported monetary policy in helping to deliver economic stability, through the automatic stabilisers and an easing of the fiscal stance when the economy moved below trend and, subsequently as the economy returns to trend, by the overall impact of fiscal policy moving back towards a more neutral position.

A30 The labour market has remained robust in 2004, building further on the achievements of the Government's supply-side reforms in creating a more dynamic and flexible labour market. In the year to the third quarter, employment rose by just over 230,000. Although the employment rate has come down fractionally from its recent peak earlier in 2004, this reflects the population of working age rising a little faster than employment. Unemployment, measured on the International Labour Organisation (ILO) definition, declined by just under 110,000 in the year to the third quarter, with the rate falling to 4.6 per cent – the lowest among the G7 economies. Claimant unemployment has also continued to trend down, albeit a little more slowly than ILO unemployment, and stood at 2.7 per cent in October, 0.3 percentage points lower than a year earlier. Claimant unemployment has now been consistently below 1 million for over three and a half years. Over the past year, employment levels have risen in most regions and countries of the UK, with the West Midlands and the North East seeing the sharpest rise in their employment rates.

A31 In 2003 as a whole UK GDP rose 2.2 per cent, somewhat below its estimated trend rate. However, annual growth had already moved above trend by the final quarter of 2003, for the first time in three years, and it continued at above trend rates through the first half of 2004. GDP growth of 0.9 per cent in the third quarter of 2003 was followed by 1.0 per cent in the final quarter, 0.7 per cent in the first quarter of 2004 and 0.9 per cent in the second.

A32 Latest data suggest that growth in the economy eased in the third quarter of 2004 compared with the first half of the year, with GDP currently estimated to have risen by 0.4 per cent between the second and third quarters, though non-oil Gross Value Added (GVA) was up 0.5 per cent. The GDP reading appears to have been erratically low, with underlying growth considerably stronger. It was largely attributable to a decline in the manufacturing output index, which rose strongly in the second quarter before losing some ground in the third. However, oil and gas production was also unusually weak in the third quarter. Operators appear to have postponed routine maintenance work earlier in the year in order to capitalise on high oil prices, but were unable to delay this any further. Overall, weaker industrial production is estimated to have subtracted 0.3 percentage points from GDP growth in the third quarter.

A33 Manufacturing output has, however, risen modestly over the past year and, in the year to the third quarter, output remained 0.5 per cent up on a year earlier. The service sector has seen particularly strong expansion of late, with growth in the year to the second and third quarters of 2004 at its fastest for about four years. Growth within services has been broadly based, but particularly sharp in real estate, renting and business activities and financial intermediation. Royal Bank of Scotland Purchasing Managers' Indices (PMIs) have reported a continued expansion in output throughout all regions and devolved countries of the UK in recent months, despite some widespread easing compared with peaks around the turn of the year. Over the past year, London, the South East, South West and Northern Ireland have registered the strongest growth, according to PMIs.

A34 The rise in oil prices this year has gone hand-in-hand with strong global GDP growth, as discussed in Box A2. The recent oil price rise has still served as a negative supply shock for UK producers of non-oil goods and services. However, these same producers are also sharing in the stronger global demand for non-oil goods and services that has been driving up oil prices, boosting demand for UK exports. Moreover, the UK economy, by virtue of being an oil producer - indeed still a small net exporter of oil - also benefits from higher value added in the oil-producing sector. The net short-term impact on UK GDP of the negative supply and positive global demand effects associated with recent oil price movements is judged to be broadly neutral, though the impact on inflationary pressure is unambiguously positive. The UK is certainly less exposed to the risk of negative impacts on GDP and employment than most other major industrialised countries, and the global impact itself has so far been relatively limited for the reasons discussed in Box A2. The impact of oil prices on the UK public finances is discussed in Chapter 2.

A35 Despite strong growth of GDP, and nominal oil prices rising to record highs, wage pressures have remained subdued and CPI inflation has continued to undershoot its symmetrical 2 per cent target. CPI inflation stood at 1.2 per cent in October, and has averaged 1.3 per cent over the past 12 months.

Trend growth and the output gap

Table A2: Contributions to trend output growth[1]

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[2, 3]		Trend average hours worked[3]	Trend employment rate[3]	Population of working age[4]	**Trend output**
	Underlying	Actual				
	(1)	(2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1	2.22	2.04	–0.11	0.36	0.24	**2.55**
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	2.14	1.96	–0.37	0.36	0.66	**2.63**
Budget 2003	2.35	2.14	–0.47	0.43	0.50	**2.61**
PBR 2003 and Budget 2004	2.65	2.44	–0.47	0.42	0.54	**2.94**
PBR 2004	2.70	2.50	–0.43	0.41	0.58	**3.06**
Projection[5]						
2001Q4 to 2006Q4						
Budget 2002	2.10	2.00	–0.1	0.2	0.6	**2¾**
Budget 2003/PBR 2003/Budget 2004	2.35	2.25	–0.1	0.2	0.5	**2¾**
PBR 2004[6]	2.35	2.25	–0.1	0.2	0.5	**2¾**
2007Q1 onwards						
PBR 2004[6]	2.35	2.25	–0.1	0.2	0.3	**2½**

[1] *Treasury analysis based on judgement that 1986Q2, 1997H1 and 2001Q3 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components going forward. Columns (2) + (3) + (4) + (5) = (6). Full data definitions and sources are set out in Annex A of 'Trend Growth: Recent Developments and Prospects', HM Treasury, April 2002.*

[2] *The underlying trend rate is the actual trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant.*
Column (1) = column (2) + (1-a).column (4), where a is the ratio of new to average worker productivity levels. The figuring is consistent with this ratio being of the order of 50 per cent, informed by econometric evidence and LFS data on relative entry wages.

[3] *The decomposition makes allowance for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that hours lag output by just one quarter, though this lag is hard to support by econometric evidence, not least because quarterly LFS data only extend as far back as 1992Q2. Hours worked and the employment rate are measured on a working-age basis.*

[4] *UK household basis.*

[5] *Neutral case assumptions for trend from 2001Q3.*

[6] *Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2004Q4 are anchored.*

A36 The Treasury's neutral estimate of the economy's trend rate of output growth for the 2004 Pre-Budget Report is $2^3/_4$ per cent a year to the end of 2006 and $2^1/_2$ per cent from early 2007 onwards, unchanged from Budget 2004 and first introduced in Budget 2002.[3] Between the end of 2006 and 2010, projections by the Government Actuary's Department (GAD) show that demographic effects are expected to depress growth in the working-age population, and hence trend output growth, by $^1/_4$ percentage point, reflecting post-War baby-boom women reaching retirement age. The Treasury reassesses its estimates of trend growth around the time each cycle is judged to have ended.

A37 Table A2 presents historical estimates of trend output growth and its decomposition between the estimated on-trend points in 1997 and 2001, and for the preceding cycle, as well as the forward-looking assumptions for trend growth built up from projections of components for the current cycle and beyond.

Box A3: Assessing the output gap

Output gap estimates are subject to a range of unavoidable uncertainties, particularly for the most recent past. Treasury estimates for the current cycle involve assessment of both the latest on-trend point and the subsequent trend rate of output growth, as well as depending on the accuracy of recent national accounts data. Other methods of output gap estimation are at least equally prone to uncertainty, as discussed in the Budget 2002 Trend Growth paper.[a] Reflecting the challenging nature of the assessments involved, there is a growing body of literature that looks at the range of errors around real-time output gap estimates.[b] It is difficult to be sure whether movements in economic variables are due to cyclical, short-term factors or more permanent, structural factors.

As one illustration, it is possible that more of the recent fall in average hours worked could be structural rather than cyclical, implying a less negative output gap than currently estimated. Uncertainties also apply in the opposite direction, despite the Treasury's estimate of the current output gap being more negative than estimates by most outside analysts. For example, the lack of inflationary pressure from average earnings growth suggests that the NAIRU may have fallen significantly more than assumed, and could be below the current unemployment rate of 4.6 per cent. This points to countenancing that the sustainable employment rate over the current cycle may exceed the projection, assisted by the Government's policies to improve employment opportunity and work incentives, in which case the actual employment rate would be further below trend than estimated, indicating a more negative output gap.

The present forecast, implying the current cycle comes to an end in early 2006, depends for its reliability on the inter-related assessments of the current output gap and output growth prospects. As some outside forecasters expect, in the event that the current output gap were to prove less negative than now estimated, and this was solely accounted for by over-estimation of the current trend rate of growth, then the existing short-term growth forecast would imply the current cycle ending earlier than 2006.

[a] *Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002.

[b] For example, *Should we be surprised by unreliability of real-time output gap estimates? Density estimates for the Eurozone*, National Institute of Economic and Social Research, 2003; *Estimates of the output gap in real time: how well have we been doing?* Reserve Bank of New Zealand, 2004; and *Output gaps in real time: are they reliable enough to use for monetary policy?* Reserve Bank of Australia, 2002.

[3] *Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002.

A38 In arriving at the judgement to retain the $2^3/_4$ per cent trend growth assumption for the current cycle, the following developments since Budget 2004 have been assessed as not having a material impact on the trend rate of growth and so not warranting any changes:

- Updated population projections: GAD released their 2003-based population projections in September 2004. The updated projections do not imply any need to revise the previously assumed $^1/_2$ percentage point contribution of working-age population growth to trend output growth. The implicit net migration assumption makes slightly over $^1/_4$ percentage point contribution to trend output growth.

- GDP revisions: National accounts revisions introduced in Blue Book 2004 were relatively modest compared with last year's data changes.[4] Blue Book 2004 revised up GDP growth between 1999 and 2002 by 0.1 to 0.2 percentage points a year. There were small revisions to components of GDP, with government consumption being the most notable exception, partly reflecting improvements introduced in tandem with the Atkinson Review. These revisions slightly increased estimated productivity growth between the on-trend points in 1997 and 2001.

A39 The $2^3/_4$ per cent trend growth assumption continues to reflect a cautious approach to the assessment of trend productivity growth rather than mechanistically projecting forward the full extent of estimated trend productivity growth from the 1997 to 2001 period, which would imply trend growth 0.3 percentage points higher than assumed.

A40 In light of recent output data, the trend growth assumption implies a negative output gap in the third quarter of 2004 at around 1 per cent of non-oil GVA, consistent with the Budget 2004 projection. Estimates of quarterly non-oil GVA growth in the second half of 2003 have been revised up since Budget time, tending to narrow the estimated output gap, but this effect has been offset by the current estimate of non-oil growth in the third quarter of 2004, at 0.5 per cent, being lower than the Budget forecast. Consistent with the decomposition of trend output growth, the output gap can be broken down into components by comparing productivity (output per hour), average hours worked and the employment rate against their assumed trend levels that make up the overall trend output projection:

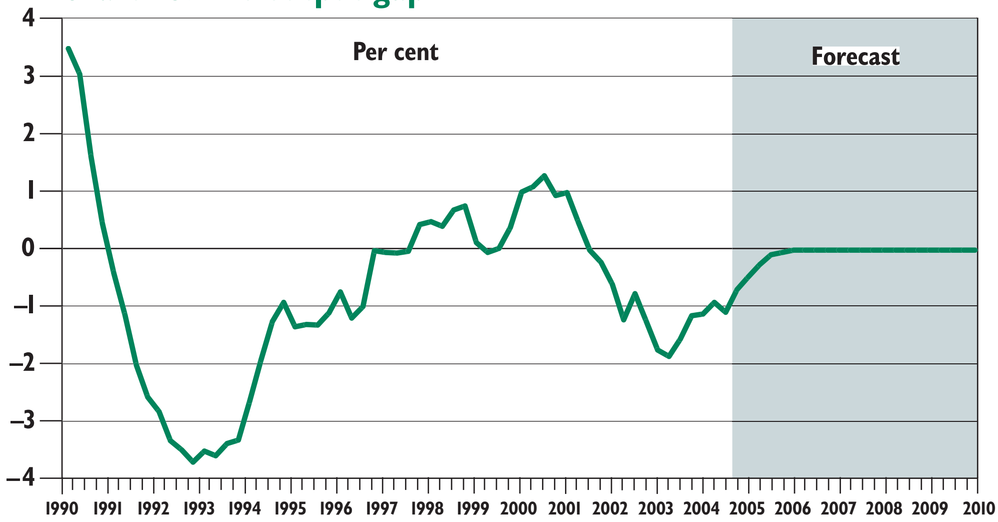
- between the third quarters of 2001 and 2003, the relevant measure of productivity grew below its assumed trend rate, averaging 2 per cent a year. However, with output accelerating and hours worked remaining relatively weak, output per hour has been growing well above its assumed trend rate since the end of 2003, and is now around its assumed trend level;

- average hours worked remain below their projected trend levels, implying a significant contribution to the negative output gap. The accelerated decline in average hours worked over the two years or so to early 2003 is judged largely to have been in response to global economic weakness, in the absence of convincing evidence to suggest it was structural. Average hours tend to move with the economic cycle as employers may prefer to adjust hours rather than employment when it is uncertain whether shocks to the economy are permanent or temporary. Over the past year or so average hours worked have continued to fall, but at a slower rate, and are judged to remain cyclically low;

[4] In September 2003, the Office for National Statistics introduced extensive new survey information and methodological improvements, including annual chain linking.

- the employment rate has grown at a little less than its assumed trend since the second half of 2003, and now makes an implied small negative contribution to the output gap. Growth in the employment rate can be divided between changes in the unemployment rate and changes in labour force participation. The unemployment rate has been below the assumed rate consistent with stable inflation (the NAIRU), implying a positive contribution to the output gap. However, participation has also been below assumed trend levels, entailing a negative contribution to the output gap, and the size of this effect has outweighed the unemployment rate effect.

Chart A3: The output gap[1]



[1] *Actual output less trend output as a percent of trend output (non-oil basis).*

A41 Thus the arithmetic of the assumed trend growth decomposition set out in table A2 attributes the estimated present negative output gap of around 1 per cent mainly to cyclical weakness in average hours worked, together with a small contribution from the employment rate.

A42 Other economic indicators also provide information on the output gap, including private sector business survey measures of capacity utilisation and recruitment difficulties:

- business survey indicators of capacity utilisation can be expected to be informative about the utilisation rates of both capital and labour that tend to drive fluctuations in output per worker around trend, and so mainly bear on the output per hour and average hours components of the output gap rather than the employment rate component. Surveys by the Confederation of British Industry (CBI) and British Chambers of Commerce (BCC) give mixed signals about the output gap, with capacity utilisation in manufacturing rising until the most recent quarter, and more volatile readings for the services sector;

- indicators of recruitment difficulties are more likely to provide information on the degree of slack in the labour market, and hence the employment rate component of the output gap. Survey indicators for both the manufacturing and service sectors have been fluctuating, but are now mainly just below levels seen on latest occasions when the output gap has been judged to be zero.

A43 Nevertheless, despite ambiguous signals from utilisation and to some extent recruitment indicators, wage and price data show little evidence of unsustainable inflationary pressures emerging. Although underlying average earnings growth, as measured by the rate excluding bonuses, appears higher than during the second half of 2003, it has been stable for the past six months. At around 4¼ per cent, it has remained significantly below the rate judged consistent with trend productivity growth and the inflation target in the medium term, despite the unemployment rate coming down to 4.6 per cent in the third quarter. In addition, CPI inflation recently has been well below the Bank of England's 2 per cent target, at around just 1¼ per cent over the past few months. The lack of apparent inflationary pressure in the economy lends strong support to the current assessment of a negative output gap.

A44 However, there are inevitable uncertainties that surround output gap estimates, as discussed in Box A3. The estimated output gap at the present time, together with the inter-linked judgements on trend and forecast rates of output growth, imply that the current cycle will come to an end in early 2006. However, were the present output gap less negative than estimated, then this would tend to point to the current cycle ending sooner.

A45 Another issue relevant to estimation of the current output gap relates to the method of trend projection for the current cycle. The cautious practice of not mechanistically projecting forward Blue Book upward revisions to trend productivity growth between 1997 and 2001 into the current trend output growth assumption provides an insurance against any factors that might tend to depress trend productivity in the current cycle relative to the 1997 to 2001 period. One such factor is the influence of compositional changes in the economy between higher and lower productivity sectors, and in particular between private and government sectors.[5] One possible implication is that at some point it may be desirable to refine the methodology for projecting trend growth and estimating the output gap.

A46 Notwithstanding these considerations, the balance of evidence on the components of the output gap and the evaluation of business surveys and indicators of inflationary pressure is judged to support the Pre-Budget Report retaining the 2¾ per cent neutral assumption for current trend output growth first adopted in Budget 2002. This is consistent with the assessment that the economy remains materially below trend. However, the public finance projections continue to be based on a deliberately cautious annual trend growth assumption that is ¼ percentage point lower than the neutral view.

Summary of prospects

A47 Sound macroeconomic fundamentals, recent underlying growth at above trend rates, and continued strong growth in the world economy point to a further period of robust growth in demand for UK output. Forward-looking private sector business survey indicators have already shown signs of stronger growth following a softer third quarter. For example, consumer confidence rose in both October and November and is currently above its long-run average and up on a year ealier, while the CIPS Reports on manufacturing and services point to a re-acceleration in demand in both sectors. Moreover, on the supply side, evidence of remaining slack in the economy supports the judgement that the economy has the potential for a period of further above trend growth in the short term, without risking inflationary pressures. UK GDP is expected to grow by 3¼ per cent in 2004, up from 2.2 per cent last year and 1.8 per cent in 2002, and unchanged since the Pre-Budget Report 2002 forecast.

[5] See Paragraph 3.11 of *Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002.

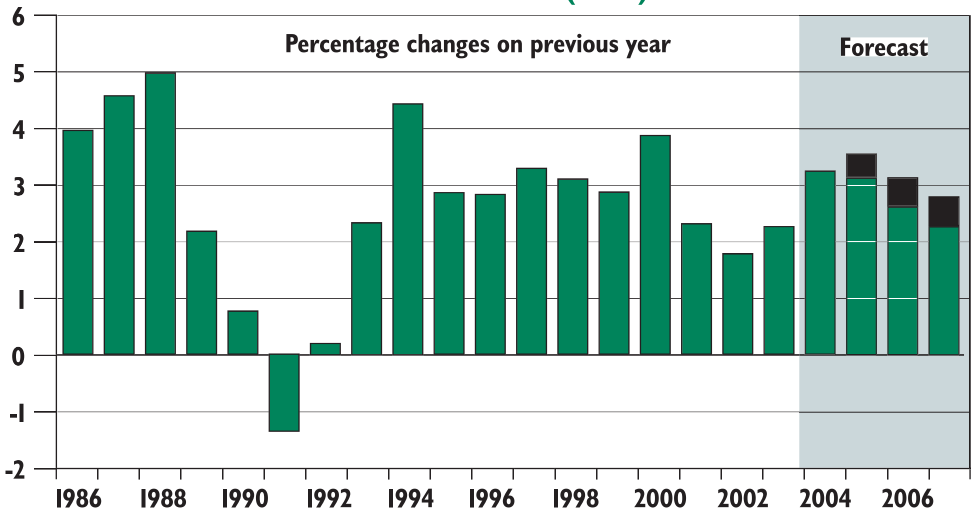
Table A3: Summary of forecast[1]

		Forecast			
	2003	2004	2005	2006	2007
GDP growth (per cent)	$2\frac{1}{4}$	$3\frac{1}{4}$	3 to $3\frac{1}{2}$	$2\frac{1}{2}$ to 3	$2\frac{1}{4}$ to $2\frac{3}{4}$
CPI inflation (per cent, Q4)	$1\frac{1}{2}$	$1\frac{1}{4}$	$1\frac{3}{4}$	2	2

[1] *See footnote to table A9 for explanation of forecast ranges.*

A48 Growth is forecast to remain within the 3 to $3\frac{1}{2}$ per cent range for 2005 as a whole. However, the annual figures mask an underlying gradual slowing since the second half of 2003 as the output gap narrows. By early 2006, the output gap is forecast to have closed and GDP growth is expected to be back to trend rates. Moreover, with UK export markets expected to grow strongly in 2005, albeit less quickly than in 2004, the forecast also sees a shift in the composition of growth, with easing domestic demand growth offset by a much smaller drag from net trade. GDP growth forecasts for 2005 and 2006, and the implied ending of the current cycle in early 2006, therefore remain as in the Budget 2004 forecast, which was itself unchanged from both Pre-Budget Report and Budget 2003. In 2007, GDP growth is forecast to ease to $2\frac{1}{4}$ to $2\frac{3}{4}$ per cent in line with the trend projection.

Chart A4: Gross Domestic Product (GDP)[1]



[1] *Shaded areas on bars represent forecast ranges.*

A49 Consumer Prices Index (CPI) inflation is expected to rise gradually back to target by mid-2006, as upward pressure from import prices, accentuated by the recent depreciation of sterling, feeds through. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

A50 Although the overall shape of the economic forecast is broadly unchanged from Budget time, the configuration of the surrounding risks and uncertainties has changed. In particular, high oil prices – if sustained – would tend to dampen growth, though to the extent that they partly reflect strong global demand rather than supply-side or risk premia shocks there are likely to be offsetting effects. Global developments will remain a key influence on the UK outlook, with risks on both the upside and downside, and challenging judgements will continue to be faced in setting monetary and fiscal policy.

UK DEVELOPMENTS AND PROSPECTS IN DETAIL

Demand

Consumption **A51** Real private consumption has grown broadly in line with the expansion of the economy as a whole over the recent past. It increased by almost 3 per cent in the year to the third quarter of 2004, supported by continued domestic macroeconomic stability with low inflation and further strong labour market outcomes. The four-quarter growth rate has averaged just under 3 per cent for the past year, in line with its post-2000 average and only marginally above the estimated trend rate of growth of the economy. In contrast, over the five years up to 2000, real private consumption had grown at an unsustainable average rate of over 4 per cent a year. Further evidence of the sustainability of recent rates of real private consumption growth is given by the declining share of *nominal* consumption in *money* GDP since 2001, with falling relative consumer prices providing significant support for real growth in spending. Although, the household saving ratio has recently moved slightly above its average since the late 1990s, over this period it has essentially been broadly flat, reflecting consumption on average growing in line with disposable income.

A52 With household debt still at historically high levels, households are expected to continue to be reluctant to increase spending at a faster rate than income. Recent interest rate increases and weaker growth in house prices may also act as further constraining factors on consumer spending growth. Private consumption is expected to rise by $3^1/_4$ per cent this year, broadly in line with GDP growth for the year. Thereafter, private consumption growth is forecast to be below GDP growth.

A53 Blue Book 2004 introduced revisions to government consumption going back to 1996. These revisions were partly attributable to new measures of real health output, implemented in tandem with the Atkinson Review. Although nominal government consumption was unchanged, there were significant upward revisions to estimates of real government consumption growth over recent years, and consequently lower increases in the implied deflator. Following strong growth over the past few years, real government consumption is expected to slow over the 2004 Spending Review period.

Investment **A54** Investment has strengthened significantly since early 2003, spurred by faster growth in government investment, continued strong growth in investment in private dwellings, and a marked upturn in business investment following what latest data show to have been a relatively shallow decline in the face of weakness in the world economy. With global conditions having strengthened, business confidence has risen compared with early 2003, and capital expenditure has followed suit. At the same time, private non-financial corporations have strengthened their balance sheets, becoming strong net lenders over the past two years, notwithstanding the stronger investment. Business investment has now grown for six consecutive quarters, and has clearly recovered from the effects of world economic weakness between 2001 and 2003.

A55 Business investment is expected to rise by $5^3/_4$ per cent in 2004, rather stronger than forecast in Budget 2004. With profitability and corporate balance sheets having strengthened considerably, and demand still judged to be growing strongly, business investment is expected to continue to grow solidly over the forecast horizon, albeit at a slightly slower rate than this year. It is forecast to rise by $4^1/_2$ to 5 per cent in 2005 and by $3^1/_2$ to $4^1/_4$ per cent in 2006. For the economy as a whole, growth in gross fixed capital formation is expected to be supported by continued strong growth in government investment into next year, reflecting the Government's spending plans.

Balance of growth **A56** The composition of UK GDP growth has therefore already undergone a significant degree of rebalancing. High levels of household debt, coupled with five increases in repo rates over the past year, have contributed in holding back private consumption growth. At the same time, the strong global environment has underpinned the pick-up in business investment seen over recent quarters. So far in 2004, whole economy gross fixed capital formation has grown by almost twice the rate of private consumption growth on a year earlier. Indeed, with further strong increases in the levels of government investment, quarterly growth in whole economy gross fixed capital formation growth has now been above that of private consumption in five of the past six quarters. The Pre-Budget Report forecasts a consolidation of these developments going forward, with investment growth outstripping that of consumption in every year of the projection period.

Exports **A57** There are also signs that improvements in external demand are beginning to feed through to UK exports. Until recently export growth had shown few signs of benefiting from the upturn in global demand since mid-2003, and goods and services export volumes ended 2003 marginally below levels prevailing at the start of the year. However, this masked a pick-up in growth to non-EU markets offset by further falls in export volumes destined for the EU, partly reflecting the composition of international demand growth in the initial stages of the global recovery. The recorded level of exports to the EU was also reduced by Customs and Excise efforts to tackle Missing Trader Intra-Community Fraud (MTIC), which led to the closure of a number of fraudulent VAT evading businesses and a reduction in illicit exports.

A58 Nonetheless, there have been signs of a broadening of export strength in the course of 2004. Goods export volumes in the third quarter were over 4 per cent up on a year earlier. Moreover, goods export volumes to the EU were at their highest level for a year and a half in the third quarter, though underlying growth to EU destinations continues to lag behind that to non-EU markets.

A59 Export growth is expected to gather more momentum in coming quarters as the recent pick-up in external demand continues to filter through to UK exports. The recent depreciation of sterling should provide some further impetus to export growth over the forecast horizon. UK goods and services export volumes are forecast to rise by 6½ to 7 per cent next year, building on growth of around 2¼ per cent this year, following two years when exports were more or less flat.

Table A4: Contributions to GDP growth[1,2]

	Percentage points, unless otherwise stated				
		Forecast			
	2003	2004	2005	2006	2007
Private consumption	1½	2	1¾	1½	1½
Business investment	0	½	½	½	¼
Government	1	1	1¼	¾	¾
Change in inventories	0	0	0	0	0
Net trade	–¼	–¾	0	0	0
GDP growth, per cent	**2¼**	**3¼**	**3¼**	**2¾**	**2½**

[1] *Components may not sum to total due to rounding and omission of private residential investment, the transfer costs of land and existing buildings and the statistical discrepancy.*

[2] *Based on central case. For the purpose of public finance projections, forecasts are based on the bottom of the forecast GDP range.*

Imports **A60** Import growth this year has picked up on the back of the acceleration in domestic demand. The pick-up in manufacturing output is also likely to have given an additional boost to imports through demand for component parts and semi-finished products. Imports of goods and services were up by over 6 per cent on a year earlier in both the second and third quarters of 2004, their fastest growth for over three years. Imports are forecast to grow slightly slower than exports in 2005 and beyond, implying a broadly neutral impact from net trade on GDP growth, following the drag exerted in 2004.

Output

A61 Manufacturing output growth has firmed significantly since the end of 2002. In 2003 as a whole, it rose marginally for the first time in three years, following a protracted period of declining output in almost all major economies. It then rose by 1.2 per cent between the first and second quarters of 2004, to stand 2.1 per cent higher than a year earlier. Moreover, most parts of the sector have seen output expand, with around three quarters of manufacturing industries recording positive growth in production over the past year. From a regional and country perspective, the BCC survey for the third quarter showed particularly strong growth in orders for manufacturers in the West Midlands, Wales and Yorkshire and Humberside.

A62 Over the third quarter, manufacturing output lost some of the ground made up since early 2003. Business survey evidence has also pointed to an easing in the pace of manufacturing output growth compared with the first half of 2004, although it has still signalled expansion.

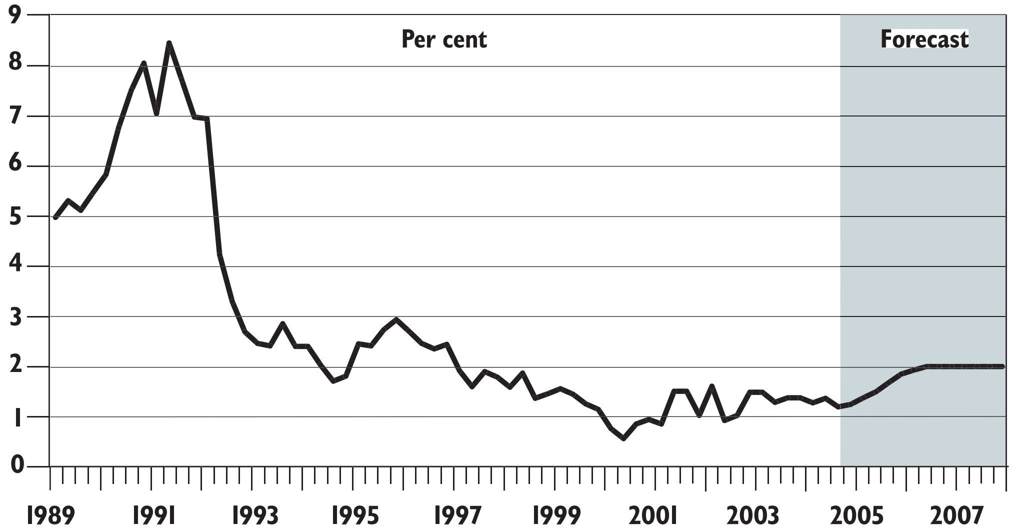
A63 Most indicators still point to underlying growth in the manufacturing sector. For example, while output has faltered, manufactured exports have continued to grow in recent months, while strengthening UK business investment should also give a boost to the production of capital goods in the near term. Most business survey indicators too are pointing to further growth in manufacturing output going forward, although at a slower rate than in the first quarter of the year. Manufacturing output is expected to grow by $1^1/_4$ per cent this year, up from $^1/_2$ per cent in 2003, with growth rising again in 2005 and 2006 to $1^1/_4$ to $1^3/_4$ per cent and $1^3/_4$ to $2^1/_4$ per cent respectively.

A64 Services output has continued to expand briskly in recent quarters, and is estimated to have risen 4 per cent in the year to the third quarter of 2004. Business survey evidence suggests the service sector should continue to expand at relatively robust rates going forward with the BCC survey for the third quarter showing particularly solid growth in domestic orders amongst service companies in the North East and East.

Inflation

CPI **A65** CPI inflation remains low. Over the past year, it has averaged 1.3 per cent, below the Government's symmetrical 2 per cent target. UK inflation remains among the lowest of all 25 EU countries. The gap between CPI and RPIX inflation has been broadly unchanged since Budget time, at just under 1 per cent.

A66 Recent inflation outturns reflect a variety of factors, with downward contributions more than offsetting a number of upward influences. This year saw relatively sharp seasonal reductions in airfares and, on a smaller scale, sea fares following the summer season. Price recoveries on clothing and footwear were also lower than normal after the summer sales. Average household energy bills have also risen of late, reflecting increases in gas and electricity tariffs. Unsurprisingly, as oil prices have risen, petrol and fuel prices have tended to exert an upward effect on inflation since the spring.



[1] Outturns until 2004Q3; forecasts for every second quarter from 2004Q4 to 2007Q4.

Producer prices

A67 Higher oil and commodity prices have fed through to increased manufacturers' input prices in recent months, with the cost of materials and fuels purchased rising by almost 8½ per cent in the year to October. While output prices have not accelerated to the same extent, suggesting some margin compression in the short term, they have picked up steadily over recent months, and rose at their fastest rate for over eight and a half years in the year to October.

Import prices

A68 Import prices fell almost continuously throughout the last world economic slowdown. As the world economy has strengthened and commodity prices have risen, goods import price inflation has picked up, rising at its fastest rate for four years in recent quarters.

House price inflation

A69 House price inflation picked up further over the spring and early summer, counter to most independent forecasters' expectations following earlier signs of easing. More recently, with five ¼ percentage point increases in repo rates since November 2003, coupled with high levels of existing debt, house price growth has again moderated. Halifax and Nationwide data show recent three-month on three-month house price inflation at its lowest for roughly four years. Regional indices suggest price growth in Greater London, the South East and the South West has been particularly weak in recent months.

Average earnings

A70 Average earnings growth has remained below rates judged consistent in the medium term with trend productivity growth and the Bank of England's 2 per cent symmetrical target for CPI inflation. Average earnings in the third quarter of 2004 were up 3.7 per cent on a year earlier, although excluding bonus payments they rose by 4.3 per cent over the same period, around the same rate that has been recorded since the spring. Private and public sector average earnings have increased at similar rates in recent months.

Prospects

A71 Going forward, the take-up of remaining slack in the economy is expected to remove a source of downward pressure on prices. With strong global demand growth already having contributed to higher world prices, the recently prolonged period of sterling import price deflation is expected to end, with the recent decline in the value of sterling also translating into a higher cost of overseas goods and services for UK consumers. As a result of these influences, inflation is forecast to rise through 2005 and to return to its 2 per cent symmetrical target by mid-2006. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

The household sector

Private consumption

A72 UK household consumption has not been growing at unsustainable rates over the recent past. On average over the past decade, nominal private consumption has grown at similar rates to the economy as a whole. However, since mid-2001 the share of nominal consumption in money GDP has trended downwards, as relative consumer prices have tended to fall, and the share has recently been at its lowest since the end of 1998, as shown in Box A4, chart a. The household saving ratio has risen slightly since 2002, and in the second quarter of 2004 stood a little above its average since the late 1990s. Over the past six years or so, households have not increased their spending at a faster rate than their income.

Table A5: Household sector[1] expenditure and income

		Percentage changes on previous year unless otherwise stated			
			Forecast		
	2003	2004	2005	2006	2007
Household consumption[2]	2¼	3¼	2¼ to 2¾	2 to 2½	2 to 2½
Real household disposable income	2¼	4	2½ to 2¾	1¾ to 2¼	1¾ to 2¼
Saving ratio (level, per cent)	5½	6¼	6½	6½	6½

[1] *Including non-profit institutions serving households.*

[2] *Chained volume measures.*

A73 Underlying real private consumption rose by almost 3 per cent in the year to the third quarter of 2004, and has continued to be supported by further strong labour market outcomes, sound macroeconomic fundamentals and continued falls in relative consumer prices. Retail sales growth, which comprises around 35 per cent of private consumption, has been particularly solid over much of 2004: in the third quarter volumes were up over 1 per cent on the previous quarter and about 6½ per cent on a year earlier.

A74 Nonetheless, growth in real consumer spending post-2000 has been comfortably below rates seen in the preceding five years, broadly keeping track with the economy as a whole, as shown in Box A4, chart (b). Over the three years to 2003, real private consumption growth averaged 2.8 per cent, close to the economy's estimated trend rate of growth and significantly weaker than the unsustainable rate of over 4 per cent averaged during the previous five years.

Housing and household debt

A75 Housing market indicators now unambiguously suggest activity is slowing down, and aggregate house price indices have stopped rising in recent months. This has prompted speculation about whether and by how much house prices might need to decline, and whether any such adjustment might be gradual or sharp, and the potential impact on consumer spending.

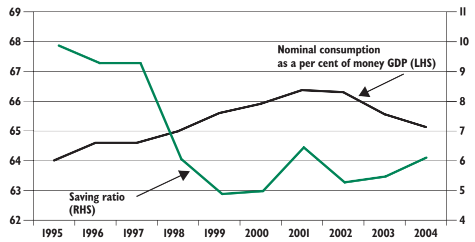
A76 The consensus view is that house prices exceed sustainable levels, though there is a wide range of opinion on the extent of disequilibrium. However, the common method of assessing this by comparing the current ratio of house prices to earnings (or some wider measure of income) with its long-run average can be highly misleading. There is no economic law to dictate that this ratio must revert to some constant level over the long term. Indeed, under conditions of price inelastic housing supply that characterise the UK housing market it would not be surprising if equilibrium house prices were to rise faster than incomes.

Time-series analysis of the ratio of house prices to income points to an upward trend, as suggested in Box A4, chart (c). If this were the case the implied extent of disequilibrium would be much narrower than if a constant ratio were assumed as the benchmark. Moreover, a relatively low degree of required adjustment, along with low inflation and general conditions of macroeconomic stability, tend to improve the chances of reversion taking place gradually rather than abruptly.

A77 Furthermore, in assessing the relationship between house prices and consumer spending, account should be taken not only of the effects via the impact on asset values for home-owners, but also effects tending to work in the opposite direction via the impact on the cost of housing services. This raises issues in interpreting the typically close co-movement between house prices and aggregate household consumption over the past (Box A4, chart (b)). Growth in real household consumption has been relatively moderate over the recent past when conditions of macroeconomic stability have prevailed. As house prices have risen so has mortgage equity withdrawal (MEW), with households maintaining a relatively stable proportion of equity in the value of the housing stock. MEW peaked at record levels earlier in 2004. However, instead of using it mainly to finance spending, households appear to have saved much of MEW, as borne out by the saving ratio edging up, and built-up their holdings of currency and deposits. Almost three quarters of the increase in households' mortgage debt since early 2000 has been matched by the rise in their deposit holdings.

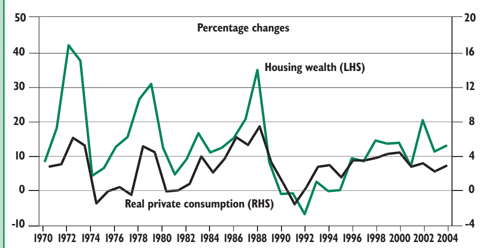
Box A4: Consumption and housing indicators

Chart a: Household saving ratio and nominal consumption[a]



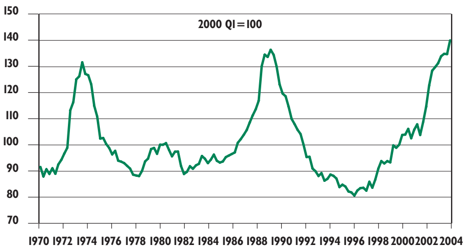
[a] 2004 = H1

Chart b: Housing wealth and real private consumption growth[a]



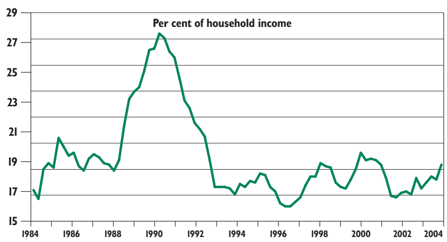
[a] 2004 = Part forecast.

Chart c: House price-income ratio



[1] OPDM Index

Chart d: Mortgage payments



[1] OPDM Index

A78 Some commentators have still questioned the sustainability of household spending in recent years on the grounds that household debt has become excessive. The ratio of household debt to income has risen to record levels, although growth in personal borrowing has eased back. Total lending to individuals rose at its slowest rate for around two years in the year to October, with both secured borrowing and unsecured credit growth having moderated. However, personal borrowing needs to be viewed alongside movements in overall household liabilities and assets: where households have significant levels of financial assets that can be easily liquidated, then the risk of debt burdens becoming unmanageable is reduced. A 2003 NMG Research survey for the Bank of England showed that the level of personal debt is positively correlated with income, and that debt had risen only amongst debtors in the highest income group over the previous three years, suggesting less exposure to the risk of adverse shocks than if borrowing has been concentrated amongst lower income groups. Moreover despite high levels of mortgage debt, the burden of mortgage repayments in relation to income for new mortgage holders remains low (Box A4, Chart d).

A79 Thus not only is the risk of a sizeable downward adjustment in house prices easily exaggerated, but conditions of macroeconomic stability may serve to limit the risk of any such adjustment significantly curtailing spending. Nevertheless symmetry across differing stages of the housing market cycle cannot be taken for granted, and the possibility of a housing market downturn adversely impacting on the wider economy needs to be recognised.

Prospects

A80 Real private consumption is forecast to rise by 3¼ per cent in 2004. While this is higher than seen over 2003 as a whole, it largely reflects a particularly strong rise in the first quarter of the year, with significantly weaker growth in subsequent quarters. The easing of consumption growth in recent years is expected to be consolidated going forward, as recent increases in interest rates, existing levels of debt, and more moderate house price inflation tend to inhibit borrowing and spending. Real private consumption is thus forecast to rise by between 2¼ and 2¾ per cent next year and by 2 to 2½ per cent in 2006, below the forecast rates of GDP growth. The saving ratio is expected to rise a little further next year and to stabilise thereafter.

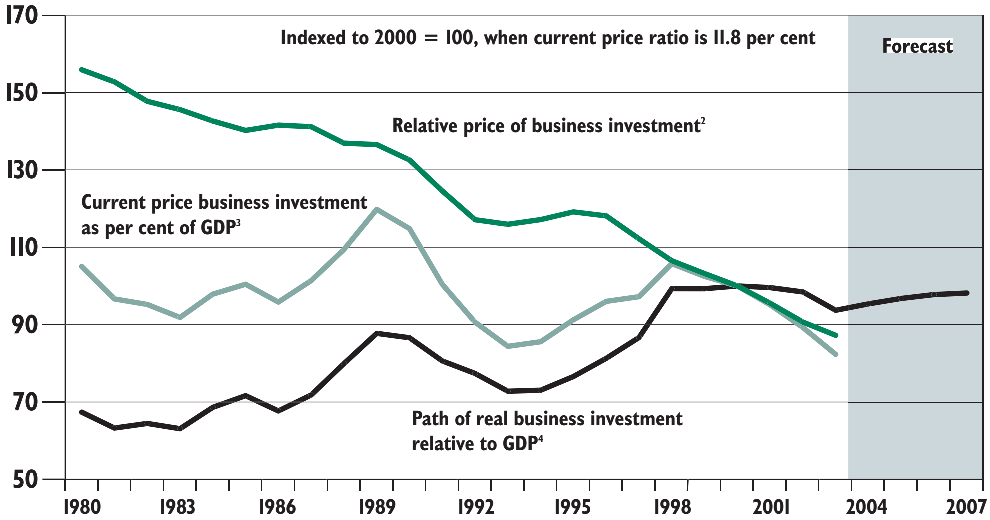
Companies and investment

A81 As with most industrialised countries, UK business investment was adversely affected by the weakness of the world economy between 2001 and 2003. However, although some temporary stalling during that period remains evident, latest data now show business investment held up far better than had been initially estimated. For example, preliminary data suggested a decline in business investment expenditure of 10 per cent in 2002. After subsequent revisions, reflecting both new information and methodological change, the data now show a small increase compared with 2001. Latest data also confirm that the downturn in business investment over the recent past was far shallower than in previous global slowdowns, with a peak to trough fall in the level of business investment of 6¾ per cent comparing with a decline of almost 20 per cent in the early 1990s.

A82 Indeed, since the end of 2001, latest data show there has only been one quarter in which business investment expenditure contracted. A sharp fall in the first quarter of 2003 coincided with the peak of international uncertainties and weakening in business sentiment throughout the global economy. The relatively smooth path of business investment in recent years suggests enhanced macroeconomic stability in the UK economy may have reduced the volatility of capital spending, compared with the very pronounced fluctuations of previous cycles.

A83 Since early 2003, as the global environment has strengthened, general business conditions have improved significantly, and UK business confidence rose solidly between early 2003 and 2004. Although recent months have seen a softening in sentiment, partly as a result of concern about rising oil and commodity prices, confidence generally remains firmer than in late 2002 and early 2003. Business sentiment has also seen some divergences between different regions and countries of the UK in recent months. While the CBI Regional Trends Survey for the third quarter reported a weakening in confidence nationally, this masked rising optimism in Yorkshire and Humberside, the North East and South West.

Chart A6: Business investment[1]



[1] *Business investment includes investment by public corporations and investment under the Private Finance Initiative.*
[2] *Ratio of implied business investment deflator to GDP deflator.*
[3] *Ratio of business investment to GDP in current prices.*
[4] *Ratio of business investment to GDP in chained volume measures.*

A84 At the same time, the pick-up in the international economy and the acceleration in domestic demand growth has bolstered profitability amongst UK businesses, despite the recent effects of rising commodity prices on input costs alongside less buoyant rates of output price inflation. Wage growth has remained subdued. Rates of return amongst private non-financial companies in the second quarter of 2004 were at their highest level since the end of 1999.

A85 Improved global prospects and strengthening in corporate conditions have underpinned a significant turnaround in real business investment over recent quarters. It has now increased for six consecutive quarters, and so far this year stands almost 6 per cent up on a year earlier. Real business investment has also been supported by declining prices for investment goods, with nominal capital spending having risen only modestly over the recent past. However, nominal expenditure on computer software and hardware – where asset prices typically trend downwards – has increased particularly sharply, rising over 13 per cent in the year to the third quarter of 2004, over twice the rate of increase in total business capital spending.

Table A6: Gross fixed capital formation

	Percentage changes on previous year				
		Forecast			
	2003	2004	2005	2006	2007
Whole economy[1]	2¼	6½	6¾ to 7¼	3¼ to 3¾	2¾ to 3¼
of which:					
Business[2,3]	–1	5¾	4½ to 5	3½ to 4¼	2½ to 3¼
Private dwellings[3]	8	9½	1¼ to 1½	1½ to 2	1¾ to 2¼
General government[3]	23½	5¾	30¾	4¾	5¾

[1] *Includes costs associated with the transfer of ownership of land and existing buildings.*

[2] *Private sector and public corporations' non-residential investment. Includes investment under the Private Finance Initiative.*

[3] *Excludes purchases less sales of land and existing buildings.*

A86 Business survey indicators point to further gains in investment spending going forward, with the BCC survey for the third quarter of 2004 showing both manufacturers and service sector firms intending to raise plant and machinery expenditure in coming months. In both manufacturing and services, investment intentions were strongest in the South West, while planned spending on plant and machinery was also relatively strong amongst manufacturers in Yorkshire and Humberside and service companies in the East.

A87 Pension fund deficits have decreased a little over the recent past, on account of rising equity values but also due to some companies raising cash contributions with the aim of tackling existing shortfalls. Overall there is little reason to change the Budget 2004 judgement regarding the likely impact of existing deficits on future business investment prospects.

Prospects

A88 In Budget 2004, business investment was considered to present upside risks to the economic forecast this year, and the current projection for 2004 is higher than the Budget forecast, with business investment now expected to grow by 5¾ per cent, compared with 3½ to 4 per cent at Budget time. Beyond 2004, business investment is forecast to continue growing solidly, although the projection cautiously assumes weaker growth than seen in previous cycles. The relatively shallow downturn in investment spending as the world economy slowed implies companies should have a lighter backlog of delayed capital projects to bring on stream under stronger international conditions. The Government's success in delivering macroeconomic stability may now be starting to encourage a smoother evolution of business investment spending relative to historical experience.

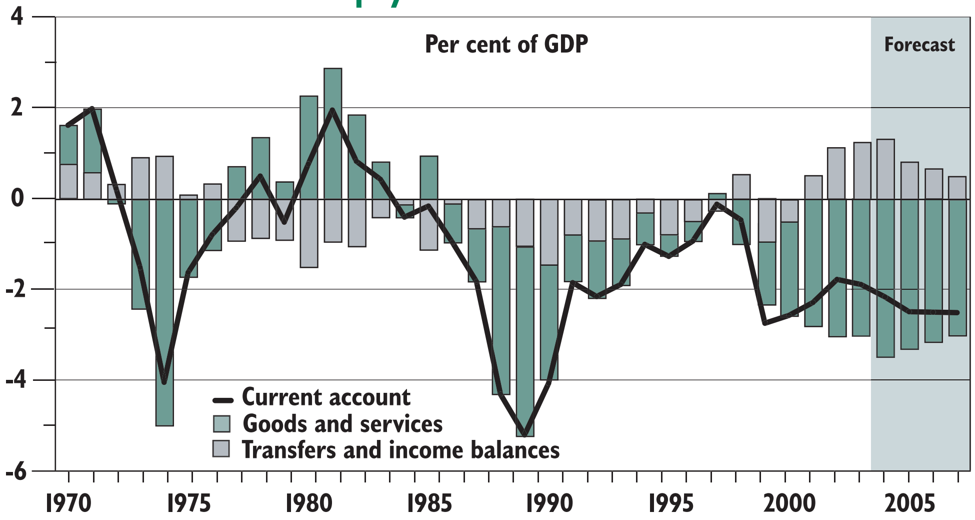
A89 Government investment is expected to continue growing strongly into next year, in line with the Government's spending plans.

Trade and the balance of payments

Trade in goods

A90 Trade volumes have been more erratic than usual of late, especially to non-EU markets where the introduction of a new system for recording export transactions by HM Customs and Excise has temporarily affected the recorded monthly export profile in recent months. Nonetheless, exports appear to have gained momentum through the course of 2004 on the back of stronger external demand. In the third quarter, goods export volumes were up over 4 per cent on a year earlier, with volumes to EU markets up over 5 per cent against a 3 per cent rise to non-EU destinations, though underlying growth in exports still appears to be somewhat stronger to the non-EU.

Chart A7: Balance of payments current account



A91 However, aggregate data on EU and non-EU exports masks variations within these markets. UK exports have risen strongly to many key EU economies in the course of the past year. Yet, despite strong growth of the US economy, nominal goods exports to that market have remained broadly flat, in contrast to many other non-EU destinations to which exports have grown sharply. Recent trade figures also continue to highlight the increasing importance of China to the UK's non-EU trade. In the third quarter of 2004, the nominal value of both exports to and imports from China was up about 30 per cent on a year earlier.

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]	
2003	0	1¼	1¼	½	¾	–32¾
Forecast						
2004	2¼	4¾	–¾	–¾	¼	–39¾
2005	6½ to 7	6 to 6¼	1¼	1	¼	–40
2006	6¼ to 6¾	5¼ to 5¾	2¾	2¾	0	–40¼
2007	6¼ to 6¾	5¼ to 5¾	2¼	2¼	0	–40½

[1] *Average value indices.*

[2] *Ratio of export to import prices.*

A92 Strong UK GDP growth has fed through to higher import volumes over the recent past. Goods import volumes rose about 7½ per cent in the year to the third quarter of 2004, the fastest rate of growth for three and a half years. As a result of import growth outstripping that of exports, the trade in goods deficit was £2¾ billion larger in the third quarter than a year earlier.

Trade in services

A93 A rising services surplus has, however, resulted in a more moderate widening of the total trade deficit. While the UK registered a deficit on oil trade in September, this reflected the impact of delayed maintenance work in reducing output and exports, and the UK remains a small net exporter of petroleum.

Current account **A94** As a result of the larger deficit on trade in goods and services, the current deficit has widened a little since the end of 2003 although, as a share of GDP, it has been broadly flat over the past five years. At the same time, the overseas investment income surplus has also eased back a little. Even after a recent slight moderation, the income surplus remains robust and close to historically high levels. Indeed, over the past eight quarters the income surplus has averaged 2 1/4 per cent of GDP, compared with a long-run average of 0.5 per cent. Some of this is likely to reflect temporary factors that are expected to unwind over the forecast horizon.

Prospects **A95** Export growth is forecast to gather more momentum in coming quarters as the recent pick-up in external demand continues to filter through to UK exports. Moreover, the sterling Exchange Rate Index has depreciated by around 4 per cent since the summer, largely due to a softening in the pound's value against the euro. This should provide some additional impetus to export growth over the forecast horizon. Goods and services export volumes are forecast to rise by 6 1/2 to 7 per cent next year, building on growth of around 2 1/4 per cent this year and following two years when exports were more or less flat.

A96 In 2004, UK export volumes are expected to grow significantly less than UK export markets and world trade, implying a corresponding loss of market share. While UK export market share has historically trended downwards, partly as a by-product of emerging economies experiencing strong growth of their internationally traded sectors, the recent implied fall is larger than would be expected on the basis of long-term trends. The forecast assumes further loss of market share, but more in line with its longer-term trend rate of decline.

A97 With the trade deficit widening a little next year, and the income surplus expected to moderate slightly compared with the record levels of recent years, the current deficit is expected to widen slightly in 2005, and thereafter to stabilise at around 2 1/2 per cent of GDP.

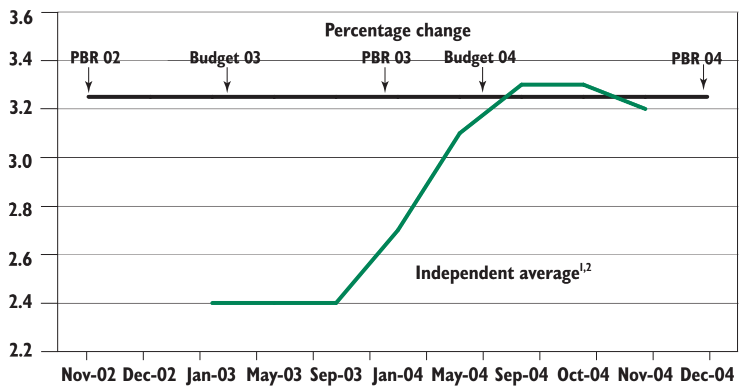
Independent forecasts

A98 The 2004 Pre-Budget Report forecast for GDP growth in 2004 of 3 1/4 per cent is at the centre of the forecast range of 3 to 3 1/2 per cent that has been maintained unchanged since it was first published as a two-year ahead forecast in the 2002 Pre-Budget Report. In contrast, the average of independent forecasts for GDP growth in 2004 (which was not fully canvassed until early 2003) was 2.4 per cent at the time of Budget 2003, rising progressively after the summer to 2.6 per cent by the time of Pre-Budget Report 2003 and 3.0 per cent by the time of Budget 2004. Subsequently the independent average for 2004 has increased further, and in November stood at 3.2 per cent, exactly in the middle of the 3 to 3 1/2 per cent range. The Treasury's recent economic forecasting performance is discussed in Box A5.

Box A5: Recent economic forecasting performance

As was the case at the time of Budget 2004, the Pre-Budget Report forecast for UK GDP growth in 2005 is higher than the latest external consensus, as presented in HM Treasury's comparison of independent forecasts.

HM Treasury and independent average GDP forecasts for 2004



[1] *Forecasts for the UK economy: A comparison of independent forecasts, HM Treasury.*
[2] *The average of independent forecasts for 2004 was not fully canvassed until January 2003.*

This is not the first time in recent years that Treasury forecasts have been above the prevailing consensus for a prolonged period. As discussed elsewhere in this annex, at the time of Budget 2003, the Treasury's GDP growth forecast for 2004 – at 3 to 3½ per cent – was significantly above the independent average but outside forecasters have subsequently converged on the Treasury's projection, as shown in the chart. Moreover, during the Asian and emerging markets crisis of the late 1990s, outside forecasters took a more pessimistic view of UK prospects at the time of Budget 1999: the independent average for GDP growth in that year was 0.6 per cent, compared with the Budget forecast range of 1 to 1½ per cent. In the event, the Treasury's projection proved closer to the actual outturn for the year, although both Treasury and outside forecasts proved too pessimistic, with subsequent data revisions for 1999 now showing GDP growth of 2.9 per cent.

More generally, the Treasury's recent forecasting record has been relatively good. Analysis of forecast errors for current and year-ahead forecasts made since 1995 indicates that Treasury forecasts have on average outperformed the independent consensus. However, both HM Treasury and the independent forecast have tended to under-predict GDP growth more often than they have over-predicted in recent years.

A99 Since the 1975 Industry Act first obliged governments to publish economic forecasts twice a year, it is without precedent for a government GDP growth forecast for any particular year to have been maintained unchanged for five successive forecasts up to and including the forecast made in the autumn of the year in question.

Table A8: Budget and independent[1] forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2004			2005		
		Independent			Independent	
	PBR 2004	Average	Range	**PBR 2004**	Average	Range
Gross domestic product	3¼	3.2	2.9 to 3.6	3 to 3½	2.5	0.5 to 3.5
CPI (Q4)	1¼	1.4	1.2 to 2.0	1¾	1.8	1.3 to 2.8
Current account (£ billion)	–24¾	–26.6	–31.8 to –18.0	–30¼	–28.6	–41.2 to –15.0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts', November 2004.*

A100 The independent average GDP forecast for 2005, at 2.5 per cent, is currently still below the Pre-Budget Report range of 3 to 3½ per cent. Independent forecasters expect CPI inflation to rise to just fractionally below target by the end of next year.

Forecast risks

A101 The configuration of risks and uncertainties surrounding the economic forecast has changed since Budget time, and challenging judgements continue to be faced in setting monetary and fiscal policy, for example in estimating the economy's supply-side potential. Global developments remain a key influence on the UK outlook. Near-term uncertainties, which apply both ways, include movements in oil prices and their economic effects. Over the medium term, key factors posing risks to the global economy include correction of global imbalances through exchange rate adjustment and growth realignment, and the need for fiscal consolidation and corporate and household balance sheet adjustment in some countries.

A102 UK house prices continue to pose risks both ways, despite recent signs of gradual adjustment. While a smooth adjustment remains the most likely outcome, a sharper correction cannot be ruled out. However, evidence suggests that with the Government's macroeconomic framework delivering stability, private consumption growth has been relatively moderate compared to previous episodes of strong house price inflation, so the potential economic consequences of a weaker housing market would seem less clear than in the past.

A103 There are also upside risks to the UK forecast. For example, as has been the case in 2004, business investment could continue to surprise on the upside, given rising profitability and the improvements in corporate balance sheets over the recent past; and there may be headroom for stronger consumer spending without household finances getting stretched.

Table A9: Summary of economic prospects[1, 2, 3]

	Percentage changes on a year earlier unless otherwise stated					
				Forecast[4]		Average errors from past forecasts[5]
	2003	2004	2005	2006	2007	
Output at constant market prices						
Gross domestic product (GDP)	2¼	3¼	3 to 3½	2½ to 3	2¼ to 2¾	¾
Manufacturing output	½	1¼	1¼ to 1¾	1¾ to 2¼	1¾ to 2¼	1¾
Expenditure components of GDP at constant market prices[6]						
Domestic demand	2½	4	3 to 3½	2½ to 3	2¼ to 2¾	¾
Household consumption[7]	2¼	3¼	2¼ to 2¾	2 to 2½	2 to 2½	¾
General government consumption	3½	4½	3	3	2½	1
Fixed investment	2¼	6½	6¾ to 7¼	3¼ to 3¾	2¾ to 3¼	2¼
Change in inventories[8]	0	0	0	0 to ¼	0	¼
Exports of goods and services	0	2¼	6½ to 7	6¼ to 6¾	6¼ to 6¾	2½
Imports of goods and services	1¼	4¾	6 to 6¼	5¼ to 5¾	5¼ to 5¾	2¼
Balance of payments current account						
£ billion	–20½	–24¾	–30¼	–31¾	–33¼	9
per cent of GDP	–1¾	–2¼	–2½	–2½	–2½	¾
Inflation						
CPI (Q4)	1½	1¼	1¾	2	2	–
Producer output prices (Q4)[9]	1½	3½	2½	2	2	1½
GDP deflator at market prices	3	2¼	2½	2¾	2¾	¾
Money GDP at market prices						
£ billion	1100	1161	1226 to 1231	1292 to 1303	1356 to 1376	8
percentage change	5¼	5½	5¾ to 6	5¼ to 5¾	5 to 5½	¾

[1] *The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2004, released by the Office for National Statistics on 29 September 2004, and output, income and expenditure data to the third quarter released on 26 November 2004.*

[2] *All growth rates in tables throughout this chapter are rounded to the nearest ¼ percentage point.*

[3] *As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of 2½ per cent a year trend growth used as the basis for projecting the public finances.*

[4] *The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

[5] *Average absolute errors for year-ahead projections made in autumn forecasts over the past 10 years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2004 and 2005.*

[6] *Further detail on the expenditure components of GDP is given in Table A10.*

[7] *Includes households and non-profit institutions serving households.*

[8] *Contribution to GDP growth, percentage points.*

[9] *Excluding excise duties.*

Table A10: Gross domestic product and its components

		£ billion chained volume measures at market prices, seasonally adjusted									
		Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
2003		697.6	203.7	173.6	2.5	1077.4	272.9	1350.3	315.9	0.2	1034.6
2004		719.5	212.8	185.1	2.2	1119.6	279.2	1398.8	330.5	0.2	1068.4
2005		735.8 to 739.0	219.0	197.7 to 198.5	1.5 to 2.4	1154.0 to 1158.9	297.5 to 298.8	1451.5 to 1457.7	350.0 to 351.5	0.2	1101.6 to 1106.3
2006		750.8 to 757.7	225.8	204.0 to 205.9	1.8 to 3.9	1182.4 to 1193.3	316.3 to 319.2	1498.7 to 1512.5	368.5 to 371.9	0.2	1130.4 to 1140.8
2007		766.0 to 776.8	231.6	209.7 to 212.7	0.5 to 3.8	1207.8 to 1224.8	335.8 to 340.5	1543.6 to 1565.3	387.9 to 393.3	0.2	1155.9 to 1172.2
2003	1st half	346.2	100.3	85.7	0.7	533.0	136.5	669.6	157.0	0.1	512.7
	2nd half	351.5	103.3	87.9	1.8	544.4	136.4	680.8	159.0	0.1	521.9
2004	1st half	357.6	105.5	91.3	1.8	556.1	137.2	693.3	162.9	0.1	530.5
	2nd half	361.8	107.4	93.9	0.5	563.5	142.0	705.5	167.7	0.1	537.9
2005	1st half	365.9 to 367.0	108.7	98.2 to 98.5	0.1 to 0.4	572.8 to 574.6	146.5 to 146.9	719.3 to 721.5	172.6 to 173.2	0.1	546.8 to 548.4
	2nd half	369.9 to 371.9	110.4	99.5 to 100.0	1.4 to 2.0	581.2 to 584.4	151.0 to 151.8	732.2 to 736.2	177.4 to 178.4	0.1	554.9 to 557.9
2006	1st half	373.6 to 376.5	112.1	100.8 to 101.6	1.4 to 2.3	587.9 to 592.6	155.7 to 157.0	743.7 to 749.6	181.9 to 183.4	0.1	561.8 to 566.3
	2nd half	377.3 to 381.2	113.7	103.1 to 104.2	0.4 to 1.6	594.5 to 600.7	160.6 to 162.2	755.0 to 762.9	186.6 to 188.5	0.1	568.6 to 574.5
2007	1st half	381.1 to 386.0	115.1	104.0 to 105.4	0.6 to 2.1	600.8 to 608.5	165.4 to 167.5	766.2 to 776.0	191.4 to 193.9	0.1	574.9 to 582.2
	2nd half	384.9 to 390.8	116.4	105.7 to 107.3	0.0 to 1.7	607.0 to 616.3	170.4 to 173.0	777.4 to 789.3	196.4 to 199.4	0.1	581.0 to 590.0
		Percentage changes on previous year[4,5]									
2003		2¼	3½	2¼	0	2½	0	2	1¼	0	2¼
2004		3¼	4½	6½	0	4	2¼	3½	4¾	0	3¼
2005		2¼ to 2¾	3	6¾ to 7¼	0	3 to 3½	6½ to 7	3¾ to 4¼	6 to 6¼	0	3 to 3½
2006		2 to 2½	3	3¼ to 3¾	0 to ¼	2½ to 3	6¼ to 6¾	3¼ to 3¾	5¼ to 5¾	0	2½ to 3
2007		2 to 2½	2½	2¾ to 3¼	0	2¼ to 2¾	6¼ to 6¾	3 to 3½	5¼ to 5¾	0	2¼ to 2¾

[1] Includes households and non-profit institutions serving households.

[2] Also includes acquisitions less disposals of valuables.

[3] Expenditure adjustment.

[4] For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.

[5] Growth ranges for GDP components do not necessarily sum to the ½ percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.

B THE PUBLIC FINANCES

The interim projections for the public finances published in this Pre-Budget Report show that the Government is meeting its fiscal rules over the economic cycle:

- **the current budget since the start of the current economic cycle in 1999-2000 show an average surplus up to 2005-06 of 0.1 per cent of GDP, showing the Government is meeting the golden rule on the basis of cautious assumptions. The average annual current surplus from 2005-06 to the end of the forecast period is about ¼ per cent of GDP; and**
- **public sector net debt is projected to be low and stable over the forecast period stabilising at 37 per cent of GDP, well below the 40 per cent ceiling set in the sustainable investment rule.**

The 2004 *End of year fiscal report* is published alongside this Pre-Budget Report, underlining the Government's commitment to transparency in fiscal policy by providing detailed retrospective information on the public finances in 2002-03 and 2003-04.

INTRODUCTION

B1 Chapter 2 describes the Government's fiscal policy framework and shows how the projections of the public finances presented in this Pre-Budget Report are consistent with the fiscal rules. This annex explains the fiscal projections in more detail. It includes:

- five-year projections of the current budget and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule respectively;
- projections of public sector net borrowing, the fiscal aggregate relevant to assessing the impact of fiscal policy on the economy;
- projections of the cyclically-adjusted fiscal balances; and
- detailed analysis of the outlook for the government receipts and expenditure.

B2 The fiscal projections continue to be based on deliberately cautious key assumptions audited by the National Audit Office (NAO).

B3 As described in Chapter 2, an *End of year fiscal report* is published alongside this Pre-Budget Report. The report underlines the Government's commitment to transparency in fiscal policy by providing detailed retrospective information on the state of the public finances in 2002-03 and 2003-04, 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.

B4 The Pre-Budget Report updates the projections of the public finances contained in Budget 2004, to take account of subsequent developments in both the public finances and the world and UK economies. The projections represent an interim forecast update and are not necessarily the outcome the Government is seeking.

MEETING THE FISCAL RULES

B5 Table B1 shows five-year projections for the current budget and public sector net debt, the key aggregates for assessing the performance against the golden rule and the sustainable investment rule respectively. Outturns and projections of other important measures of the public finances, including net investment and net borrowing, are also shown.

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.

Table B1: Summary of public sector finances

	Per cent of GDP							
	Outturns		Estimate	Projections				
	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
Fairness and prudence								
Surplus on current budget	–1.3	–1.9	–1.1	–0.6	0.0	0.3	0.6	0.8
Average surplus since 1999-2000	1.0	0.4	0.2	0.1	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–0.7	–1.0	–0.4	–0.4	0.1	0.3	0.6	0.8
Long-term sustainability								
Public sector net debt[1]	31.5	32.9	34.3	35.4	36.2	36.8	37.0	37.1
Core debt[1]	31.1	31.6	32.4	33.4	34.3	35.0	35.3	35.4
Net worth[2]	24.2	22.0	19.6	17.1	16.5	15.4	15.5	14.8
Primary balance	–0.8	–1.5	–1.3	–1.0	–0.5	–0.3	0.0	0.2
Economic impact								
Net investment	1.1	1.2	1.8	2.1	2.2	2.3	2.2	2.3
Public sector net borrowing (PSNB)	2.4	3.1	2.9	2.7	2.2	2.0	1.6	1.5
Cyclically-adjusted PSNB	1.8	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Financing								
Central government net cash requirement	2.1	3.5	3.4	2.9	2.5	2.1	1.7	1.8
Public sector net cash requirement	2.3	3.6	3.1	2.8	2.5	2.2	1.8	1.8
European commitments								
Treaty deficit[3]	2.2	3.1	2.8	2.7	2.2	2.0	1.6	1.5
Cyclically-adjusted Treaty deficit[3]	1.6	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Treaty debt ratio[4]	37.8	39.5	40.9	41.8	42.4	42.8	42.8	42.6
Memo: Output gap	–1.2	–1.4	–0.8	–0.1	0.0	0.0	0.0	0.0

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

The golden rule

B7 The projections show that the Government is meeting the golden rule, on the basis of cautious assumptions, with an average annual surplus on the current budget over this economic cycle of around 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £8 billion in this cycle, including the AME margin.

B8 The economy is projected to return to trend by early 2006. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2009-10 is $^1/_4$ per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on course to meet the golden rule after the end of this economic cycle.

Box B1: Measuring the golden rule

The golden rule will be met if the average annual surplus on the current budget expressed as a ratio to GDP, measured from the year in which the economic cycle begins up to and including the year in which the economic cycle ends, is in balance or surplus.[a] This is shown in Table B1, which reports the average surplus since the beginning of the cycle, rounded to one decimal place. When the economic cycle has been judged to have finished, it will be this measure that is used to determine whether the golden rule has been met.

The rationale for the Government's fiscal rules and their measurement is discussed in detail in Chapter 9 of *Reforming Britain's economic and financial policy*.[b] The golden rule helps to promote intergenerational fairness and is fully consistent with the Government's objective of sustainable public finances.

The margin against the golden rule shows the amount by which receipts can be lower than projected or spending higher than projected over the remainder of the economic cycle and the Government continue to meet the golden rule. The margin against the golden rule includes the AME margin, which is a safety margin within Total Managed Expenditure (TME) to guard against unexpected events. Any AME Margin that remains unspent at the end of the year will add to the current surplus.

[a] This measure has been used since the beginning of the framework: Budget 1997 used this measure when commenting on the golden rule over the then most recently completed economic cycle; the Economic and Fiscal Strategy Report 1998, which adopted the current format for the presentation of the public finances that corresponds more closely to the fiscal rules, included the average annual surplus on the current budget as a ratio to GDP since the beginning of the cycle; and Budget 2000 reported on performance against the golden rule over the short economic cycle that ran from 1997-98 to 1999-2000 using this measure.

[b] Balls and O'Donnell (eds.), 2002.

The sustainable investment rule

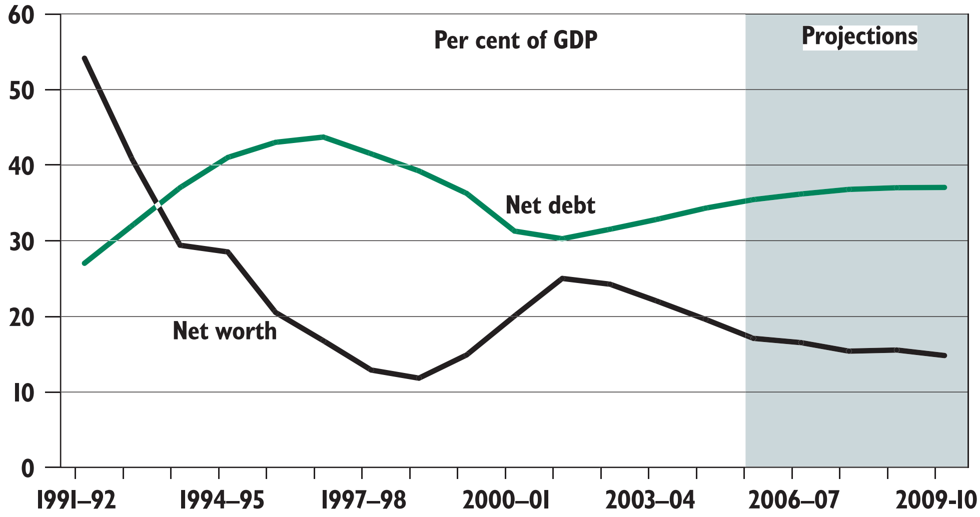
B9 The sustainable investment rule is also met over the economic cycle. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and expenditure taken by the Government, including the decision to use the proceeds from the auction of spectrum licences to repay debt, reduced debt to around 30 per cent of GDP by the end of 2001-02. It is now projected to grow slowly, as the Government borrows modestly to fund increased investment in public services, reaching 35.4 per cent of GDP at the end of this economic cycle, £59 billion below the 40 per cent level, and stabilising at around 37 percent at the end of the projection period. The projections for net debt take account of the full impact of the Graduate Contributions scheme. The projections for core debt, which exclude the estimated impact of the economic cycle, increase to just over 35 per cent of GDP. This is consistent with the fiscal rules, and with the key objective of intergenerational fairness that underpins the fiscal framework.

Net worth

B10 Net worth is the approximate stock counterpart of the current budget balance. Modest falls in net worth are expected for the remainder of the projection period from the high level of 25 per cent of GDP in 2001-02. At present, net worth is not used as a key indicator of the public finances, mainly as a result of the difficulties involved in accurately measuring many government assets and liabilities.

B11 Chart B1 shows public sector net debt and net worth as a per cent of GDP from 1991-92 to 2009-10.

Chart B1: Public sector net debt and net worth



Net investment **B12** As a result of decisions taken in the 2004 Spending Review public sector net investment is projected to rise to 2¼ per cent by 2007-08. This increase is sustainable and fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being held at a stable and prudent level, well below 40 per cent of GDP.

Net borrowing **B13** Public sector net borrowing is expected to fall from 2.9 per cent of GDP in 2004-05, reaching a level of around 1.5 per cent of GDP by 2009-10.

Financing **B14** The central government net cash requirement was 3.5 per cent of GDP in 2003-04. It is projected to decrease to 3.1 per cent in 2004-05, and decreasing further to 1.8 per cent of GDP by 2009-10, mirroring the profile of net borrowing.

European commitments **B15** Table B1 shows the Treaty measures of debt and deficit used for the purposes of the Excessive Deficit Procedure – Article 104 of the Treaty. The Pre-Budget Report projections meet the EU Treaty reference value for general government gross debt (60 per cent of GDP) by a considerable margin. In addition, the cyclically adjusted level of general government net borrowing does not exceed 2.5 per cent of GDP throughout the projection period. The projections are therefore consistent with the Government's prudent interpretation of the Stability and Growth Pact.

CHANGES TO THE FISCAL BALANCES

B16 Table B2 compares the latest estimates for the main fiscal balances with those in Budget 2004.

Table B2: Fiscal balances compared with Budget 2004

	Outturn[1]	Estimate[2]	Projections			
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Surplus on current budget (£ billion)						
Budget 2004	–21.3	–10.5	–5	0	4	9
Effect of revisions and forecasting changes	0.2	–1.2	–1	1	–½	–1
Effect of discretionary changes	0.0	–0.8	–½	0	–½	0
PBR 2004	**–21.1**	**–12.5**	**–7**	**1**	**4**	**9**
Net borrowing (£ billion)						
Budget 2004	37.5	32.9	31	27	27	23
Changes to current budget	–0.2	2.0	1½	–½	½	½
Forecasting changes to net investment	–2.5	–0.7	1½	2	½	0
PBR 2004	**34.8**	**34.2**	**33**	**29**	**28**	**24**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2004	–1.0	–0.2	–0.2	0.0	0.3	0.7
PBR 2004	**–1.0**	**–0.4**	**–0.4**	**0.1**	**0.3**	**0.6**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2004	2.4	2.1	2.3	2.1	1.9	1.6
PBR 2004	**2.2**	**2.2**	**2.5**	**2.2**	**2.0**	**1.6**
Net debt (per cent of GDP)						
Budget 2004	33.2	34.4	35.3	35.9	36.3	36.4
PBR 2004	**32.9**	**34.3**	**35.4**	**36.2**	**36.8**	**37.0**

[1] *The 2003–04 figures were estimates in Budget 2004.*
[2] *The 2004–05 figures were projections in Budget 2004.*

B17 The revisions to the public sector current budget in this Pre-Budget Report are mainly due to changes to receipts, especially corporation tax.

B18 Overall, the current budget has been revised from a deficit of £10.5 billion to a deficit of £12.5 billion in 2004-05, and from a deficit of £5 billion to a deficit of £7 billion in 2005-06. In subsequent years there are only small changes.

B19 Net borrowing increases by about £1 billion in 2004-05 as changes to the current budget are partly offset by changes to forecast of net investment in the light of recent outturn data.

FORECAST DIFFERENCES AND RISKS

B20 The fiscal balances represent the difference between large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. Over the past ten years, the average absolute difference between year-ahead forecasts of net borrowing and subsequent outturns has been around 1 per cent of GDP. These tend to grow as the forecast horizon lengthens. A full account of differences between the projections made in Budget 2002 and Budget 2003 and the subsequent outturns is provided in the *End of year fiscal report.*

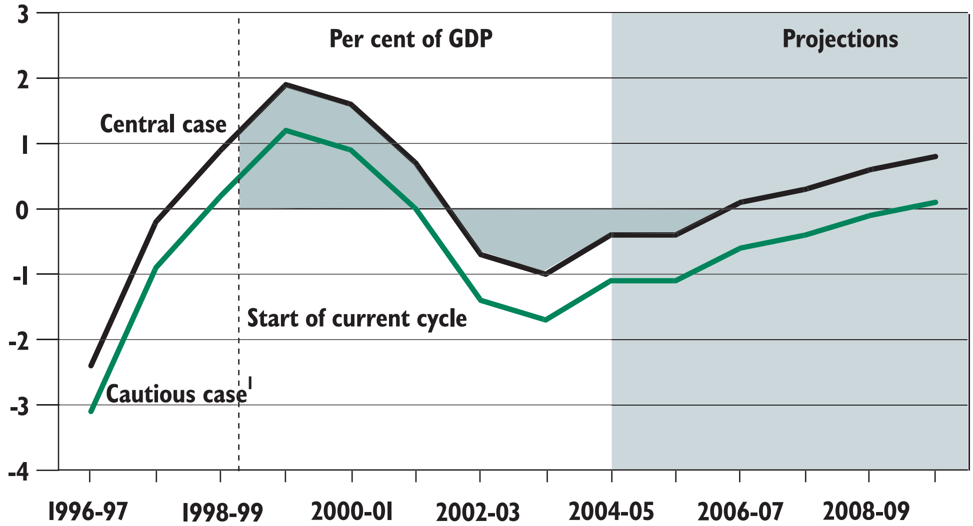
B21 As explained in Annex A, UK GDP growth began to pick up sharply during the second quarter of 2003, as some of the previous major international uncertainties diminished, and recovery in the world economy became more firmly entrenched. Sound macroeconomic fundamentals, recent underlying growth at above trend rates, and continued strong growth in the world economy point to a further period of robust growth in demand for UK output. On the supply side, evidence of remaining slack in the economy supports the judgement that the economy has the potential for a period of further above trend growth in the short term, without risking inflationary pressures.

B22 However, although the overall shape of the economic forecast is broadly unchanged from Budget time, the configuration of the surrounding risks and uncertainties has changed. In particular, high oil prices – if sustained – would tend to dampen growth, though to the extent that they partly reflect strong global demand rather than supply-side or risk premia shocks there are likely to be offsetting effects. Global developments remain an influence on the UK outlook, and challenging judgements will continue to be faced in setting monetary and fiscal policy. In the UK forecast, as has been the case in 2004, business investment could continue to surprise on the upside, and there may be headroom for stronger consumer spending.

B23 The use of cautious assumptions audited by the NAO builds a margin into the public finance projections to guard against unexpected events. One of the key audited assumptions is that for the trend of GDP growth, which is assumed to be $^1/_4$ of a percentage point below the neutral view. This means that the rate of economic growth used to forecast the public finances is the bottom end of the projection range. For example, in this Pre-Budget Report, the forecast for economic growth used in the public finance projections over the period 2005-06 to 2009-10 averages under $2^1/_2$ per cent, $^1/_4$ per cent below the central case, implying the level of GDP used in the public finance forecast is 1.4 per cent below the neutral view in 2009-10.

B24 A second important source of potential error results from misjudging the position of the economy in relation to trend output. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart B2 illustrates the Pre-Budget Report projection for this cautious case.

Chart B.2: 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.

B25 The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. This was combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt. This has allowed the Government to safeguard the increase in investment in priority public services, allow the automatic stabilisers to work in full during the period of global economic uncertainty that began in 2000 and meet in full the UK's international commitments, while continuing to meet the fiscal rules.

ASSUMPTIONS

B26 The fiscal projections are based on the following assumptions:

- the economy follows the path in Annex A. In the interests of caution, the fiscal projections continue to be based on the deliberately prudent and cautious assumption of trend output growth of $2^1/_2$ per cent up to 2006-07, $^1/_4$ percentage point lower than the Government's neutral view. The Government's neutral view of trend output growth is reduced to $2^1/_2$ per cent between 2007-08 and 2009-10, and so, to maintain a cautious approach, an assumption of $2^1/_4$ per cent is used in the public finances projections, still $^1/_4$ percentage point lower than the Government's neutral view;
- there are no tax or spending policy changes beyond those announced since Budget 2004 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 2004 Spending Review up to 2007-08, but adjusted for the impact of policy decisions and reclassifications;
- total Annually Managed Expenditure (AME) is as set out in 2004 Spending Review up until 2007-08, but adjusted for reclassifications, re-profiling of capital expenditure and the impact of policy decisions. Forecasts of individual components have been updated with changes absorbed by the AME margin within set total AME;
- As is normal, the Treasury is setting out its assumption for public sector current expenditure for the period beyond the next Spending Review. Public sector current expenditure in 2008-09 is assumed to grow by 1.9 per cent in real terms, in line with the assumed growth rate in the 2003 Pre-Budget Report, and, by the same rate in 2009-10. Taken together, these assumptions imply public sector current expenditure grows on average in line with the cautious view of trend GDP growth used in the public finance projections for the three year period starting in 2007-08; and
- net investment is assumed to remain at $2^1/_4$ per cent of GDP in 2008-09 and 2009-10.

Table B3: Economic assumptions for the public finance projections

	Percentage changes on previous year						
	Outturn	Estimate	Projections				
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
Output (GDP)	2¾	3¼	3	2½	2¼	2¼	2¼
Prices							
CPI	1¼	1¼	1¾	2	2	2	2
GDP deflator	2¾	2¼	2½	2¾	2¾	2¾	2¾
RPI[1] (September)	3	3	2¼	2½	2¾	2¾	2¾
Rossi[2] (September)	2	1¼	2¼	2½	2¼	2¼	2¼
Money GDP[3] (£ billion)	1116	1176	1243	1308	1373	1440	1511

[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.*

B27 The key assumptions underlying the fiscal projections are audited by the National Audit Office (NAO) and details of the main audited assumptions are given in Box B2. All these assumptions are subject to review by the NAO under the three-year rolling review process, but none were due for review in this Pre-Budget Report.

Box B2: Key assumptions audited by the NAO[a]

• Privatisation proceeds	Credit is taken only for proceeds from sales that have been announced.
• Trend GDP growth	$2^1/_2$ per cent a year to 2006-07 and $2^1/_4$ per cent in subsequent years.
• UK claimant unemployment	Rising slowly to 0.89 million in 2007-08, from recent levels of 0.84 million.
• Interest rates	3-month market rates change in line with market expectations (as of 19 November).
• Equity prices[b]	FTSE All-Share index rises from 2,389 (close 18 November) in line with money GDP.
• VAT[b,c]	The VAT gap will rise by 0.5 percentage points per year from a level that is at least as high as the estimated outturn for the current year.
• Consistency of price indicies[b]	Projections of price indices used to project the public finances are consistent with CPI.
• Composition of GDP[c]	Shares of labour income and profits in national income are broadly constant in the medium term.
• Funding[c]	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
• Oil prices	$38.2 a barrel in 2005, the average of independent forecasts, and then constant in real terms.
• Tobacco	The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. A share of 14.5 per cent, in line with the latest outturn for 2003-04, is used for 2005-06 onwards.

[a] For details of all NAO audits before the 2003 Pre-Budget Report, see Budget 2003, 9 April 2003 (HC500).
[b] Audit of Assumptions for the 2003 Pre-Budget Report, 10 December 2003 (HC35).
[c] Audit of Assumptions for the 2004 Budget, 17 March 2004 (HC434).

PRE-BUDGET REPORT POLICY DECISIONS

B28 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all firm decisions announced in the Pre-Budget Report or since Budget 2004. The fiscal impact of these measures is set out in Table B4. They include:

- a continuation of the freeze on the Budget 2004 annual duty increases for main road fuels;
- a ten year strategy for childcare;
- a National Employer Training Programme;
- a further addition to the special reserve to meet the cost of military operations in Iraq and the UK's other international obligations; and
- action to protect tax revenues and modernise the tax system, including measures to combat tax fraud and avoidance.

B29 In line with the conventions in previous Pre-Budget Reports, expenditure measures in AME for future years have been added to total AME, and to current expenditure in 2008-09 and 2009-10, and measures in DEL have been added to total DEL.

B30 The projections do not take account of decisions where the impact cannot yet be quantified, such as the Pension Protection Fund, or of measures proposed in the Pre-Budget Report where final decisions have yet to be taken, these include:

- further extensions to paid maternity leave;
- extending financial support for young people;
- changes to Individual Savings Account limits from 2006-07; and
- increasing Child Trust Fund Payments.

B31 The measures in Table B4 that either close tax loopholes or tackle tax fraud represent the estimated direct Exchequer effect of the measure on existing levels of avoidance or fraud activity. Further details explaining the conventions used in Table B4 can be found in Appendix A2 of the Financial Statement and Budget Report 2004.

Table B4: Estimated costs of Pre-Budget Report policy decisions and others announced since Budget 2004[1]

£ million

	2004–05	2005–06	2006–07	2007–08
Meeting the productivity challenge				
National Employer Training Programme	0	0	–80	–160
New Deal for Skills	0	–10	–10	–25
Increasing employment opportunity for all				
Incapacity benefit: additional Pathways to Work	0	*	–60	–65
Increasing Working Tax Credit thresholds	0	–140	–140	–140
Building a fairer society				
Social Fund reform	0	0	–5	–5
£50 payment for the over 70s	0	–260	0	0
Tax consequences of the Civil Partnerships Act	0	–10	–25	–30
VAT: grant to Band Aid 20	0	–5	*	*
Modernising the taxation of leasing	0	0	65	170
10 year Childcare Strategy				
Working Tax Credit: increase childcare element to 80%	0	0	–130	–130
Working Tax Credit: increase childcare limits to £175/£300 per week	0	–30	–30	–30
Extension of paid maternity leave to 9 months	0	0	0	–285
Improving childcare quality and sustainability	0	0	–240	–155
Protecting revenues				
Capital gains options avoidance	10	50	80	80
Remuneration based avoidance	200	500	500	500
Reform of film tax reliefs	20	90	110	120
Life insurance companies avoidance	0	35	50	50
Abuse of Controlled Foreign Companies regime	0	30	50	80
Abuse of double tax relief	0	145	200	200
VAT: abuse of input tax rules	15	45	45	50
Loans and financial instruments avoidance	10	115	150	150
Protecting the environment				
Company car tax: reform of diesel supplement	0	0	40	100
Fuel duties: freeze of main rates	–370	–665	–685	–710
Rebated oils: narrowing of the differential	–80	–105	–110	–110
Other Pre-Budget Report policy decisions				
Addition to local authorities	0	–150	0	0
Addition to special reserve	–520	0	0	0
TOTAL POLICY DECISIONS	**–715**	**–365**	**–225**	**–345**

* *Negligible.*

[1] *Costings shown relative to an indexed base.*

B32 For 2005-06 the income tax personal allowances for those aged under 65 will increase in line with inflation. The NICs threshold and limits will also increase in line with inflation. There will be no change in NICs rates for employers and employees, or the profit-related NICs paid by the self-employed. Other NICs rates for 2005-06 will increase in line with inflation, for the self-employed the rate of Class 2 contributions will be £2.10, the special rate of Class 2 contributions for share fisherman will be £2.75, the rate of class 3 voluntary contributions will be £7.35 and the special rate of Class 2 contributions for volunteer development workers will be £4.10. Tables B5 and B6 set this out in greater detail.

Table B5: National insurance contribution rates 2005–06

	Class 1 rates			Self employed NICs	
Earnings[1]	Employee (primary) NIC rate[2]	Employer (secondary) NIC rate[3]	Profits[1]	Class 2	Class 4
£ per week	per cent	per cent	£ per year	£ per year	per cent
Below 82 (LEL)	0	0	below 4,345 (SEE)	0[5]	0
82 to 94 (PT/ST)	0[4]	0	4,345 to 4,895 (LPL)	2.10	0
94 to 630 (UEL)	11	12.8	4,895 to 32,760 (UPL)	2.10	8
Above 630	1	12.8	Above 32,760	2.10	1

[1] *The limits are defined as LEL – lower earnings limit; PT - primary threshold; ST – secondary threshold; UEL – upper earnings limit; LPL – lower profits limit; UPL – upper profits limit.*
[2] *The contracted-out rebate for primary contributions in 2004–05 is 1.6 per cent of earning between the LEL and UEL for contracted-out-salary-related schemes (CORS) and contracted out money purchase schemes (COMPS).*
[3] *The contracted-out rebate for secondary contributions is 3.5 per cent of earnings between the LEL and UEL for CORS and 1.0 per cent for COMPS. For COMPS, an additional age related rebate is paid direct to the scheme following the end of the tax year. For appropriate personal pensions, the employee and employer pay NICs at the standard, not contracted out rate. An age and earnings-rebate is paid direct to the personal pension provder following the end of the tax year.*
[4] *No NICs are actually payable but a notional Class 1 NIC will be deemed to have been paid in respect of earnings between the LEL and PT to protect benefit entitlement.*
[5] *The self-employed may apply for exception from paying Class 2 contributions if their earnings are less than, or expected to be less than, the level of the small earning exceptions (SEE).*

Table B6: Income tax allowances 2005–06

	£ a year		
	2004–05	2005–06	Increase
Personal allowance			
age under 65	4,745	4,895	150
age 65–74	6,830	7,090	260
age 75 and over	6,950	7,220	270
Married couple's allowance[1]			
aged less than 75 and born before 6 April 1935	5,725	5,905	180
age 75 and over	5,795	5,975	180
minimum amount[2]	2,210	2,280	70
Income limit for age-related allowances	18,900	19,500	600
Blind person's allowance	1,560	1,610	50

[1] *Tax relief for this allowance is restricted to 10 per cent.*
[2] *This is also the maximum relief for maintenance payments where at least one of the parties is born before 6 April 1935.*

B33 As set out in Table B7, the child element of the Child Tax Credit will be increased by £65 to £1,690 a year from 6 April 2005, in line with earnings growth. The other elements of tax credits which are increasing in 2005-06 rise in line with inflation (the increase in the RPI in the year to September 2004): the disabled child elements and the elements of the Working Tax Credit. The first income threshold will also increase in line with inflation, as will the rates of Child Benefit and Guardian's Allowance. The limits on eligible childcare costs in Working Tax Credit will rise to £175 per week for one child and £300 per week for two or more children, from April 2005.

Table B7: Working and Child Tax Credit rates and thresholds

		£ a year	
	2004–05	2005–06	Increase
Working Tax Credit			
Basic Element	1,570	1,620	50
Couple and lone parent element	1,545	1,595	50
30 hour element	640	660	20
Disabled worker element	2,100	2,165	65
Severe disability element	890	920	30
50 plus element,16-29 hours	1,075	1,110	35
50 plus element, 30+ hours	1,610	1,660	50
Childcare element			
– maximum eligible cost for one child	*£135 per week*	*£175 per week*	*40*
– maximum eligible cost for two or more children	*£200 per week*	*£300 per week*	*100*
– *per cent of eligible costs covered*	*70%*	*70%*	–
Child Tax Credit			
Family element	545	545	–
Family element, baby addition	545	545	–
Child element	1,625	1,690	65
Disabled child element	2,215	2,285	70
Severely disabled child element	890	920	30
Income thresholds and withdrawal rates			
First income threshold	5,060	5,220	160
First withdrawal rate (per cent)	*37%*	*37%*	–
Second income threshold	50,000	50,000	–
Second withdrawal rate (per cent)	*6.67%*	*6.67%*	–
First threshold for those entitled to Child Tax Credit only	13,480	13,910	430
Income disregard	2,500	2,500	–

FISCAL AGGREGATES

B34 Tables B8 and B9 provide more detail on the projections for the current and capital budgets.

Table B8: Current and capital budgets (£ billion)

	£billion						
	Outturn	Estimate	Projections				
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
Current budget							
Current receipts	418.7	451.0	487	520	552	582	612
Current expenditure	425.5	448.6	478	503	531	555	581
Depreciation	14.3	14.9	16	17	18	19	20
Surplus on current budget	**–21.1**	**–12.5**	**–7**	**1**	**4**	**9**	**12**
Capital budget							
Gross investment	34.0	42.1	48	50	53	55	54
Less asset sales	–6.0	–5.5	–6	–4	–4	–4	0
Less depreciation	–14.3	–14.9	–16	–17	–18	–19	–20
Net investment	13.7	21.7	27	29	31	32	34
Net borrowing	**34.8**	**34.2**	**33**	**29**	**28**	**24**	**22**
Public sector net debt – end year	**375.7**	**414.6**	**452**	**484**	**517**	**546**	**574**
Memos:							
Treaty deficit[1]	34.9	33.5	34	29	28	24	23
Treaty debt[2]	441.2	480.6	520	554	587	616	644

[1] *General government net borrowing on a Maastricht basis.*
[2] *General government gross debt on a Maastricht basis.*

Table B9: Current and capital budgets (per cent of GDP)

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
Current budget							
Current receipts	37.5	38.3	39.2	39.8	40.2	40.4	40.5
Current expenditure	38.1	38.1	38.5	38.4	38.6	38.5	38.4
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Surplus on current budget	**–1.9**	**–1.1**	**–0.6**	**0.0**	**0.3**	**0.6**	**0.8**
Capital budget							
Gross investment	3.0	3.6	3.8	3.8	3.8	3.8	3.6
Less asset sales	–0.5	–0.5	–0.4	–0.3	–0.3	–0.3	0.0
Less depreciation	–1.3	–1.3	–1.3	–1.3	–1.3	–1.3	–1.3
Net investment	1.2	1.8	2.1	2.2	2.3	2.2	2.3
Net borrowing	**3.1**	**2.9**	**2.7**	**2.2**	**2.0**	**1.6**	**1.5**
Public sector net debt – end year	**32.9**	**34.3**	**35.4**	**36.2**	**36.8**	**37.0**	**37.1**
Memos:							
Treaty deficit[1]	3.1	2.8	2.7	2.2	2.0	1.6	1.5
Treaty debt ratio[2]	39.5	40.9	41.8	42.4	42.8	42.8	42.6

[1] *General government net borrowing on a Maastricht basis.*
[2] *General government gross debt on a Maastricht basis.*

B35 Following a deficit of 3 per cent of GDP in 1996-97, current budget surpluses of more than 2 per cent were recorded in 1999-2000 and 2000-01. These surpluses allowed the Government to use fiscal policy to support monetary policy during the economic slowdown in 2001 and 2002, and as a result the current budget moved into deficit. The current budget is expected to remain in deficit until 2005-06 and then move back into surplus in 2006-07, with increasingly larger surpluses in later years, reaching 0.8 per cent of GDP in 2009-10.

B36 The current budget surplus is equal to public sector receipts minus public sector current expenditure and depreciation. Underlying the projections of the current budget are steady increases in the ratio of current receipts to GDP. This partly reflects measures taken to protect revenues. The other reasons behind this are explained in later sections.

B37 Table B8 also shows that net investment is projected to increase from £14 billion in 2003-04 to £31 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 37 per cent of GDP or less throughout the projection period, well within the 40 per cent limit set by the sustainable investment rule.

RECEIPTS

B38 This section looks in detail at the projections for public sector tax receipts. It begins by looking at the main determinants of changes in the overall projections since Budget 2004, before looking in detail at changes in the projections of individual tax receipts. Finally, it provides updated forecasts for the tax-GDP ratios.

Changes in total receipts since Budget 2004

B39 The forecast for public sector current receipts for 2004-05 has been revised down by £3.7 billion since Budget 2004. However about £1½ billion of this change is due to the fiscally neutral reclassification of NHS trusts from the public corporation sector to central government (see Other factors paragraph below). Current receipts remain lower throughout the forecast, although the shortfall in receipts relative to Budget 2004 gradually diminishes. Table B10 breaks down the causes of these revisions between economic assumptions audited by the NAO, other economic determinants, fiscal forecasting changes, and other factors.

Table B10: Changes in current receipts since Budget 2004

	£ billion				
	Estimate	Projections			
	2004–05	2005–06	2006–07	2007–08	2008–09
Effect on receipts of non-discretionary changes in:					
Assumptions audited by the NAO	1½	2	2	1½	1½
of which:					
Oil price	*1½*	2	2	2	2
Other economic determinants	½	–1	–1	–½	–½
Fiscal forecasting changes	–4.0	–2½	–1½	–1½	–1½
Other	–1½	–1	–1	–1	–1
Total before discretionary changes[1]	**–3½**	**–3**	**–2**	**–1**	**–1½**
Discretionary changes	0	0	½	½	½
Total change[1]	**–3½**	**–3**	**–1½**	**–½**	**–½**

[1] *Total may not sum due to rounding.*

Economic determinants audited by the NAO

B40 Changes in economic determinants audited by the NAO increase public sector receipts by between £1½ billion and £2 billion from 2004-05 onwards. The main impact from the NAO assumptions is through the higher oil price. Oil prices are expected to average $38.2 a barrel in 2005, around $10 higher than assumed in Budget 2004. Only the direct effect of this increase on North Sea corporation tax and petroleum revenue tax is included in this category. The overall effect on the public finances as outlined in Chapter 2 is likely to be limited due to a number of offsetting effects from higher oil prices on fuel duties, inflation and the wider economy. In particular higher pump prices are expected to reduce demand for road fuel and lead to a reduction in fuel duties of around £½ billion a year in fuel duties. This is included in other economic determinants here.

Other economic determinants

B41 For 2005-06 onwards, changes to current price GDP components have a small downward effect on receipts over the forecast period mainly due to slower growth in the GDP components that are used to project the VAT tax base, including modestly lower growth in nominal consumer expenditure.

Fiscal forecasting changes

B42 These include all changes to corporation tax other than those directly applicable to GDP components. Further details are given in the tax by tax analysis section.

Other factors

B43 In the 2004 Blue Book, the ONS reclassified NHS Trusts to the central government sector rather than public corporations. This classification change has no effect on the public sector as a whole, but does reduce the public sector gross operating surplus and VAT refunds. This has the effect of reducing both receipts and expenditure by around £1½ billion each year and is included in the other category in Table B10. Details of other fiscally neutral changes are included in paragraph B68.

Tax-by-tax analysis

B44 Table B11 shows outturns for cash receipts in the first 7 months of 2004-05 and estimated receipts for the remainder of the year, along with percentage changes over the corresponding period in 2003-04. These growth rates can vary considerably across the year, reflecting the rules for payment of each tax and the various time lags. Table B12 shows the changes to the projections of individual taxes since Budget 2004, while B13 contains updated projections for the main components of public sector receipts for 2003-04, 2004-05 and 2005-06.

Table B11: Net taxes and national insurance contributions 2004–05

	£ billion			Percentage change on 2003–04		
	Outturn[1] Apr–Oct	Estimate Nov–Mar	2004–05	Outturn[1] Apr–Oct	Estimate Nov–Mar	Full year
Inland Revenue						
Income tax, NICs and capital gains tax[2]	110.3	93.1	203.4	7.1	8.7	7.8
Corporation tax[2]	21.8	10.6	32.4	12.5	21.5	15.3
Petroleum revenue tax	0.7	0.7	1.5	–0.3	62.9	23.0
Inheritance tax	1.7	1.2	2.9	17.9	12.8	15.7
Stamp duties	5.4	3.4	8.8	23.8	6.1	16.4
Total Inland Revenue (net of tax credits)	**139.9**	**109.0**	**249.0**	**8.6**	**10**	**9.2**
Customs and Excise						
Value added tax	43.3	30.3	73.5	6.2	6.9	6.5
Fuel duties	13.8	9.8	23.6	3.5	3.9	3.7
Tobacco duties	4.9	3.3	8.1	1.2	–0.3	0.6
Alcohol duties	4.5	3.3	7.8	5.1	0.6	3.2
Other Customs duties and levies	4.9	3.6	8.5	6.1	2.5	4.5
Total Customs and Excise	**71.3**	**50.3**	**121.6**	**5.2**	**5.1**	**5.2**
Vehicle excise duties	3.0	2.0	5.0	6.8	0.7	4.2
Business rates	13.5	5.5	19.0	3.7	3.1	3.5
Council tax	13.1	6.6	19.7	4.0	6.9	5.0
Other taxes and royalties	6.8	4.5	11.3	2.4	–2.3	0.5
Net taxes and national insurance contributions	**247.6**	**177.9**	**425.5**	**6.9**	**7.8**	**7.3**

[1] *Provisional.*

[2] *Net of tax credits scored as negative tax in net taxes and national insurance contributions.*

Table B12: Changes in current receipts by tax since Budget 2004

	£ billion		
	2003–04	2004–05	2005–06
Income tax (gross of tax credits)	–0.8	–0.5	0.4
National insurance contributions	0.2	0.1	0.1
Non-North Sea corporation tax[1]	0.0	–3.1	–2.5
Less tax credits[2]	0.0	–0.1	–0.1
North Sea revenues	0.0	1.7	2.2
Capital taxes[3]	1.0	0.6	0.9
Stamp duty	0.0	–0.6	–0.9
Value added tax	–0.7	0.5	–0.1
Excise duties[4]	0.0	–0.6	–0.7
Other taxes and royalties[5]	–1.1	–1.7	–1.8
Net taxes and national insurance contributions	**–1.5**	**–3.9**	**–2.4**
Other receipts and accounting adjustments	–1.3	0.2	–0.4
Current receipts	**–2.8**	**–3.7**	**–2.8**

[1] *National Accounts measure: gross of enhanced and payable tax credits.*
[2] *Includes enhanced 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.*

Table B13: Current receipts

		£ billion	
	Outturn 2003–04	**Estimate 2004–05**	**Projection 2005–06**
Inland Revenue			
Income tax (gross of tax credits)	118.3	127.4	137.8
Income tax credits	–4.3	–3.7	–3.7
National insurance contributions	72.5	77.7	82.3
Corporation tax[1]	28.6	32.9	41.3
Corporation tax credits[2]	–0.5	–0.5	–0.5
Petroleum revenue tax	1.2	1.5	1.6
Capital gains tax	2.2	2.0	2.8
Inheritance tax	2.5	2.9	3.3
Stamp duties	7.5	8.8	9.5
Total Inland Revenue (net of tax credits)	**228.0**	**249.0**	**274.3**
Customs and Excise			
Value added tax	69.1	73.5	77.3
Fuel duties	22.8	23.6	24.9
Tobacco duties	8.1	8.1	8.4
Spirits duties	2.4	2.4	2.4
Wine duties	2.0	2.1	2.3
Beer and cider duties	3.2	3.3	3.4
Betting and gaming duties	1.3	1.4	1.4
Air passenger duty	0.8	0.9	1.0
Insurance premium tax	2.3	2.5	2.6
Landfill tax	0.6	0.7	0.7
Climate change levy	0.8	0.8	0.8
Aggregates levy	0.3	0.3	0.3
Customs duties and levies	1.9	2.1	2.1
Total Customs and Excise	**115.7**	**121.6**	**127.6**
Vehicle excise duties	4.8	5.0	5.3
Business rates[3]	18.4	19.0	20.1
Council tax[4]	18.8	19.7	21.3
Other taxes and royalties[5]	11.2	11.3	12.5
Net taxes and national insurance contributions[6]	**396.7**	**425.5**	**461.1**
Accruals adjustments on taxes	2.9	1.9	0.8
Less own resources contribution to European Communities (EC) budget	–4.6	–3.9	–3.8
Less PC corporation tax payments	–0.1	–0.1	–0.1
Tax credits adjustment[7]	0.5	0.6	0.6
Interest and dividends	4.4	5.1	5.1
Other receipts[8]	18.8	21.9	23.3
Current receipts	**418.7**	**451.0**	**487.0**
Memo:			
North Sea revenues[9]	4.3	5.3	5.9

[1] *National Accounts measure: gross of enhanced and payable tax credits.*
[2] *Includes enhanced company tax credits.*
[3] *Includes district council rates in Northern Ireland paid by business.*
[4] *Council Tax increases are determined annually by local authorities, not by the Government. As in Budget 2004 the council tax figures for 2005-06 onwards are projections based on stylised assumptions and are not government forecasts. The assumption used here is a 6.8 per cent annual increase in council tax each year – the average for 1993-04 to 2003-04. The Government expects council tax rises in 2005-06 to be significantly below last year's 5.9 per cent rise, since changes to council tax are broadly balanced by changes to locally financed expenditure, they have no material impact on the current balance or net borrowing.*
[5] *Includes VAT refunds and money paid into the National Lottery Distribution Fund.*
[6] *Includes VAT and 'traditional own resources' contributions to EC budget.*
[7] *Tax credits which are scored as negative tax in the calculation of NTNIC but expenditure in the national accounts.*
[8] *Includes gross operating surplus and rent; net of oil royalties and business rate payments by Local Authorities.*
[9] *Consists of North Sea corporation tax, petroleum revenue tax and royalties.*

Income tax and national insurance contributions

B45 Cash receipts from income tax and NICs are expected to be about £½ billion lower in 2004-05 than forecast in Budget 2004. There was a strong increase in self-assessment receipts in early 2004 which was included in income tax in 2004 and projected forward. However about £1 billion of the increase was, in fact, capital gains tax and as a result the level of income tax expected from self-assessment in the forecast has been reduced throughout the forecast period. Although cash PAYE and NICs paid on wages and salaries is lower in 2004-05 much of the shortfall relates to liabilities for 2003-04. On the accruals basis used in national accounts, PAYE and NICs for 2004-05 are higher than forecast in Budget 2004.

B46 For the first 7 months of 2004-05 cash income tax (net of tax credits) and NICs are up 7.1 per cent on the same period in 2003. Growth is expected to be modestly higher for the remainder of this year. Self assessment income tax and NIC payments made so far in 2004-05 are based on the amounts due for the 2002-03 tax year, but those due on 31 January 2005 will reflect tax due on 2003-04 income. This is expected to lead to higher growth rates for January onwards and income tax and NIC payments made by employers are also expected to show higher growth from January because of growth in bonuses.

B47 Receipts for 2005-06 and subsequent years are expected to be slightly higher than in Budget 2004, largely reflecting the improved underlying accruals position in 2004-05 and measures to protect tax revenues included in Table B4 which add around £½ billion a year to income tax and NICs revenues.

Non-North sea corporation tax

B48 Non-North Sea corporation tax receipts in 2004-05 are estimated to be around £3 billion below the Budget projection. Although receipts have grown strongly over the year to date and are expected to grow slightly more rapidly over the remainder of 2004-05, the overall growth in receipts in 2004-05 is slower than in the Budget forecast, mainly due to weaker growth in corporation tax receipts from financial companies. A number of factors may be responsible, including a larger than expected backlog of unused losses or allowances which have temporarily depressed taxable profits.

B49 The higher growth in total corporation tax receipts over the rest of 2004-05 mainly reflects increases in receipts for North Sea Oil companies. However, growth is also expected to be slightly higher for onshore companies, because of the impact of the quarterly instalment payment system for large companies. Quarterly instalment payments by large companies account for the majority of corporation tax receipts, and most payments on 2004 accounts fall due first in July, next in October and then in January. Between July and October there was a marked improvement in the level of payments compared to last year, and payments in January are expected to continue this trend, producing the greater growth over the rest of the year shown in table B11.

North Sea revenues

B50 North Sea revenues are expected to be about £1¾ billion higher in 2004-05 than forecast in Budget 2004, largely because of higher oil prices for calendar year 2004, oil prices are now expected to average almost $12 a barrel above the NAO audited assumption in Budget 2004 of $28.4 a barrel. The full impact of higher oil prices on North Sea revenues will not be felt until towards the end of 2004-05, because of lags built into the tax system. Petroleum revenue tax (PRT) and North Sea Corporation Tax have different regimes, which allow for some payments for a liability period to be made in that period and some in the following period. The average lag for calendar year liabilities is about 8½ months from the start of the year for PRT and 11 months for Corporation Tax.

B51 PRT is based on 6-month chargeable periods with a system of monthly instalment payments, these payments start 2 months after the beginning of the chargeable period, but are based on tax liabilities for the preceding period. A balancing payment is then made 2 months after the end of the period. This system means that tax received in the first 7 months of 2004-05 reflects tax due for the first half of 2004 or earlier, and is slightly lower than in 2003 because of lower oil production. The high oil prices in the second half of 2004 will have no impact on PRT receipts until the balancing payment is received in March 2005, but by then are expected to show very high growth on the same period in 2003-04.

B52 The October 2004 instalment payments of North Sea corporation tax will have reflected the higher oil prices to some extent as they will have been based on company estimates of profits for the whole year. However, the full effect will not be seen until further instalments in respect of 2004 profits are paid in January and April 2005, by which time receipts to date are expected to show a much larger increase on the preceding year than so far apparent.

B53 North Sea revenues are expected to be over £2 billion a year higher from 2005-06 onwards than in Budget 2004. Oil prices in the Pre-Budget Report forecast are assumed to average $38.2 a barrel in 2005, in line with the average of independent forecasts and then remain constant in real terms. This is just over $10 a barrel higher than assumed in Budget 2004 and explains most of the increase in North Sea revenues.

Capital gains tax and inheritance tax

B54 Receipts from capital gains tax in 2003-04 were £1 billion higher than forecast in the Budget. The increase in receipts was probably caused by larger than expected disposals of business assets arising from the maturing of the business asset taper in 2002-03. Some of this effect is likely to continue into 2004-05 and later years. Changes in house and other asset prices and turnover levels are expected to lead to modest increases in both capital gains tax and inheritance tax. However tax payment lags means that most of these effects will be delayed until 2005-06.

Stamp duties

B55 Stamp duty in the first seven months of 2004-05 benefited from the strong housing market, with robust gains recorded in both housing transactions and prices. With recent data indicating a more subdued market going forward, growth in stamp duty receipts is expected to be more modest. Overall stamp duties are expected to be down £0.6 billion in 2004-05 relative to Budget 2004. This is due to lower than expected stamp duty on shares, due in part to lower equity prices and volumes in the first part of 2004-05.

VAT receipts

B56 VAT receipts on a cash basis are expected to be £0.5 billion higher in 2004-05 than the Budget 2004 forecast. Since Budget 2004, VAT revenue projections have been based on a new assumption audited by NAO (see Box B2). The new method takes account of the whole VAT tax base rather than just consumers' expenditure and makes a cautious assumption about the VAT gap, the difference between the theoretical tax liability and actual receipts. The lower VAT projection from 2005-06 onwards compared with the Budget 2004 forecast reflects slower growth in the VAT tax base. This in part reflects lower growth in nominal consumers' expenditure but also slower growth in the economic determinants driving the non-consumer elements of the tax base. Further detail on the new VAT forecasting methodology can be found in Annex A of the *End of year fiscal report*.

Excise duties

B57 Receipts from excise duties are expected to be £0.6 billion lower in 2004-05 than forecast in the Budget. This is more than explained by the expected drop in fuel duties. This is partly the result of the decision in the Pre-Budget Report to continue to freeze the level of fuel duty. The Budget 2004 forecast assumed that fuel duties would be raised in line with inflation at the start of September. In addition, fuel duty forecasts will be lower from 2004-05 onwards by about £$^1/_2$ billion a year due to the impact of higher oil prices on the demand for fuel.

B58 Tobacco duties are likely to be close to the Budget forecast in 2004-05. Over the forecast horizon, the positive impact on revenues from the lower market share of smuggled cigarettes is largely offset by lower overall tobacco consumption. Receipts from excise duties on alcohol are higher than expected in Budget 2004 mainly as a result of stronger receipts from duties on wine.

Council tax

B59 Council tax increases are determined annually by local authorities, not by the Government. As in Budget 2004 the council tax figures for 2005-06 onwards are projections based on stylised assumptions and are not Government forecasts. The assumption used here is a 6.8 per cent annual increase in council tax each year, the average for 1993-04 to 2003-04. The Government expects council tax rises in 2005-06 to be significantly below last year's 5.9 per cent rise, since changes to council tax are broadly balanced by changes to locally financed expenditure, they have no material impact on the current balance or net borrowing.

Other receipts

B60 Other receipts are expected to be £1.7 billion lower in 2004-05 than projected in Budget 2004. This is largely the effect of the NHS Trusts reclassification.

Tax-GDP ratio

B61 Table B14 shows projections of receipts from major taxes as a per cent of GDP, and Table B15 sets out current and previous projections of the overall tax-GDP ratio.

B62 The tax-GDP ratio is expected to rise in 2004-05, mainly because of higher receipts from income tax, corporation tax and stamp duties.

B63 The increase in the ratio from 2004-05 onwards is largely driven by the recovery in receipts arising from financial company profits and the normal fiscal forecasting convention for the treatment of fiscal drag.

Table B14: Current receipts as a proportion of GDP

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
Income tax (gross of tax credits)	10.6	10.8	11.1	11.3	11.5	11.7	11.8
National insurance contributions	6.5	6.6	6.6	6.7	6.7	6.8	6.8
Non-North Sea corporation tax[1]	2.3	2.5	3.0	3.3	3.4	3.4	3.4
Tax credits[2]	–0.4	–0.4	–0.3	–0.3	–0.3	–0.3	–0.2
North Sea revenues[3]	0.4	0.4	0.5	0.5	0.5	0.5	0.4
Value added tax	6.2	6.3	6.2	6.2	6.2	6.2	6.1
Excise duties[4]	3.4	3.4	3.3	3.3	3.2	3.2	3.1
Other taxes and royalties[5]	6.6	6.6	6.7	6.8	6.9	7.0	7.1
Net taxes and national insurance contributions[6]	**35.6**	**36.2**	**37.1**	**37.7**	**38.1**	**38.3**	**38.4**
Accruals adjustments on taxes	0.3	0.2	0.1	0.1	0.2	0.1	0.1
Less EC transfers	–0.4	–0.3	–0.3	–0.3	–0.3	–0.3	–0.3
Tax credits[7]	0.1	0.0	0.0	0.0	0.0	0.0	0.1
Other receipts[8]	2.1	2.2	2.2	2.2	2.2	2.2	2.2
Current receipts	**37.5**	**38.3**	**39.2**	**39.8**	**40.2**	**40.4**	**40.5**

[1] *National Accounts measure: gross of enhanced and payable tax credits.*
[2] *Tax credits scored as negative tax in net taxes and national insurance contributions.*
[3] *Includes oil royalties, petroleum revenue tax and North Sea corporation tax.*
[4] *Fuel, alcohol and tobacco duties.*
[5] *Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*
[6] *Includes VAT and 'own resources' contributions to EC budget. Cash basis.*
[7] *Tax credits scored as negative tax in net taxes and national insurance contributions but expenditure in the National Accounts.*
[8] *Mainly gross operating surplus and rent, excluding oil royalties.*

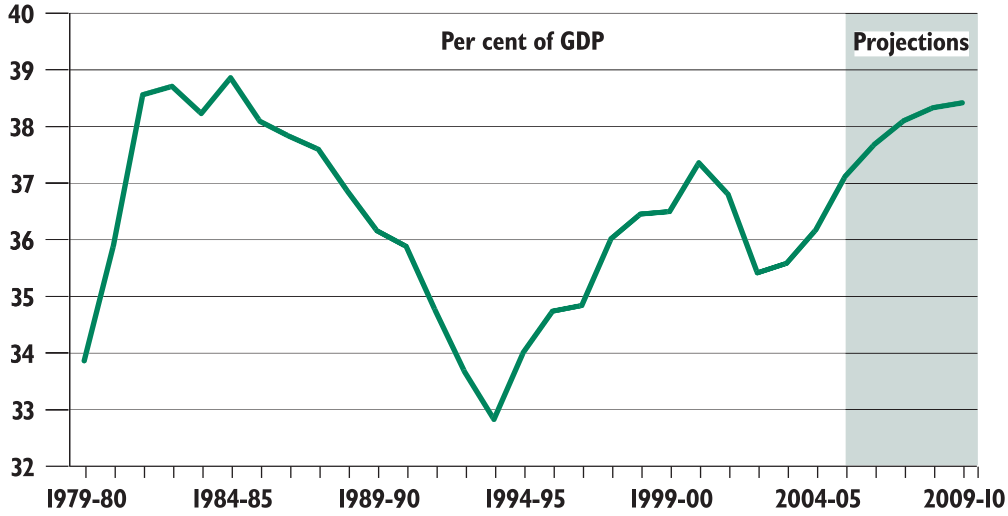
Table B15: Net taxes and national insurance contributions[1]

	Per cent of GDP						
	Outturn[2]	Estimate[3]	Projections				
	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
Budget 2004	35.7	36.5	37.3	37.8	38.1	38.3	
PBR 2004	**35.6**	**36.2**	**37.1**	**37.7**	**38.1**	**38.3**	**38.4**

[1] *Cash basis. Uses OECD definition of negative tax credits.*
[2] *The 2003–04 figures were estimates in Budget 2004.*
[3] *The 2004–05 figures were projections in Budget 2004.*

B64 Chart B3 shows the tax-GDP ratio from 1978-79 to 2009-10.

Chart B3: Tax-GDP ratio[1]



[1] Net taxes and national insurance contributions as defined in Table B15.

PUBLIC EXPENDITURE

B65 This section looks in detail at the projections for public expenditure. The spending projections cover the whole of the public sector, using the national accounts aggregate Total Managed Expenditure (TME).

B66 For fiscal aggregates purposes, TME is split into national accounts components covering public sector current expenditure, public sector net investment and depreciation. For budgeting and other purposes, TME is split into Departmental Expenditure Limits (DEL) – firm three year limits for departments' programme expenditure – and Annually Managed Expenditure (AME) – expenditure that is not easily subject to firm multi-year limits.

Changes in TME since Budget 2004

B67 The only forecasting changes to TME for 2004-05 to 2007-08, the last year of the Spending Review 2004 period, since Budget 2004 relate to reclassifications and carrying forward of expenditure between years.

B68 Public sector current expenditure has been reduced because of reclassifications incorporated since Budget 2004. This is mainly due to the reclassification of NHS Trusts from public corporations to central government introduced by ONS in June 2004, which reduced both current expenditure and receipts by about £1½ billion each year. This was partially offset by the decision announced in the 2004 Spending Review to bring the Nuclear Decommissioning Authority into the public spending framework, which increases expenditure and receipts by around £½ billion a year.

B69 As announced in the 2004 Spending Review, about £1 billion of current expenditure was carried forward from 2006-07 to 2007-08 in order to better meet the Government's spending priorities. These changes also have no effect on the golden rule across the forecast period.

B70 Apart from minor switches from current to capital spending, the only other forecasting change to current expenditure since the Budget reflects the effects of the assumption used to project current expenditure following the end of the 2004 Spending Review period.

B71 Public sector net investment in 2003-04 fell £$2\frac{1}{2}$ billion short of the estimate made in Budget 2004, but was still 21 per cent higher than in 2002-03. Net investment to date in 2004-05 is 13 per cent higher than in the same period of 2003-04 and, in line with previous experiences, is expected to increase significantly over the remainder of the year. However, lower than expected investment, especially by local authorities and public corporations, means that overall investment is unlikely to meet the Budget 2004 forecast and the forecast for capital expenditure in 2004-05 has been reduced by £$1\frac{1}{4}$ billion. To reinforce the Government's commitment to increasing public sector investment, this expenditure has been carried forward to 2005-06 and 2006-07, consistent with the overall intention to increase public sector net investment to $2\frac{1}{4}$ per cent of GDP by 2007-08.

B72 The other changes to net investment over the 2004 Spending Review period reflect the timing changes, capital expenditure announced then and changes to National Accounts depreciation. Although net investment remains at $2\frac{1}{4}$ per cent of GDP in 2008-09, gross investment is about £$\frac{1}{2}$ billion lower because of the reduction in depreciation.

B73 Discretionary changes to TME include the spending measures in Table B4.

Table B16: Total Managed Expenditure 2003-04 to 2007-08

					£ billion
	Outturn	Estimate		Projections	
	2003–04	2004–05	2005–06	2006–07	2007-08
Departmental Expenditure Limits					
Resource Budget	250.5	266.7	286.6	304.2	319.6
Capital Budget	23.2	26.2	29.1	31.5	34.9
Less depreciation	–9.1	–11.0	–11.7	–12.1	–11.8
Total Departmental Expenditure Limits	**264.6**	**281.9**	**304.0**	**323.6**	**342.7**
Annually Managed Expenditure					
Social security benefits[1,2]	117.0	121.2	126.4	131.2	138.6
Tax credits[1]	13.3	14.8	14.3	13.7	13.2
Common Agricultural Policy	2.8	3.1	3.1	3.2	3.2
Net public service pensions[3]	1.8	0.5	–0.3	–0.9	–1.4
National Lottery	1.9	1.8	1.7	1.5	1.3
Non-cash items in AME	27.2	26.9	27.6	29.8	31.4
Other departmental expenditure	1.8	3.5	4.0	3.4	3.4
Net payments to EC institutions[4]	2.4	2.0	3.0	4.1	4.5
Locally-financed expenditures[5]	21.9	24.0	25.6	27.6	29.7
Central government gross debt interest	22.2	23.8	25.1	26.6	27.8
Public corporations' own-financed capital expenditure	2.5	2.3	2.2	2.2	2.3
Total AME before margin and accounting adjustments	**214.7**	**224.0**	**232.7**	**242.4**	**254.0**
AME margin	0.0	1.0	2.9	2.4	2.7
Accounting adjustments[6]	–25.8	–21.7	–19.1	–19.5	–20.0
Annually Managed Expenditure	**189.0**	**203.3**	**216.4**	**225.3**	**236.7**
Total Managed Expenditure	**453.6**	**485.3**	**520.5**	**548.9**	**579.4**
of which:					
Public sector current expenditure	425.5	448.6	478.1	502.8	530.6
Public sector net investment	13.7	21.7	26.5	29.3	31.2
Public sector depreciation	14.3	14.9	15.8	16.7	17.7

[1] *Child allowances in Income Support and Jobseekers' Allowance, which will be paid as part of the Child Tax Credit, have been included in the tax credits line and excluded from the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.*

[2] *For 2003-04, the rent rebate element of Housing Revenue Account subsidies, which, from 2004-05 are administered by DWP, have been included in the social security benefits line. This is in order to give figures on a consistent definition over the forecast period.*

[3] *Net public service pensions expenditure is reported under FRS17 accounting requirements.*

[4] *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):*

2003-04	2004-05	2005-06	2006-07	2007-08
3.3	2.6	3.6	4.8	5.1

[5] *This expenditure is mainly financed by council tax revenues. The Council Tax projection figures for 2005-06 onwards are based on stylised assumptions and are not government forecasts. The assumption here is a 6.8 per cent annual increase in Council Tax each year, the average for 1993-2004 to 2003-04. The Government expects Council Tax rises in 2005-06 to be significantly below last year's 5.9 per cent rise, since changes to council tax are broadly balanced by changes to locally financed expenditure, they have no material impact on the current balance or net borrowing.*

[6] *Excludes depreciation.*

B74 Chart B4 shows TME as a per cent of GDP from 1970-71 to 2007-08.

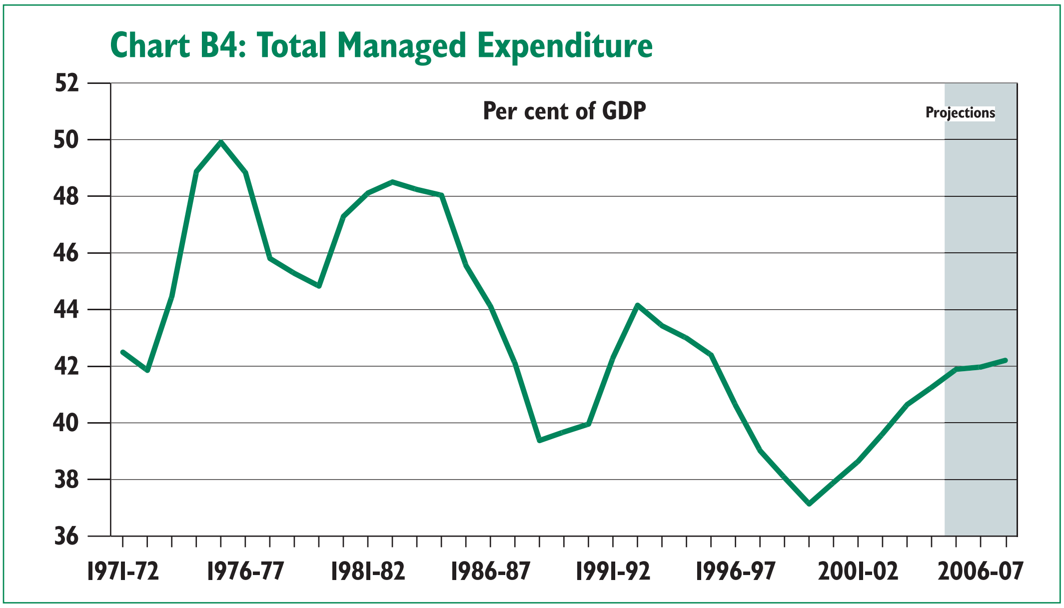


Table B17: Changes to Total Managed Expenditure since 2004 Spending Review

	Outturn 2003–04	Estimate 2004–05	Projections 2005–06	2006–07	2007–08
	£ billion				
Departmental Expenditure Limits					
Resource Budget	–1.4	2.8	2.1	2.3	2.3
Capital Budget	–0.7	–0.1	0.0	0.0	0.0
Less depreciation	1.4	0.0	0.2	0.0	0.0
Total Departmental Expenditure Limits	**–0.7**	**2.7**	**2.3**	**2.3**	**2.3**
Annually Managed Expenditure					
Social security benefits	0.3	–2.0	–1.4	–1.8	–1.4
Tax credits	–0.7	1.0	0.0	–0.8	–1.3
Common Agricultural Policy	0.3	0.6	0.6	0.7	0.6
Net public service pensions[1]	1.1	0.2	0.1	–0.5	–0.6
National Lottery	–0.1	–0.2	0.1	0.1	0.0
Non-cash items in AME	–2.8	–1.1	–2.1	–1.5	–1.6
Other departmental expenditure	–0.1	0.8	1.2	0.8	0.7
Net payments to EC institutions	0.0	–0.7	–0.7	0.0	0.1
Locally-financed expenditure	–0.5	–0.2	–0.4	–0.3	–0.3
Central government gross debt interest	0.0	–0.1	–0.3	0.1	0.4
Public corporations' own–financed capital expenditure	0.0	–0.4	0.0	0.1	0.2
Total AME before margin and accounting adjustments	**–2.6**	**–2.0**	**–2.9**	**–3.1**	**–3.3**
AME margin	0.0	–0.2	0.8	0.4	–0.2
Accounting Adjustments[2]	–2.2	–2.8	–0.6	0.1	0.6
Annually Managed Expenditure	**–4.8**	**–5.0**	**–2.6**	**–2.6**	**–2.9**
Total Managed Expenditure	**–5.4**	**–2.3**	**–0.3**	**–0.4**	**–0.6**
of which:					
Public sector current expenditure	–2.5	–1.1	–1.2	–1.2	–0.9
Public sector net investment	–2.5	–0.7	1.4	1.4	0.7
Public sector depreciation	–0.5	–0.6	–0.5	–0.5	–0.5

[1] *Net public sector pensions expenditure is reported under FRS17 accounting requirements.*
[2] *Accounting Adjustments are net of depreciation.*

Central Government spending in 2004-05

B75 Monthly spending outturn information is only available for central government. Current expenditure in the first 7 months of 2004-05 was 6.7 per cent higher than in the corresponding period of 2003-04, higher growth than in the Pre-Budget Report estimate for 2004-05 as a whole, reflecting the many different factors which affect the pattern of spending across the year.

B76 Debt interest payments for the year to date are up only 2.8 per cent on the corresponding period in 2003, but are expected to grow at a higher rate over the remainder of the financial year. The main reason is the impact of monthly changes RPI on the pattern of index linked gilts payments.

B77 Net social benefits for the year to date are 7.0 per cent higher than in April – October 2003, partly reflecting increased take-up of income tax credits.

B78 Other current expenditure is 6.8 per cent up for the year to date, but growth is expected to slow over the next few months, with average growth for the year as a whole at around 4 per cent. This expenditure is largely DEL and is expected to show a flatter profile this year with only 42 per cent of the annual total being spent in the last 5 months of the year compared with 43 per cent in 2003-04.

DEL and AME analysis

B79 Table B16 sets out projected spending on DEL and the main components of AME to the end of the 2004 Spending Review period in 2007-08. Table B17 shows changes since the 2004 Spending Review.

B80 Changes to resource DEL in 2003-04 since the Budget reflect revised depreciation figures for the Ministry of Defence. The reduction in capital DEL of £0.7 billion reflects lower than expected capital spending, particularly on transport and defence. Unspent capital allocations were carried forward under the EYF arrangements to maintain the Government's investment plans. Changes in other years reflect discretionary measures including the new special reserve allocation, employer training pilots and improving childcare quality, and reclassification of expenditure on the Supporting People programme from AME to DEL.

B81 The detailed allocations of DELs are shown in Table B18. In line with previous practice, resource and capital DEL for 2004-05 includes an allowance for shortfall reflecting likely underspends against departmental prevision.

B82 The main economic assumptions underpinning the AME projections are set out in Box B2 and Table B3. In particular it is assumed that the UK claimant count unemployment rises slowly to 0.89 million in 2007-08, from recent levels of 0.84 million. The AME total is also affected by the reclassifications described in paragraphs B67 and B68 and the reclassification of expenditure on the Supporting People programme from AME to DEL.

B83 After allowing for the reclassification of expenditure on the Supporting People programme social security expenditure is slightly higher. Pension Credit expenditure is up, largely reflecting improvements in forecast methodology, which exploit newly available outturn data. These changes are partly offset by lower expenditure on unemployment related benefits.

B84 Forecast spending on the Child and Working Tax Credits differs from Budget 2004. In 2004-05 and 2005-06 forecast costs have increased because of higher than expected take up and because of re-profiling of payment schedules. The latter means that forecast costs from 2006-07 onwards are lower than at the 2004 Spending Review. The forecast also incorporates the changes to Child and Working Tax Credits spending outlined in paragraph B33.

B85 Common Agricultural Policy payments have increased by around £½ billion a year. This reflects a number of factors including movements in exchange rates and the phased introduction of the dairy premium from 2003-04 to compensate for institutional price cuts in the dairy sector. These increases are largely offset by higher receipts from the EU, which are included in the net payments to EC institutions component of AME.

B86 Net public service pensions figures are reported on a FRS17 basis and record changes in the accruing liabilities of the various pensions schemes. National accounts pensions expenditure, which is recorded on a transactions basis, shows only small changes in 2004-05 and 2005-06, but increases in 2006-07 by £0.3 billion and by £0.9 billion in 2007-08. This reflects decreased estimates for the NHS pensions scheme and, in particular, the Principal Civil Service Pensions Scheme (PCSPS), accounting for the impact of the efficiency gains outlined in Chapter 2 of the 2004 Spending Review.

B87 National Lottery figures reflect the latest view on the timing of draw down by the distributing bodies.

B88 Changes to non-cash items in AME reflect a presentational change to include the release of provisions. Non-cash items do not score in TME and are removed in the accounting adjustments. Therefore these changes have no impact on TME.

B89 Changes in other departmental expenditure since the 2004 Spending Review reflect a number of changes, including revised expectations of coal health liabilities expenditure on chronic obstructive pulmonary disease claims and the inclusion of spending on Local Authority business growth incentives measure announced in Budget 2004, which was formerly included in the local authority self-financed expenditure forecast.

B90 The net payments to EC institutions forecast reflects increases in departmental estimates of CAP and Structural Funds receipts. It also takes account of more recent information on the EC Budget than was available at the time of the Spending Review and of changes in assumptions about the timing of payments made to the EC Budget.

B91 Changes to local authority self-financed expenditure mainly reflect the reclassification of the Local Authority business growth incentives measure. This expenditure is mainly financed by council tax revenues. The council tax projections figures for 2005-06 onwards are based on stylised assumptions and are not Government forecasts. The assumption used here is of 6.8 per cent annual increase in council tax each year, the average for 1993-04 to 2003-04. The Government expects council tax rises in 2005-06 to be significantly below last year's 5.9 per cent rise, since changes to council tax are broadly balanced by changes to locally financed expenditure, they have no material impact on the current balance or net borrowing.

Table B18: Departmental Expenditure Limits – resource and capital budgets

	Outturn	Estimate	Plans £ billion		
	2003–04	2004–05	2005–06	2006–07	2007-08
Resource Budget					
Education and Skills	23.0	24.5	26.7	28.4	30.0
Health	62.7	69.3	74.8	81.4	88.8
of which: NHS	60.9	67.1	72.7	79.5	86.9
Transport	7.9	7.8	8.9	10.8	9.9
Office of the Deputy Prime Minister	4.7	6.4	6.6	6.8	7.3
Local Government	40.9	43.4	45.8	48.3	50.8
Home Office	11.7	12.4	12.5	13.3	14.0
Departments for Constitutional Affairs	3.2	3.5	3.7	3.8	3.8
Attorney General's Departments	0.5	0.6	0.6	0.7	0.7
Defence	31.5	32.0	32.7	32.7	33.0
Foreign and Commonwealth Office	1.6	1.8	1.7	1.7	1.7
International Development	3.8	3.8	4.5	5.0	5.3
Trade and Industry	4.5	5.5	5.9	6.1	6.3
Environment, Food and Rural Affairs	2.8	3.2	3.2	3.3	3.4
Culture, Media and Sport	1.3	1.5	1.5	1.6	1.6
Work and Pensions	8.3	8.3	8.4	8.3	8.3
Scotland[1]	18.5	20.5	21.3	22.9	24.1
Wales[1]	9.8	10.6	11.3	12.0	12.7
Northern Ireland Executive[1]	6.4	6.8	7.2	7.6	7.9
Northern Ireland Office	1.1	1.2	1.2	1.1	1.1
Chancellor's Departments	4.6	5.0	5.2	5.2	5.2
Cabinet Office	1.8	1.9	1.9	2.0	2.0
Invest to Save Budget	0.0	0.0	0.0	0.0	0.0
Reserve	0.0	0.3	0.9	1.1	1.5
Unallocated special reserve[2]	0.0	0.7	0.0	0.0	0.0
Allowance for shortfall	0.0	–4.0	0.0	0.0	0.0
Total Resource Budget DEL	**250.5**	**266.7**	**286.6**	**304.2**	**319.6**
Capital Budget					
Education and Skills	3.3	3.8	4.4	4.8	5.5
Health	2.6	3.1	4.3	5.3	6.3
of which: NHS	2.5	3.0	4.2	5.2	6.1
Transport	3.0	3.5	3.3	4.1	4.2
Office of the Deputy Prime Minister	2.3	2.3	2.4	2.5	2.5
Local Government	0.2	0.4	0.3	0.2	0.2
Home Office	0.9	1.2	1.1	1.2	1.3
Departments for Constitutional Affairs	0.1	0.2	0.1	0.1	0.1
Attorney General's Departments	0.0	0.0	0.0	0.0	0.0
Defence	5.9	6.4	6.9	7.0	7.6
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	0.6	0.2	0.3	0.5	0.5
Environment, Food and Rural Affairs	0.4	0.3	0.3	0.3	0.3
Culture, Media and Sport	0.1	0.2	0.1	0.1	0.1
Work and Pensions	0.2	0.3	0.3	0.2	0.1
Scotland[1]	1.4	2.0	2.1	2.0	2.2
Wales[1]	0.8	0.9	1.0	1.1	1.2
Northern Ireland Executive[1]	0.4	0.4	0.4	0.5	0.5
Northern Ireland Office	0.1	0.1	0.1	0.1	0.1
Chancellor's Departments	0.3	0.4	0.3	0.4	0.5
Cabinet Office	0.6	0.3	0.2	0.2	0.3
Invest to Save Budget	0.0	0.0	0.0	0.0	0.0
Reserve	0.0	0.6	0.8	0.7	1.2
Allowance for shortfall	0.0	–0.4	0.0	0.0	0.0
Total Capital Budget DEL	**23.2**	**26.2**	**29.1**	**31.5**	**34.9**
Depreciation	**–9.1**	**–11.0**	**–11.7**	**–12.1**	**–11.8**
Total Departmental Expenditure Limits	**264.6**	**281.9**	**304.0**	**323.6**	**342.7**
Total education spending	59.5	64.5	68.1	72.3	76.8

[1] *For Scotland, Wales and Northern Ireland, the split between current and capital budgets is decided by the respective executives.*
[2] *This represents provision for the costs of Iraq and other International obligations.*

B92 Central government debt interest payments for 2005-06 are lower than in Budget 2004, largely as a result of the impact of lower RPI on indexed linked gilt payments. In 2006-07 and 2007-08 payments are higher mainly because of the cumulative effects of higher cash requirement.

B93 Public corporations' own financed capital expenditure forecasts have been revised in line with public corporations' latest spending plans.

B94 The main accounting adjustments, which reconcile the DEL and AME measures of spending with the national accounts measure, are shown in Table B19. Changes to the accounting adjustments since the last forecast are mainly due to:

- reclassification of NHS Trusts, removing Trusts' notional profits and reducing their VAT refunds;
- presentational changes to non-cash items in AME; and
- differences between the national accounts and FRS17 estimates for public sector pensions.

B95 Table B20 shows public sector capital expenditure from 2003-04 to 2006-07.

Table B19: Accounting adjustments

	£ billion				
	Outturn	Estimate		Projections	
	2003–04	2004–05	2005–06	2006–07	2007-08
Tax credits for individuals	0.1	0.0	0.0	0.0	0.0
Pensions	–22.4	–22.2	–23.5	–24.3	–25.2
European Community contributions	–4.7	–3.9	–3.8	–4.0	–3.9
Other central government programmes	0.4	0.4	0.4	0.4	0.4
VAT refunds	9.2	9.4	10.7	11.7	12.9
Central government non-trading capital consumption	5.6	6.0	6.3	6.7	7.2
Non-cash items in resource budgets and not in TME	–11.6	–10.8	–11.1	–12.5	–13.4
Expenditure financed by revenue receipts	0.2	0.3	0.3	0.3	0.3
Local authorities	4.5	4.9	5.3	5.8	6.2
General government consolidation	–5.2	–4.9	–5.0	–5.1	–5.2
Public corporations	0.1	0.2	0.2	0.3	0.3
Financial transactions	0.9	–0.7	1.4	1.6	0.8
Other accounting adjustments	–2.8	–0.3	–0.3	–0.3	–0.3
Total accounting adjustments	**–25.8**	**–21.7**	**–19.1**	**–19.5**	**–20.0**

Table B20: Public sector capital expenditure

	£ billion			
	Outturn	Estimate	Projections	
	2003–04	2004–05	2005–06	2006–07
Capital Budget DEL	23.2	26.2	29.1	31.5
Locally-financed expenditure	0.3	2.1	2.1	2.3
National Lottery	1.2	0.9	0.9	0.8
Public corporations' own-financed capital expenditure	2.5	2.3	2.2	2.2
Other capital spending in AME	0.8	4.7	7.8	8.7
AME margin	0.0	0.4	0.0	0.6
Public sector gross investment[1]	**28.0**	**36.6**	**42.3**	**46.0**
Less depreciation	14.3	14.9	15.8	16.7
Public sector net investment	**13.7**	**21.7**	**26.5**	**29.3**
Proceeds from the sale of fixed assets[2]	6.0	5.5	5.5	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.*

B96 Table B21 shows estimated receipts from loans and sales of assets from 2003-04 to 2007-08.

Table B21: Loans and sales of assets

	£ billion			
	Outturn	Estimate		
	2003–04	2004–05	2005–06	2006–07
Sales of fixed assets				
Central government	1.1	1.0	1.0	1.0
Local authorities	3.8	4.5	4.5	4.5
Total sales of fixed assets	**4.9**	**5.5**	**5.5**	**5.5**
Total loans and sales of financial assets	**–2.3**	**–1.9**	**–2.0**	**–2.3**
Total loans and sales of assets	**2.7**	**3.6**	**3.5**	**3.2**

FINANCING REQUIREMENT

B97 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

	2004–05				2005–06			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing	**35.4**	**–1.8**	**0.7**	**34.2**	**31.7**	**2.0**	**–0.3**	**33.4**
Financial transactions								
Net lending to private sector and abroad	1.9	–0.1	0.0	1.9	2.1	–0.1	0.0	2.0
Cash expenditure on company securities	0.1	0.0	0.0	0.1	0.1	0.0	0.0	0.1
Accounts receivable/payable	3.6	0.0	–0.7	2.9	2.4	0.0	–0.7	1.7
Adjustment for interest on gilts	–2.4	0.0	0.0	–2.4	–2.4	0.0	0.0	–2.4
Miscellaneous financial transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Own account net cash requirement	38.7	–1.9	0.0	36.7	33.8	1.9	–1.0	34.8
Net lending within the public sector	1.0	–0.5	–0.5	0.0	1.9	–1.0	–0.9	0.0
Net cash requirement[1]	**39.7**	**–2.4**	**–0.6**	**36.7**	**35.8**	**0.9**	**–1.9**	**34.8**

[1] *Market and overseas borrowing for local government and public corporation sectors.*

B98 Table B23 updates the financing arithmetic for 2004-05 in line with the updated fiscal forecasts. The central government net cash requirement (CGNCR) for 2004-05 is now forecast to be £39.7 billion, an increase of £4.1 billion from the Budget 2004 forecast. The increase in the CGNCR means that the net financing requirement for 2004-05 is now forecast to be £52.4 billion, an increase of £4.1 billion from the forecast published in Budget 2004.

B99 In order to meet the increase in the financing requirement, the Debt Management Office's (DMO's) remit has been revised as follows:

- forecast gross gilts issuance has been increased by £3.2 billion to £50.3 billion. This increase is being split as follows:
  - an additional short conventional gilt issuance of £2.8 billion;
  - an incremental increase to long maturity gilt issuance of £0.2 billion; and
  - an incremental increase to index-linked gilt issuance of £0.2 billion.
- an additional conventional gilt auction has been scheduled for 20 January 2005; and
- The stock of Treasury bills will now be run down by £0.8 billion instead of the original reduction of £1.8 billion.

B100 The latest financing arithmetic set out in table B23 also takes account of a £0.1 billion smaller contribution to financing in 2003-04 from National Savings & Investments than envisaged when the revised 2004-05 financing arithmetic was published in April.

B101 The Government has also instructed the DMO formally to consult the market about the possible issuance of ultra-long (circa 50-year maturity) conventional and index-linked gilts, perhaps in the alternative format of fixed-term annuities. The DMO announced the consultation with the PBR and this will commence immediately with the deadline for responses being 21 January 2005.

B102 Full details of the DMO's consultation on possible new gilt products, together with details of changes to the financing arithmetic and a revised financing table for 2004-05 can be found on the DMO's website at www.dmo.gov.uk/news/flnews.htm.

Table B23: Financing requirement forecast

	2004–05		
£ billion	Original remit March 2003	Revised remit April 2004	Pre-Budget Report
Central government net cash requirement	**35.6**	**35.6**	**39.7**
Gilt redemptions	14.7	14.7	14.7
Financing for the Official Reserves	0.0	0.0	**0.0**
Buy-backs	0.0	0.0	0.0
Gross Financing requirement	**50.3**	**50.3**	**54.4**
less			
National Savings and Investments	2.0	2.0	2.0
DMO cash deposit at the Bank of England	0.0	0.1	0.0
Net financing requirement	**48.3**	**48.3**	**52.4**
Planned net short-term debt sales			
Change in T bill stock	0.1	–1.8	–0.8
Change in Ways and Means	0.0	0.0	0.0
Change in short-term cash position[1]	0.2	3.0	2.9
Gilt sales requirement	**0.3**	**1.2**	**2.1**
Planned gross gilt sales	**48.0**	**47.1**	**50.3**
Gilt sales to date (April–November 2004)			
of which:			
Short conventionals (1–7 years)			11.8
Medium conventionals (7–15 years)			7.8
Long conventionals (>15 years)			9.5
Index-linked			3.4
Further planned gilt sales			
Short conventionals (1–7 years)			5.9
Medium conventionals (7–15 years)			2.5
Long conventionals (>15 years)			5.0
Index-linked			4.6

Note: Figures may not sum due to rounding.

[1] *Excluding changes in the DMO's cash deposit at the Bank of England.*

ANALYSIS BY SUBSECTOR AND ECONOMIC CATEGORY

B103 Table B24 shows a breakdown of general government transactions by economic category for 2003-04 to 2007-08. Table B25 shows a more detailed breakdown for public sector transactions by sub-sector and economic category for 2003-04, 2004-05 and 2005-06.

Table B24: General government transactions by economic category

	£ billion				
	Outturn	Estimate	Projections		
	2003–04	2004–05	2005–06	2006–07	2007-08
Current receipts					
Taxes on income and wealth	145.6	162.1	180.0	197.2	211.3
Taxes on production and imports	148.7	157.0	166.0	174.0	182.3
Other current taxes	23.2	24.0	26.0	27.9	30.0
Taxes on capital	2.5	2.9	3.3	3.6	3.9
National insurance contributions	75.1	78.0	82.7	87.6	93.1
Gross operating surplus	10.5	11.2	12.0	12.9	13.8
Rent and other current transfers	1.6	1.7	1.7	1.7	1.7
Interest and dividends from private sector and abroad	3.8	4.5	4.4	4.4	4.4
Interest and dividends from public sector	5.8	7.0	7.4	7.8	8.1
Total current receipts	**416.8**	**448.4**	**484.1**	**517.1**	**548.7**
Current expenditure					
Current expenditure on goods and services	232.8	248.2	263.6	281.3	299.4
Subsidies	7.4	5.3	5.7	6.1	6.5
Net social benefits	135.2	145.8	152.0	156.2	162.3
Net current grants abroad	–0.9	–3.9	–2.4	–3.4	–4.6
Other current grants	28.3	28.3	30.7	33.5	36.1
Interest and dividends paid	22.6	24.2	25.5	27.0	28.1
AME margin	0.0	0.6	2.9	1.8	2.5
Total current expenditure	**425.4**	**448.5**	**477.9**	**502.5**	**530.2**
Depreciation	10.5	11.2	12.0	12.9	13.8
Surplus on current budget	**–19.0**	**–11.3**	**–5.8**	**1.7**	**4.7**
Capital expenditure					
Gross domestic fixed capital formation	17.6	22.3	27.8	30.3	33.3
Less depreciation	–10.5	–11.2	–12.0	–12.9	–13.8
Increase in inventories	0.0	–0.0	0.0	0.0	0.0
Capital grants (net) within public sector	1.2	0.9	0.5	0.5	0.5
Capital grants to private sector	8.7	11.1	12.6	13.3	13.1
Capital grants from private sector	–1.3	–1.2	–1.1	–1.0	–0.9
AME margin	0.0	0.4	0.0	0.6	0.3
Net investment	**15.9**	**22.3**	**27.9**	**30.8**	**32.6**
Net borrowing[1]	**34.9**	**33.6**	**33.7**	**29.1**	**27.9**
of which:					
Central government net borrowing	37.0	35.4	31.7	26.9	25.7
Local authority net borrowing	–2.1	–1.8	2.0	2.2	2.2
Gross debt (Maastricht basis)					
Central government	386.2	428.0	466.4	499.2	531.4
Local government	55.0	52.6	53.6	54.7	55.7

[1] *Although this is based on the ESA95 definition of general government net borrowing (GGNB), the projections are identical to GGNB calculated on a Maastricht definition.*

Table 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	145.6	0.0	–0.1	145.5
Taxes on production and imports	148.6	0.1	0.0	148.7
Other current taxes	5.1	18.2	0.0	23.2
Taxes on capital	2.5	0.0	0.0	2.5
National insurance contributions	75.1	0.0	0.0	75.1
Gross operating surplus	5.6	4.9	7.2	17.6
Rent and other current transfers	1.6	0.0	0.0	1.6
Interest and dividends from private sector and abroad	3.1	0.7	0.6	4.4
Interest and dividends from public sector	4.8	1.0	–5.8	0.0
Total current receipts	**392.0**	**24.9**	**1.9**	**418.7**
Current expenditure				
Current expenditure on goods and services	141.5	91.3	0.0	232.8
Subsidies	6.1	1.3	0.0	7.4
Net social benefits	121.8	13.4	0.0	135.2
Net current grants abroad	–0.9	0.0	0.0	–0.9
Current grants (net) within public sector	86.1	–86.1	0.0	0.0
Other current grants	28.2	0.0	0.0	28.3
Interest and dividends paid	22.2	0.4	0.1	22.7
AME margin	0.0	0.0	0.0	0.0
Total current expenditure	**405.1**	**20.3**	**0.1**	**425.5**
Depreciation	5.6	4.9	3.9	14.3
Surplus on current budget	**–18.8**	**–0.2**	**–2.1**	**–21.1**
Capital expenditure				
Gross domestic fixed capital formation	8.8	8.8	2.7	20.3
Less depreciation	–5.6	–4.9	–3.9	–14.3
Increase in inventories	0.0	0.0	0.0	0.1
Capital grants (net) within public sector	7.5	–6.2	–1.2	0.0
Capital grants to private sector	7.9	0.9	0.3	9.0
Capital grants from private sector	–0.4	–0.9	0.0	–1.3
AME margin	0.0	0.0	0.0	0.0
Net investment	**18.2**	**–2.3**	**–2.1**	**13.7**
Net borrowing	**37.0**	**–2.1**	**–0.1**	**34.8**

Table B25: Public sector transactions by sub-sector and economic category

	£ billion			
	2004–05			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current Receipts				
Taxes on income and wealth	162.1	0.0	–0.1	162.1
Taxes on production and imports	156.8	0.2	0.0	157.0
Other current taxes	5.2	18.8	0.0	24.0
Taxes on capital	2.9	0.0	0.0	2.9
National insurance contributions	78.0	0.0	0.0	78.0
Gross operating surplus	6.0	5.3	9.0	20.2
Rent and other current transfers	1.7	0.0	0.0	1.7
Interest and dividends from private sector and abroad	3.5	0.9	0.6	5.0
Interest and dividends from public sector	4.0	3.0	–7.0	0.0
Total current receipts	**420.3**	**28.2**	**2.6**	**451.0**
Current expenditure				
Current expenditure on goods and services	150.5	97.7	0.0	248.2
Subsidies	4.1	1.2	0.0	5.3
Net social benefits	130.5	15.3	0.0	145.8
Net current grants abroad	–3.9	0.0	0.0	–3.9
Current grants (net) within public sector	93.0	–93.0	0.0	0.0
Other current grants	28.3	0.0	0.0	28.3
Interest and dividends paid	23.8	0.4	0.2	24.3
AME margin	0.6	0.0	0.0	0.6
Total current expenditure	**426.8**	**21.6**	**0.2**	**448.6**
Depreciation	6.0	5.3	3.7	14.9
Surplus on current budget	**–12.5**	**1.2**	**–1.3**	**–12.5**
Capital expenditure				
Gross domestic fixed capital formation	10.3	12.0	3.7	26.0
Less depreciation	–6.0	–5.3	–3.7	–14.9
Increase in inventories	0.0	0.0	0.0	0.0
Capital grants (net) within public sector	8.6	–7.7	–0.9	0.0
Capital grants to private sector	9.8	1.3	0.3	11.4
Capital grants from private sector	–0.3	–0.9	0.0	–1.2
AME margin	0.4	0.0	0.0	0.4
Net investment	**22.9**	**–0.6**	**–0.6**	**21.7**
Net borrowing	**35.4**	**–1.8**	**0.7**	**34.2**

Table B25: Public sector transactions by sub-sector and economic category

	£ billion			
	2005–06			
	General government			
	Central government	Local authorities	Public corporations	Public sector
Current receipts				
Taxes on income and wealth	180.6	0.0	–0.1	180.5
Taxes on production and imports	165.9	0.2	0.0	166.0
Other current taxes	5.6	20.4	0.0	26.0
Taxes on capital	3.3	0.0	0.0	3.3
National insurance contributions	82.7	0.0	0.0	82.7
Gross operating surplus	6.3	5.7	9.6	21.6
Rent and other current transfers	1.7	0.0	0.0	1.7
Interest and dividends from private sector and abroad	3.6	0.7	0.7	5.1
Interest and dividends from public sector	3.3	4.0	–7.4	0.0
Total current receipts	**453.1**	**31.0**	**2.9**	**487.0**
Current expenditure				
Current expenditure on goods and services	159.2	104.4	0.0	263.6
Subsidies	4.3	1.3	0.0	5.7
Net social benefits	134.0	18.0	0.0	152.0
Net current grants abroad	–2.4	0.0	0.0	–2.4
Current grants (net) within public sector	98.3	–98.3	0.0	0.0
Other current grants	30.6	0.0	0.0	30.7
Interest and dividends paid	25.1	0.4	0.2	25.7
AME margin	2.9	0.0	0.0	2.9
Total current expenditure	**452.1**	**25.8**	**0.2**	**478.1**
Depreciation	6.3	5.7	3.8	15.8
Surplus on current budget	**–5.3**	**–0.5**	**–1.1**	**–6.9**
Capital expenditure				
Gross domestic fixed capital formation	12.6	15.1	2.7	30.4
Less depreciation	–6.3	–5.7	–3.8	–15.8
Increase in inventories	0.0	0.0	0.0	0.0
Capital grants (net) within public sector	9.1	–8.5	–0.5	0.0
Capital grants to private sector	11.2	1.4	0.3	12.9
Capital grants from private sector	–0.3	–0.8	0.0	–1.1
AME margin	0.0	0.0	0.0	0.0
Net investment	**26.4**	**1.5**	**–1.4**	**26.5**
Net borrowing	**31.7**	**2.0**	**–0.3**	**33.4**

HISTORICAL SERIES

Table B26: Historical series of public sector balances, receipts and debt

Per cent of GDP

	Public sector current budget	Cyclically-adjusted surplus on current budget	Public sector net borrowing	Cyclically-adjusted public sector net borrowing	Public sector net cash requirement	Net taxes and national insurance contributions	Public sector current receipts	Public sector net debt[1]	Public sector net worth[2]
1970–71	6.7	7.3	–0.6	–1.2	1.2		43.3		
1971–72	4.2	5.2	1.0	0.0	1.4		41.4		
1972–73	2.0	2.3	2.8	2.6	3.6		39.0		
1973–74	0.3	–0.8	5.0	6.0	5.9		39.6		
1974–75	–1.1	–1.8	6.6	7.3	9.0		42.3	52.1	
1975–76	–1.6	–0.4	7.0	5.9	9.3		42.9	53.8	
1976–77	–1.2	0.5	5.6	3.8	6.4		43.3	52.3	
1977–78	–1.4	–0.7	4.3	3.6	3.7		41.5	49.0	
1978–79	–2.6	–2.5	5.0	4.9	5.2	33.5	40.2	47.1	
1979–80	–1.9	–1.8	4.1	4.0	4.7	33.9	40.7	43.9	
1980–81	–3.0	–1.1	4.9	2.9	5.2	35.9	42.4	46.0	
1981–82	–1.4	2.6	2.3	–1.7	3.3	38.6	45.8	46.2	
1982–83	–1.5	2.8	3.0	–1.3	3.2	38.7	45.5	44.8	
1983–84	–2.0	1.6	3.8	0.2	3.2	38.2	44.4	45.1	
1984–85	–2.2	0.8	3.7	0.7	3.1	38.9	44.3	45.3	
1985–86	–1.2	0.6	2.4	0.6	1.6	38.1	43.2	43.5	
1986–87	–1.4	–1.2	2.1	1.9	0.9	37.8	42.0	41.0	
1987–88	–0.3	–1.6	1.0	2.2	–0.7	37.6	41.1	36.8	77.9
1988–89	1.7	–0.9	–1.3	1.3	–3.0	36.9	40.7	30.5	82.6
1989–90	1.4	–1.4	–0.2	2.6	–1.3	36.2	39.9	27.7	73.8
1990–91	0.4	–1.2	1.0	2.6	–0.1	35.9	38.9	26.2	61.4
1991–92	–2.0	–1.5	3.8	3.3	2.3	34.7	38.5	27.4	54.1
1992–93	–5.6	–3.6	7.6	5.6	5.9	33.7	36.6	32.0	40.7
1993–94	–6.2	–3.9	7.8	5.5	7.1	32.8	35.6	40.8	29.4
1994–95	–4.8	–3.3	6.3	4.8	5.3	34.0	36.7	42.7	28.5
1995–96	–3.4	–2.6	4.8	3.9	4.3	34.7	37.6	43.6	20.5
1996–97	–2.8	–2.3	3.6	3.0	2.9	34.8	37.1	41.6	16.8
1997–98	–0.2	–0.1	0.8	0.7	0.2	36.0	38.2	39.1	13.3
1998–99	1.2	0.9	–0.4	–0.2	–0.8	36.5	38.5	36.3	12.1
1999–00	2.1	1.9	–1.7	–1.4	–0.9	36.5	38.9	31.3	15.3
2000–01	2.1	1.6	–1.6	–1.0	–3.9	37.4	39.5	30.2	20.5
2001–02	0.9	0.7	0.0	0.3	0.3	36.8	38.6	31.5	25.6
2002–03	–1.3	–0.7	2.4	1.8	2.3	35.4	37.2	32.9	24.2
2003–04	–1.9	–1.0	3.1	2.2	3.6	35.6	37.5	33.0	22.0

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

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

Table B27: Historical series of government expenditure

	£ billion (2003–04 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	170.2	31.9	50.9	222.5	32.6	6.1	9.8	42.7
1971–72	178.2	28.2	47.6	227.3	33.3	5.3	8.9	42.5
1972–73	185.8	27.0	47.2	234.7	33.1	4.8	8.4	41.9
1973–74	204.3	30.4	53.2	259.3	35.1	5.2	9.1	44.5
1974–75	226.2	32.2	56.0	284.6	38.8	5.5	9.6	48.9
1975–76	230.9	31.6	56.5	289.0	39.9	5.5	9.8	49.9
1976–77	237.8	25.8	51.7	291.0	39.9	4.3	8.7	48.8
1977–78	234.4	17.5	43.1	279.4	38.4	2.9	7.1	45.8
1978–79	241.4	15.3	41.8	284.7	38.4	2.4	6.7	45.3
1979–80	247.6	14.2	41.0	290.2	38.2	2.2	6.3	44.8
1980–81	254.9	11.4	38.4	295.1	40.8	1.8	6.1	47.3
1981–82	266.4	5.8	32.7	300.8	42.6	0.9	5.2	48.1
1982–83	272.1	9.6	35.4	309.4	42.7	1.5	5.6	48.5
1983–84	280.6	11.8	37.4	320.0	42.3	1.8	5.6	48.2
1984–85	288.3	10.4	34.7	325.0	42.6	1.5	5.1	48.0
1985–86	288.5	8.8	30.7	320.6	41.0	1.2	4.4	45.6
1986–87	292.9	5.2	30.4	321.9	40.1	0.7	4.2	44.1
1987–88	259.3	4.4	23.6	282.9	38.6	0.7	3.5	42.1
1988–89	289.1	2.8	25.5	314.6	36.2	0.4	3.2	39.4
1989–90	291.4	9.7	33.3	324.0	35.7	1.2	4.1	39.7
1990–91	293.0	11.7	31.5	324.6	36.1	1.4	3.9	40.0
1991–92	310.4	14.8	31.8	342.1	38.4	1.8	3.9	42.3
1992–93	325.5	16.2	36.1	357.5	40.2	2.0	4.5	44.2
1993–94	334.9	13.1	34.2	363.5	40.0	1.6	4.1	43.4
1994–95	345.8	12.7	33.1	374.7	39.7	1.5	3.8	43.0
1995–96	350.9	12.2	32.5	379.4	39.2	1.4	3.6	42.4
1996–97	352.1	6.6	26.4	373.3	38.3	0.7	2.9	40.6
1997–98	351.7	6.0	24.9	372.0	36.9	0.6	2.6	39.0
1998–99	351.1	7.2	25.0	372.2	35.9	0.7	2.6	38.1
1999–00	357.4	4.9	21.6	376.2	35.3	0.5	2.1	37.1
2000–01	377.4	5.6	25.7	397.2	36.0	0.5	2.4	37.9
2001–02	387.5	10.5	29.4	412.3	36.3	1.0	2.8	38.6
2002–03	404.0	11.6	32.6	430.0	37.2	1.1	3.0	39.6
2003–04	425.5	13.7	31.3	453.6	38.1	1.2	2.8	40.6

[1] *Net of sales of fixed assets.*

C FLEXIBILITY IN THE UK ECONOMY

C1 The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. Ensuring opportunity for all in the global economy requires taking long-term decisions to promote flexibility and fairness.

C2 *Long-term global economic challenges and opportunities for the UK*, published alongside the Pre-Budget Report, sets out how the far-reaching changes in technology, production and trading patterns are reshaping the global economy. Faster information flows and falling communication costs are breaking down geographical barriers to economic activity. International trade and investment is growing and production is becoming increasingly flexible, specialised and dispersed across continents. Many emerging markets are growing strongly and their workforces are developing higher skills levels and becoming more productive. These trends suggest that the next ten years and beyond will see fundamental change in the global economy. Flexibility in labour, product and capital markets is critical to ensuring that individuals and firms can adapt to changes and thrive in a globally competitive environment.

C3 The Government is committed to advancing flexibility and fairness together. In the more competitive and integrated global economy, the future pace of change will be ever quicker and more intense. This has great potential benefits in terms of growth and prosperity but also entails difficult adjustments for individuals and firms as labour and capital are redeployed from traditional sectors to expanding ones. It is critical to ensure fairness through policies that expand opportunity and choice, and provide security for the vulnerable, while maintaining incentives to work and save. The introduction of the National Minimum Wage and reforms to the tax and benefits systems help to cushion the impact of economic shocks on household incomes, while high quality and responsive services such as Jobcentre Plus, provide incentives and practical support to enable people to re-enter the labour market. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

C4 In his statement to the House of Commons on 9 June 2003 on UK membership of the single currency, the Chancellor gave a commitment to publish six monthly reports on trends and progress in labour, product and capital markets. This annex is the third of these reports. It complements a range of other information the Government produces on economic developments and structural policy reforms in both the UK and internationally, particularly across Europe. The report records progress on the Government's reforms of labour, product and capital markets, which promote flexibility and fairness.

C5 This annex is divided into two sections:

- the first section explains the importance of a flexible economy in a global context and how the Government's policies combine flexibility with fairness; and

- the second section sets out the action the Government has taken to boost flexibility in labour, product and capital markets since Budget 2004 and in this Pre-Budget Report.

WHY FLEXIBILITY MATTERS

Why flexibility is needed

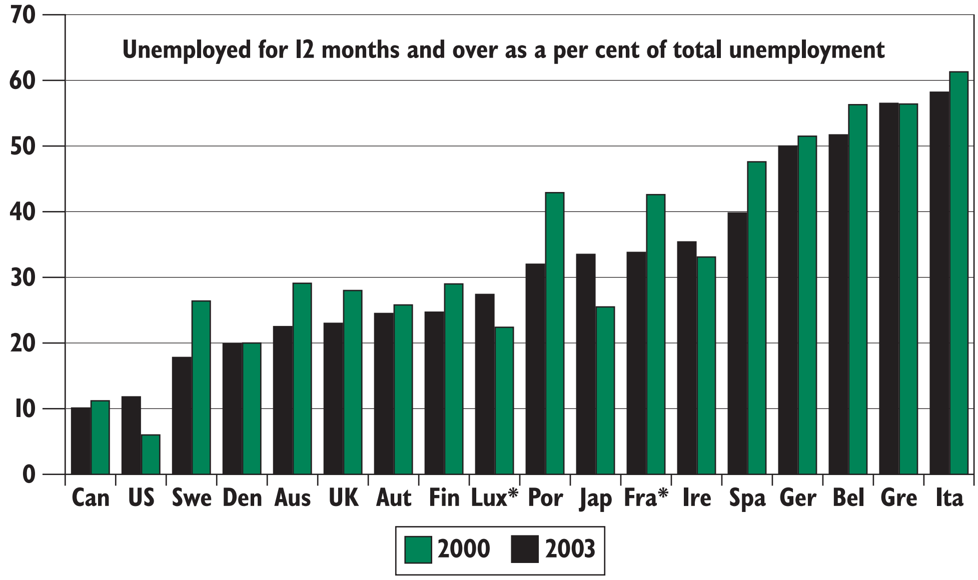
C6 Flexibility is the ability of firms and individuals to respond to economic change efficiently and quickly. Economic change can come in many different forms. In recent years, advances in information and communications technology, the increased integration of emerging markets with the global economy and high oil prices have been prominent developments affecting industry. In an increasingly integrated global economy, the pace of these changes is faster than in the past. If markets and individuals do not have the flexibility and adaptability to respond to change, then exposure to foreign competition in new markets and new technologies may result in falling relative earnings or long-term unemployment, particularly among lower skilled workers.

Characteristics of flexibility

C7 Economic flexibility describes an economy's capacity to adjust to such changes. There are many different ways in which workers and firms can adjust to change. For firms, adjustment may involve altering prices or changing a product line. For a worker, adjustment may be learning a new skill, moving into a different job in the same firm or even changing employer. Adjustment is achieved by a combination of changes occurring in the labour, product and capital markets supplemented, if necessary, by complementary changes in the stance of monetary and fiscal policy. Flexibility is about minimising the costs of adjustment.

C8 In a flexible economy, people will move in and out of employment, both within and between industries, as the demand for labour, products and capital change. One indicator of flexibility within a country is the rate of long-term unemployment. A country with large numbers of long-term unemployed is not adjusting labour or production fast enough. The UK, partly as a result of the effectiveness of the New Deal regime, has lower rates of long-term unemployment compared to many European countries. Chart C1 shows how the UK long-term unemployment rate has fallen from 28 per cent in 2000 to 23 per cent in 2003, although this still remains above the levels achieved in the US and Canada.

Chart C1: Long-term unemployment



Source: OECD Employment Outlook, 2004.

*Note: * indicates 2002 data*

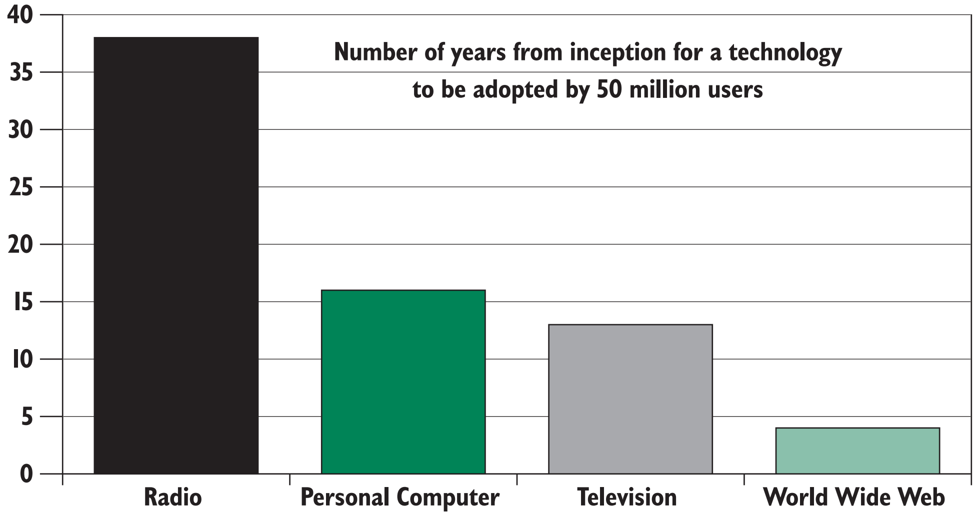
FLEXIBILITY AND THE GLOBAL ECONOMY

Globalisation and flexibility

C9 As set out in *Long-term global economic challenges and opportunities for the UK*, published alongside this Pre-Budget Report, changes in the global economy can deliver significant potential benefits. However, global change also creates new challenges. To succeed in an increasingly integrated global economy, countries need to be flexible, open and outward looking. If firms and individuals do not have the flexibility and adaptability to respond to change then exposure to overseas competition and new technologies can entail large transitional costs. The UK economy, as an open and global economy, is constantly undergoing a process of structural change, with the amount of labour and capital required by some industries declining, freeing up resources for use in the production of new goods and services.

C10 A key feature of the changing global economy is the rapid rate of technology change. As the pace of global economic change has accelerated, competition and innovation have shortened the typical life cycle of products, leading to faster renewal. As Chart C2 demonstrates, the pace of take-up of new technology has increased over recent years. As a result, firms' abilities to adapt and to take advantage of new technologies and markets are increasingly crucial to their success. The same is also true in the labour market where employees must update their skills more frequently than before and the concept of a job-for-life no longer holds.

Chart C2: Pace of take-up of new technology



Source: Economist 1999.

Flexibility, skills and innovation in the global economy

C11 Structural change is a constant feature of a well-functioning, flexible economy. As some sectors decline, so other sectors – requiring different skills – will expand. More integrated global markets and cross-border trade and investment are likely to lead to an increased pace of structural change. Increasing rewards to innovation mean that the UK will increasingly depend on its ability to create new knowledge and translate it into innovative goods and services. In addition, the number of skilled workers are rising rapidly in emerging markets such as China and India. This will create great opportunities for the global economy but, if the UK is to make full use of these opportunities, it needs to ensure it has a highly skilled, flexible workforce.

C12 The pace of technological change and global integration are expected to increase demand for a more highly skilled workforce with the ability to adapt to changing technologies and shifting product demand. For advanced economies, looking to move into high-value added areas, there will be a premium on high-skilled workers. Moreover, skills that were once regarded as high-level are now increasingly viewed as basic skills. So countries will need to invest in the skills of their whole workforces, and ensure that they equip individuals to re-skill continually in order to compete and adjust in the global economy.

Capital market flexibility in the global economy

C13 Advances in information and communications technology have facilitated the development of new financial products and enabled a greater integration of international capital markets. These developments have increased the opportunities for risk sharing and portfolio diversification. They have extended the range of financing options available to entrepreneurs, firms and households, thereby increasing both the flexibility and the resilience of the financial system. Increased financial market flexibility can also help economic adjustment by making it easier for areas with high unemployment to attract the investment needed to develop new businesses and create new jobs.

Flexibility and fairness – the UK approach

C14 The Government is committed to promoting fairness alongside flexibility and enterprise so that everyone can take advantage of opportunities to achieve their full potential in an outward-looking, flexible economy. The reforms of the welfare state introduced by the Government reflect its aims of eradicating child poverty, supporting parents to balance their work and family life, promoting saving and ensuring security for all in old age. The Government is also committed to a modern and fair tax and benefit system. The introduction of the National Minimum Wage and reforms to the tax and benefits systems help to cushion the impact of economic shocks on household incomes, while high quality and responsive services, such as Jobcentre Plus, provide incentives and practical support to enable people to re-enter the labour market. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

C15 Flexibility in labour, product and capital markets is critical to economic success in a globally competitive environment. However, in the short term, flexibility may be associated with considerable changes as labour and capital are redeployed from traditional activities into expanding industries. At any point in time, these costs will fall disproportionately on particular individuals and particular industries. For the individuals concerned this may entail considerable short-term costs, in terms of income, and in the challenges they face to acquire new skills and find new employment. It is therefore important that flexibility is accompanied by measures that enable individuals to cope with and benefit from change. Such measures ensure that flexibility is accompanied by fairness. For example, policies that support individuals through periods of unemployment, and equip them to re-enter the labour force, promote fairness by ensuring that these dislocation costs are minimised. They also contribute to flexibility by enabling individuals to make the transition between different forms of employment more rapidly.

C16 The regulatory environment is an important determinant of both flexibility and fairness. Effective and well-focused regulation can play a vital role in correcting market failures, ensuring health and safety and good working practices and in driving up standards. However, unnecessary or poorly designed regulation can be an obstacle to flexibility, restricting employment growth and competitiveness, particularly for smaller firms. The Government is committed to ensuring that the negative impacts of the regulatory framework are minimised. This includes clear impact assessments for new legislation; removing unnecessary, ineffective or counterproductive regulation; and ensuring that where legislation is appropriate it is simple, clear and effective.

FLEXIBILITY IN LABOUR, PRODUCT AND CAPITAL MARKETS

C17 The overall flexibility of the economy depends on the interaction of flexibility in the labour, capital and product markets, as illustrated in Box C1. This interdependence implies that the overall flexibility of the economy depends on each market working as effectively as possible. The diagram illustrates how changes originating in the product market are transmitted to the labour and capital market and back to the product market. Further rounds of adjustment and feedback will occur until the balance of supply and demand is restored in each market. Changes originating in labour and capital markets, for example, as a result of tax and benefit changes, which affect labour supply or a change in risk aversion affecting the cost of capital, will similarly be transmitted to other markets, with the economy's overall adjustment reflecting the interactions between all three markets.

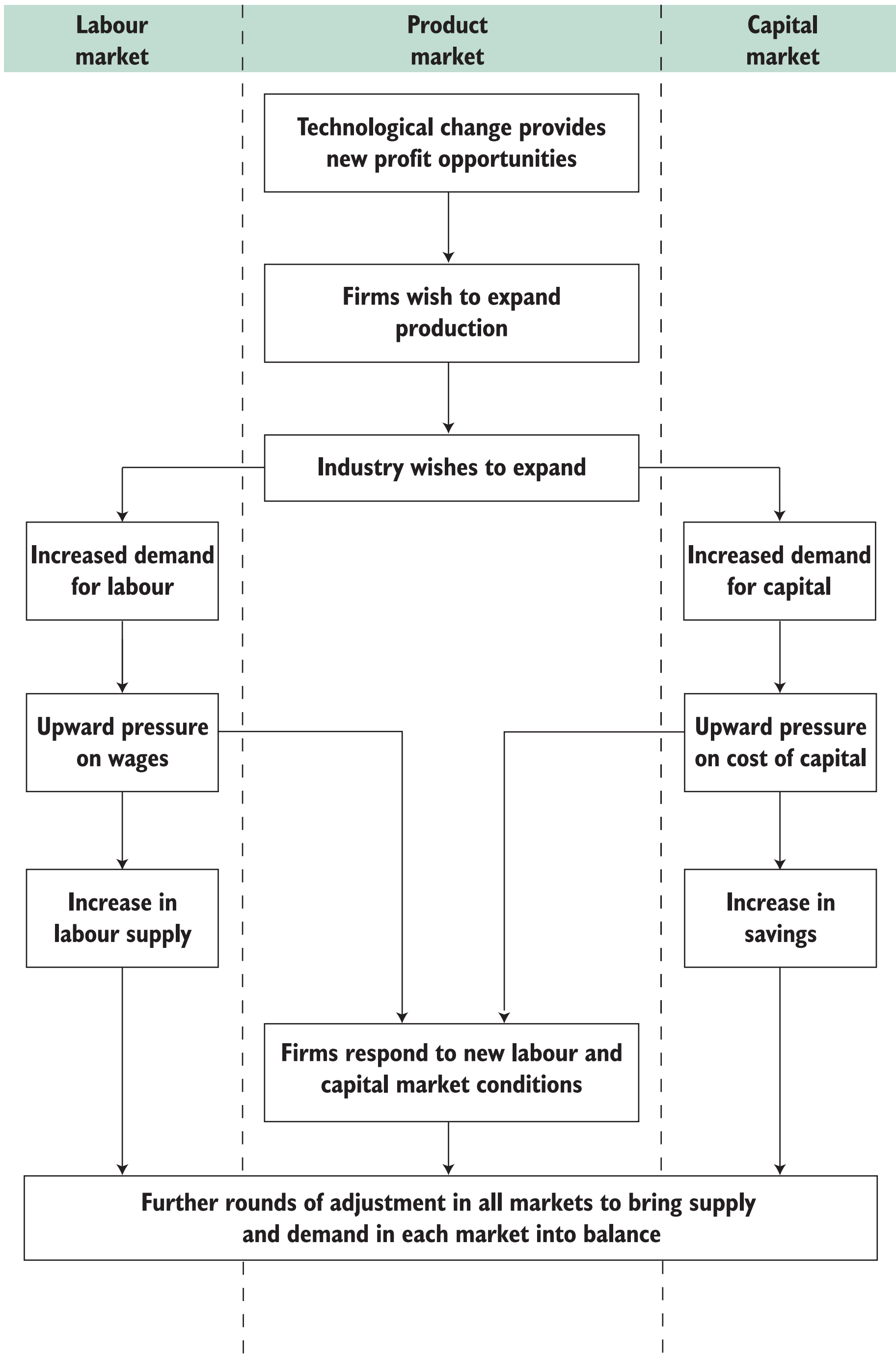
Labour market flexibility

C18 The performance of the labour market is central to the well being of the economy and society. A flexible and efficient labour market has the ability to adjust to changing economic conditions in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes. Backed up by policies which equip people rapidly to adjust to change and provide support for those who are not in employment, it implies an economy that is fairer, more competitive and more productive.

C19 The key characteristics of a flexible labour market are that:

- wages adjust to maintain the balance between labour supply and labour demand;
- the labour force is equipped with transferable skills that employers require, enabling the rapid redeployment of labour within or between firms when labour demand changes;
- firms do not find it prohibitively costly to create employment or to vary it when needed;
- workers are able to commute easily or move residence in order to find employment;
- working patterns meet the needs of both employers and employees, increasing labour supply; and
- there is an institutional environment that encourages labour force participation, equips people to adapt to change and provides support for those without employment, enabling them to remain active participants in the labour market.

Box C1: The interaction between labour, product and capital markets



Product market flexibility

C20 Product market flexibility relates to the ease with which firms are able to respond to changing market conditions. For individual firms or industries, increased flexibility enables them to respond rapidly, allowing firms to exploit new opportunities and to deal with potential challenges effectively. Flexibility provides firms with the scope to succeed in a competitive market environment.

C21 The main characteristics of a flexible product market are that:

- there is a competitive environment which rewards efficiency, discourages waste and provides firms with strong incentives to adapt the range and quality of their goods and services to provide their customers with good quality products at competitive prices;
- there is a strong capacity for innovation, enabling firms to develop and implement new processes and products ahead of their competitors;
- there are low barriers to entry which allow new firms to challenge incumbents creating incentives for innovation and efficiency; and
- a regulatory environment in which the constraints on business yield clear benefits to the wider economy, and are not disproportionately costly in terms of their effect on firms' incentives to hire, train, innovate and invest.

Capital market flexibility

C22 Capital markets contribute to the flexibility of the economy by ensuring that capital is employed effectively. Efficient capital markets ensure that business, entrepreneurs and innovators have ready access to the funds they require in order to develop their ideas. Capital markets also play an important role in balancing the risks and returns of different uses of capital, screening out projects that have an unacceptably high level of risk.

C23 Flexible capital markets can also play a role in underpinning flexibility in labour and product markets. They should allow individuals to borrow when necessary in order to enhance their education and skills with beneficial effects on productivity and the employability of the individuals concerned.

C24 In product markets, flexible access to finance should allow firms to reallocate resources efficiently and to invest, as appropriate, in new processes and products.

C25 A flexible capital market can also promote fairness by enabling all individuals to take advantage of educational and business opportunities. However, government intervention may on occasions be required to ensure that information asymmetries do not lead to some individuals being unfairly denied access to capital markets.

C26 The main characteristics of a flexible capital market are that:

- firms have a range of financing options available to them, which allows them to access the capital they require at a competitive price, and on competitive terms. This applies particularly to firms seeking capital for high risk projects, where efficient capital markets are best placed to price the risk appropriately;
- firms and households have the ability to hold a diverse portfolio of assets spread across regions and sectors, so that they can use income from these assets to insure against a fall in income that is specific to their own region and sector; and
- there is sufficient borrowing and lending capacity in credit markets to allow households and business to smooth fluctuations in income.

MEASURES TO PROMOTE FLEXIBILITY

C27 This section of the report summarises the action the Government has taken since Budget 2004 and in this Pre-Budget Report to promote flexibility and fairness in the UK economy.

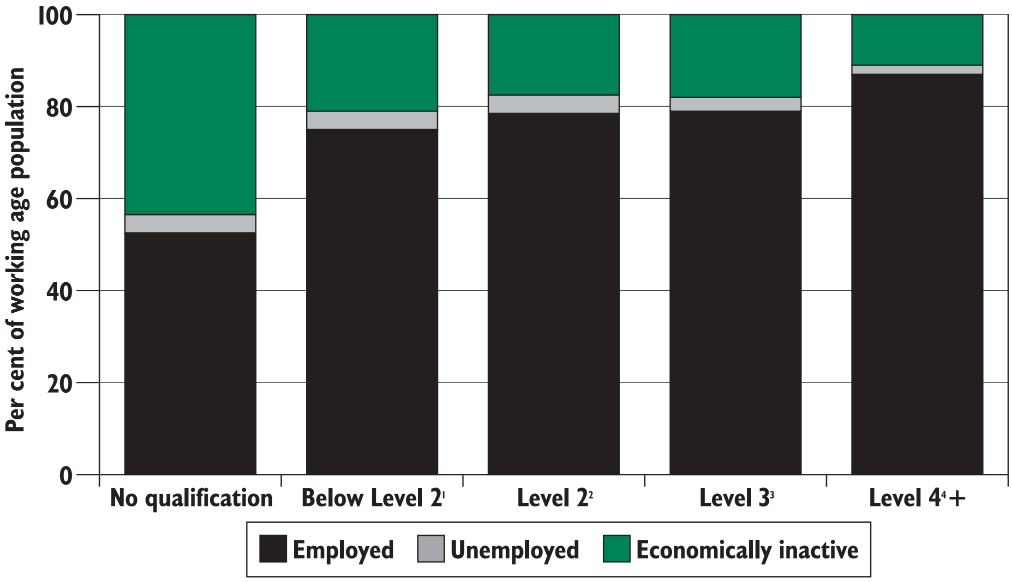
Measures to promote flexibility and fairness in labour markets

C28 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. In an increasingly open and integrated global economy, the countries that will prosper are those with flexible and outward looking economies, which can react effectively to changing economic circumstances. This Pre-Budget Report sets out action to build on the successful recent performance of the UK labour market, and tackle the long-term challenges of increasing flexibility, reducing inactivity and helping those groups in society that face particular barriers to work.

Developing skills

C29 *Skills in the global economy*, published alongside the Pre-Budget Report, explains that a highly-skilled workforce with a culture of lifelong learning is likely to be able to adapt faster and more effectively to global change: intensifying international competition; accelerating technological change and changing patterns of consumer demand. The proportion of people in the UK with high level qualifications, such as degrees, compares well internationally. However, the proportion of the workforce with intermediate level skills in the UK is comparatively low and a large proportion of people possess low or no qualifications. The Government is committed to ensuring that all adults can acquire the skills necessary to move into sustainable jobs, progress into more skilled employment and adapt to change in the workforce. Chart C3 shows how an increase in educational attainment increases the likelihood of being in work, illustrating the importance of education for individuals and the economy.

Chart C3: Economic activity and highest qualification



Source: Labour Force Survey, Winter 2003.
1: 5 GCSEs A – G or NVQ Level 1*
2: 5 GCSEs A – C or NVQ Level 2*
3: A Level or NVQ Level 3
4: degree, postgraduate or NVQ Level 4 or 5

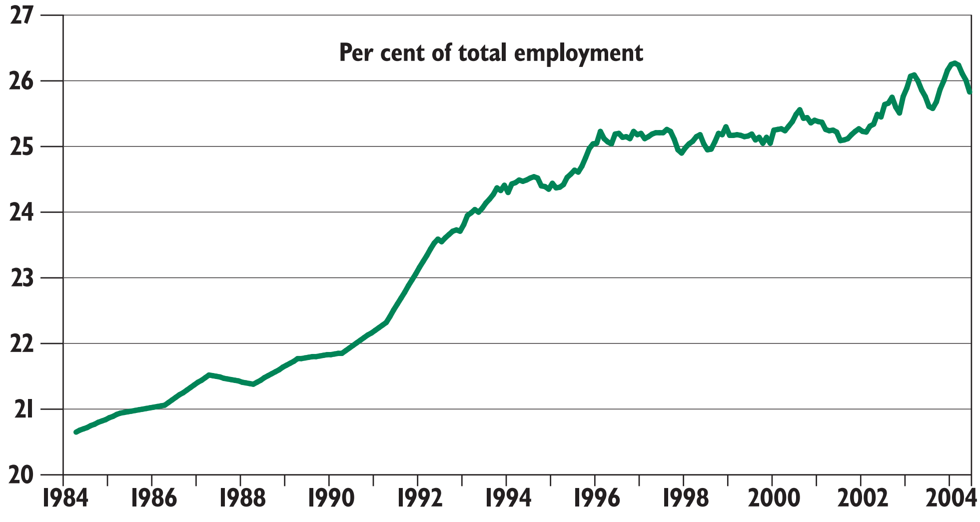
C30 Chapter 6 in this Pre-Budget Report describes the Government's programme for driving improvement at all levels of the education system. Chapter 3 sets out the measures the Government is taking to achieve its ambitions of raising workforce skill levels and enhancing employability. Measures include:

- a **National Employer Training Programme** providing free and flexibly delivered training for low-skilled adults in work;
- an **independent review to be led by Sandy Leitch,** Chairman of the National Employment Panel and formerly a Chief Executive of Zurich Financial Services to examine the UK's future skills needs and priorities;
- implementing the **New Deal for skills**; and
- piloting a **Learning Allowance** that will allow benefit claimants to participate in full-time training as well as pilots of a skills coaching service to provide one-to-one personalised support.

Employment flexibility

C31 If labour demand and supply are to be matched efficiently, a range of working patterns are needed, which give employers the flexibility to vary capacity levels and employees the choice to balance their work and other responsibilities, for example, through reduced hours or temporary work. The UK shows a significant degree of employment flexibility, with a wide distribution of hours worked and widespread adoption of flexible working practices. Chart C4 shows how the incidence of part-time employment in the UK increased over the 1980s, early 1990s and in the past few years.

Chart C4: Part-time employment in the UK



Source: Labour force survey 2004.

C32 In line with its determination to advance both flexibility and fairness in the labour market, the Government is committed to giving parents more choice and support in balancing their work and family responsibilities. The Government's strategy involves supporting parents' choices; tailoring financial support to families' circumstances; enhancing access to good quality childcare and parenting services; and working in partnership with business to promote the benefits of flexible working and support the take up of best practice approaches. New initiatives introduced since the Budget, and described further in Chapter 5, include:

- **a ten-year strategy for childcare**, setting out how the Government will achieve its long-term vision of affordable, good quality childcare for all parents who need it, and provide parents with real choices in balancing work and family responsibilities;
- an extension of paid **maternity leave** from six months to nine months from April 2007 and improvements to financial support for childcare costs;
- **improvements to the childcare element** of the Working Tax Credits; and
- allocating **£769 million in additional funding for Sure Start** in the 2004 Spending Review to establish Children's Centres in every community, increase the number of childcare places available and set up a pilot to extend free early education.

Improving labour market opportunities

C33 The performance of the UK labour market has been strong over recent years by both historical and international standards. However, the Government is determined to achieve its goal of employment opportunity for all by ensuring that everybody who is able and wants to work is given the appropriate assistance to help them to do so, while maintaining support for those people who are unable to work.

C34 To this end, the Government has introduced a number of measures, described fully in Chapter 4, to provide support to individuals to help them overcome the barriers to work that they face, including:

- a major expansion of the **Pathways to Work pilots** for incapacity benefits claimants;
- a package of changes to further help people on **incapacity benefits**;
- an extension of the **In-Work Credit for lone parents** to six further pilot areas; and
- a revised and strengthened **Jobseeker's Agreement** with a clearer focus on the jobseeker's responsibilities and personal record of job search.

Promoting geographical mobility

C35 A labour force that is able to move within and between regions enhances labour market flexibility by enabling workers to move to available employment opportunities. Evidence suggests that in the UK, as elsewhere in Europe, geographic labour mobility is low compared to the US. The Government has introduced several measures that aim to raise the ability and incentives for workers to commute or move location in order to find employment.

C36 In March 2004, Kate Barker published her final report[1], setting out the reasons underlying the lack of supply responsiveness of housing in the UK. The Government accepted the central recommendation of this report that there should be a step change in housing supply, making it easier for households to access employment opportunities wherever they occur. To achieve this goal the Government announced:

- **an additional £1.3 billion for housing in 2007-08** compared to 2004-05; and
- **the Planning Delivery Grant** (PDG) where over £150 million has been allocated to planning authorities to drive up the performance of the planning system.

C37 The current system of Housing Benefit can be complex, both for claimants to understand and Local Authorities to deliver, and is acting as a constraint on labour mobility both in and between regions. The Housing Benefit reform programme is now addressing these difficulties in the following ways:

- a **Housing Benefit Reform Fund worth £180m during 2006-08** to enable the roll out of flat-rate allowances and to improve the administration and structure of the Housing Benefit system; and
- a series of measures to continue to **simplify the Housing Benefit and Council Tax Benefit** system.

Measures to promote flexibility and fairness in product markets

C38 Chapter 3 of this Pre-Budget Report sets out the Government's programme of reform aimed at promoting flexibility and boosting productivity growth in the UK economy by focusing on measures which boost competition, enterprise, innovation, skills and investment.

Competition

C39 Competition enhances flexibility by providing incentives for firms to respond quickly to changes in market conditions. Competitive pressures on firms in UK product markets results in firms striving to adopt more efficient working methods and to develop new products and services which meet the changing demands of consumers. Greater competition enhances the incentives for firms to innovate and to invest in order to raise their productivity and keep ahead of their rivals.

C40 Globalisation, through international trade and investment, adds to the competitive intensity of the economy. Open markets, with low barriers to trade and investment, permit access to new opportunities in new countries and markets. This facilitates specialisation in those goods and services that economies produce more efficiently.

C41 The Government continues to take steps to enhance competition, empower consumers and promote flexibility, discussed in more detail in Chapter 3. These include:

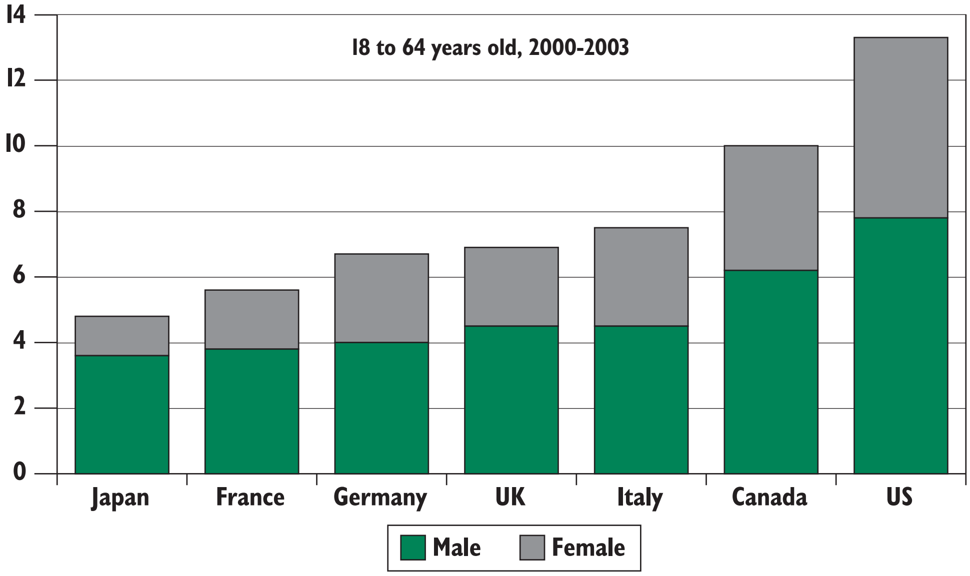
- progress on **promoting competition in a number of specific markets**;
- a range of **measures to protect consumers** including an ongoing review of the UK consumer framework; and
- action to improve **competition in public procurement**.

[1] *Delivering Stability: Securing Our Future Housing Needs*, Kate Barker, March 2004.

Enterprise **C42** Enterprise is a key driver of a modern, high-productivity economy in which opportunity is open to all. The Government believes it is essential to make the UK a more entrepreneurial economy, so that it is well placed to meet the long-term opportunities and challenges of an increasingly globalised economy.

C43 A good indicator of the enterprise culture in an economy is the proportion of the population who start a new business. Chart C5 shows the number of people starting a new business in the UK compared to the other G7 countries. The chart shows that the UK, with 6.9 start-ups per 100 people, is less entrepreneurial than some countries. The chart also shows that the proportion of women starting a company in the UK (35 per cent of new start-ups) is smaller than in the US (41 per cent), Canada (38 per cent) or Italy (40 per cent), all of which have higher aggregate totals than the UK.

Chart C5: Number of start-ups per 100 people by gender



Source: *Global Entrepreneurship Monitor 2003.*

C44 Since Budget 2004, the Government has introduced a number of initiatives to improve enterprise education and culture in the UK, described further in Chapter 3. These include:

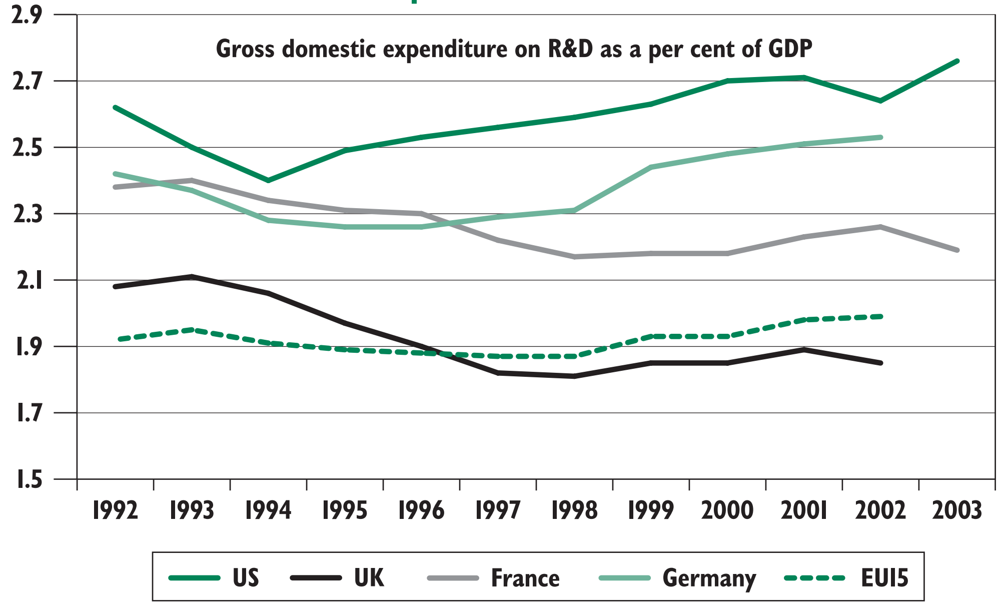
- publication of the interim report of the **Hampton Review** recommending improvements to the current system of regulatory inspection and enforcement, to reduce the administrative burden on business;
- reforms to reduce the **regulatory burden on enterprise**, including the extension of Common Commencement Dates to other areas of legislation and progress on the Panel for Regulatory Accountability;
- measures to **improve the tax system** including simplifying tax administration for small businesses and modernising the structure and administration of business tax; and
- a variety of measures to improve enterprise through **education and create a climate in which entrepreneurial activity is valued**.

Science and innovation

C45 Science and innovation are key drivers of productivity growth. Recent OECD research suggests that 1 per cent growth in public research and development leads to a 0.17 per cent increase in total factor productivity in the long run[2]. The rate of technological change is particularly rapid in today's integrated global economy. This impacts on production methods and new product development and increases the importance of innovation for businesses. The UK's future prosperity is likely to depend increasingly on the capacity to expand knowledge through science and translate it into innovative products and better services.

C46 The UK has an excellent science base but, in recent years, has been investing less on R&D research as a proportion of GDP in comparison to other major developed economies. While the UK still performs well in international comparisons of academic publications and citations, this position is unlikely to continue without an increase in public and private R&D investment.

Chart C6: Total R&D expenditure



Source: Eurostat.
2003 data not available for Germany, EU15 and UK.

C47 The Government is taking steps to promote science and innovation in the UK economy through increase in investment and by encouraging the commercial potential of primary research, discussed in more detail in Chapter 3. Further steps since the Budget include:

- implementation of the ten-year **Science and Innovation Investment Framework**, through strengthening the partnership with business on raising investment in UK R&D and taking forward the recommendations of the **Lambert review** of business-university collaboration; and

- legislation to remove the tax uncertainty for researchers involved in public sector and **university spin-off companies** to encourage the commercial development of public sector research.

[2] *R&D and Productivity Growth: Panel data analysis of 16 OECD countries*, Guellec and van Pottelsberghe de la Potterie, 2001.

Investment **C48** Investing in new technology and capital is important if firms are to respond to new opportunities in a competitive and entrepreneurial way. Where there are financial or structural barriers to new investment, firms' competitiveness will be constrained. In addition, investment in underlying infrastructure can help to facilitate flexibility in wider labour and product markets. The Government has undertaken the following action since the Budget to promote investment in the UK economy, discussed in more detail in Chapter 3:

- **implementation of the changes recommended by the Graham Review** on the Small Firms Loan Guarantee by the end of 2005; and
- draft guidance for investment managers interested in bidding to establish one of the new pathfinder **Enterprise Capital Funds**.

Measures to promote flexibility and fairness in capital markets

C49 Capital markets contribute to the flexibility of the economy by providing entrepreneurs and firms with the finance they require to fund their activities. A flexible capital market ensures that finance is provided at the lowest price appropriate to the investment risk borne by the provider. Efficient capital markets enable individuals to smooth out fluctuations in their income by offering a wide range of saving vehicles and allowing individuals prudently to borrow against future income.

SME finance **C50** The ability to access external sources of finance is essential if small businesses are to take full advantage of the investment opportunities available to them. Access to finance enables entrepreneurs and innovators to develop their ideas, ensuring that resources get directed to where they can be most profitably employed. The Government aims to ensure that the process of capital allocation works well for all businesses and that funds are allocated to all those companies who can profitably use them regardless of their size. New measures introduced include:

- easing of financial regulation by allowing **self-certification of sophisticated or high net worth investors**, making it easier for small firms to raise finance from business angels; and
- consultation on the implementation of the new **EU Prospectus Directive**, which will remove further barriers to small firms raising finance.

Investment and corporate finance **C51** An effective regulatory framework for investment decisions ensures that capital is allocated to the most efficient purposes, thus enhancing productivity, improving returns to investors and reducing the cost of capital. Improved transparency of information flows, better monitoring by principals and more effective accountability by agents are key elements of this framework. Over the past six years, the Government has undertaken a comprehensive review of all aspects of the investment chain, which connects individual savers and investing companies, and this is discussed more fully in Chapter 3. The Government has undertaken a programme of reform, going with the grain of the workings of markets. The complex interactions between the weaknesses at different points in the chain mean that each problem needs to be addressed if the overall goal of promoting more efficient approaches to investment is to be realised. The most recent elements to improve the workings of the investment chain include:

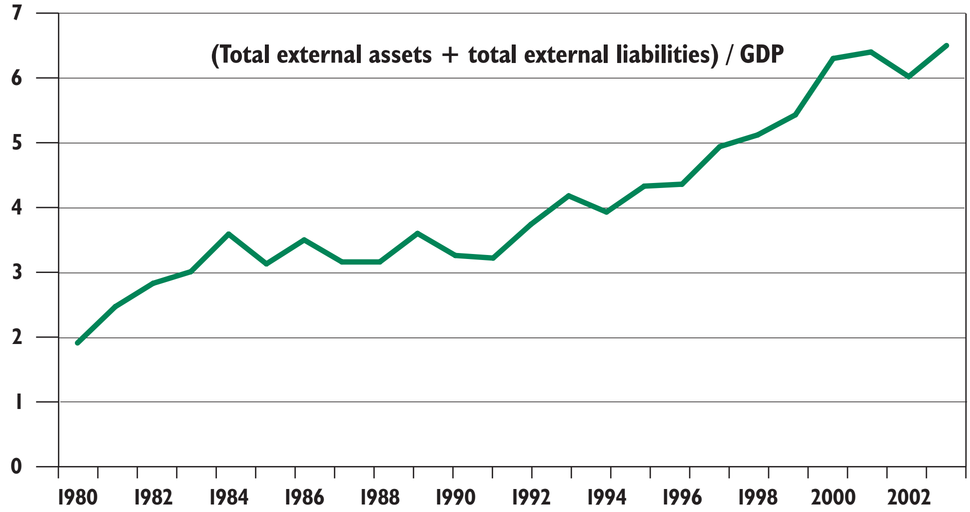
- measures to improve the efficiency of **pension funds**: strengthening the **competence of pension fund trustees**; and improving returns through the deregulation of investment restrictions;
- inviting Paul Myners to conduct an **independent review of the governance of mutual life offices**, which will report before the end of this year;
- enhancing the quality of information to investors through better **audit regulation, more extensive disclosure rules for listed companies and measures to improve shareholder voting;** and
- introducing, in the near future, deregulatory reforms to place **open-ended investment companies** on a more similar regulatory footing to authorised unit trusts.

Capital Markets integration

C52 Capital market flexibility is enhanced by greater integration of domestic and international capital markets. Greater integration provides access to deeper and more liquid capital markets with probable benefits in terms of a lower cost of capital as a result of a more efficient allocation of capital. This will ensure that savers get the best return on their money and are able to hold a diversified portfolio of assets while funds flow to firms offering the best investment opportunities encouraging innovation. Global capital integration also facilitates risk sharing where a decline in returns in one market can be offset by increasing returns in another.

C53 Chart C7 shows a summary volume-based measure of international financial integration used by the IMF.[4] The measure is the sum of total UK external assets and liabilities as a percentage of GDP and can be used as a proxy for financial openness and capital market integration. The chart suggests capital market integration has increased over 300 per cent in the UK since 1980, with a marked acceleration during the 1990s.

Chart C7: Evolution of international financial integration in the UK



Source: ONS United Kingdom Balance of Payments – The Pink Book.

[4] *International Financial Integration;* IMF working paper 03/86; April 2003.

C54 The Government also continues to work with other EU Member States towards the creation of an integrated EU capital market and to press for greater integration of EU-US capital markets. Recent important steps in this direction have included:

- joint HM Treasury/FSA consultation on UK implementation of the EU's **Market Abuse Directive**. Implementation will introduce largely minor changes to the UK's existing regime promoting the integrity of financial markets and thereby their role in the process of capital allocation; and
- consultation on proposals for UK implementation of the **EU Prospectus Directive**.

C55 Assets and savings provide opportunity and independence throughout life, flexibility to adjust to unforeseen events and financial security in retirement. Based on the principle of progressive universalism, the Government seeks to make asset ownership accessible to all and will provide more help for those who need it most. The Government seeks to provide targeted support and incentives for saving from childhood, through working life and into retirement. Chapter 5 highlights three measures the Government is taking to further promote saving and asset ownership:

- consulting on retaining the current **Individual Savings Accounts** limits;
- a larger **Saving Gateway** pilot; and
- consultation on a further payment at age 7 in the **Child Trust Fund**.

CONCLUSIONS

C56 Globalisation and the rapid pace of technological change highlight the importance of flexible and dynamic economies. Flexible labour product and capital markets which allow businesses and individuals to respond to changes in technology, consumer prices and competitive pressures by quickly adapting their production techniques, investment and employment, provides the key to economic success in a globally competitive environment.

C57 As was highlighted in the Treasury 's economic assessment of the case for joining EMU, a high level of flexibility is especially important when a country needs to adjust to country-specific shocks within a monetary union, since a country-specific monetary policy response is not an option.

C58 The Government is committed to the approach of advancing flexibility and fairness together, by enabling individuals and firms to cope with and respond to change. This report sets out the range of specific measures the Government is implementing in pursuit of these objectives, to ensure that the UK economy is well equipped to respond to current, and future, opportunities and challenges. A review of progress on the Government's reform agenda will be published at the time of Budget 2005

LIST OF ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
AEF	Aggregate External Finance
AEI	Average earnings index
AHC	After housing costs
AIS	Accrued Income Scheme
ALMPs	Active labour market policies
AME	Annually Managed Expenditure
AMLD	Amusement Machine Licence Duty
APD	Air passenger duty
APRs	Annual Percentage Rates
BCC	British Chamber of Commerce
BCS	British Crime Survey
BEA	Bank Enterprise Award
BHC	Before housing costs
BoE	Bank of England
BRTF	Better Regulation Task Force
CAP	Common Agricultural Policy
CAP	Country Assistance Plan
CASC	Community Amateur Sports Club
CAT	Charges, access and terms mark
CBI	Confederation of British Industry
CBO	Congressional Budget Office
CCAs	Climate Change Agreements
CCL	Climate change levy
CDFIs	Community Development Finance Institutions
CGAA	Coordinating Group for Accounting and Audit
CEF	Commonwealth Education Fund
CfA	Commission for Africa
CFC	Controlled Foreign Company
CGNCR	Central government net cash requirement
CGT	Capital gains tax
CHAI	Commission for Healthcare Audit and Improvement
CHP	Combined heat and power
CIC	Community Interest Company
CIPS	Chartered Institute of Purchasing and Supply
CJS	Criminal Justice System
COFOG	Classifications of functions of government
CPA	Comprehensive Performance Assessment
CPI	Consumer Prices Index
CSCS	Construction Skills Certification Scheme
CSOs	Community Support Officers
CTC	Child Tax Credit
CTF	Child Trust Fund

DCA	Department for Constitutional Affairs
DCMS	Department for Culture, Media and Sports
DDA	Disability Discrimination Act
Defra	Department for Environment, Food and Rural Affairs
DEL	Departmental Expenditure Limit
DETR	Department of Environment, Transport and the Regions
DfES	Department for Education and Skills
DfID	Department for International Development
DfT	Department for Transport
DISs	Department Investment Strategies
DMO	Debt Management Office
DPTC	Disabled Person's Tax Credit
DTI	Department of Trade and Industry
DVLA	Driver and Vehicle Licensing Agency
DWP	Department for Work and Pensions
E&A	Exploration and appraisal
EASA	Easy Access Savings Account
ECAs	Enhanced capital allowances
ECB	European Central Bank
ECFs	Enterprise Capital Funds
ECOFIN	Council of European Finance Ministers
EES	Exploration Expenditure Supplement
EFSR	Economic and Fiscal Strategy Report
EIS	Enterprise Investment Scheme
ELCI	Employers' liability compulsory insurance
EMA	Educational Maintenance Allowance
EMU	Economic and Monetary Union
EPC	Economic Policy Committee
EPCS	Environment, Protective and Cultural Services
EPD	Energy Products Directive
ERAD	Employment Retention and Advancement Demonstration
ERC	European Research Council
ESM	Energy saving materials
ESRC	Economic and Social Research Council
ETPs	Employer Training Pilots
EU	European Union
EU ETS	EU Emissions Trading Scheme
EYF	End-year flexibility
FDI	Foreign Direct Investment
FE	Further Education
FOBT	Fixed Odds Betting Terminals
FOS	Financial Ombudsman Service
FP7	7th research Framework Programme
FRS17	Financial Reporting Standard 17
FSA	Financial Services Authority

FSBR	Financial Statement and Budget Report
FSMA	Financial Services and Markets Act
FTSE	Financial Times Stock Exchange
G7	Group of Seven. A group of seven major industrial nations (comprising: Canada, France, Germany, Italy, Japan, UK and US).
GAAP	Generally Accepted Accounting Practice
GAD	Government Actuary's Department
GAP	Guaranteed Asset Protection
GAVI	Global Alliance for Vaccines & Immunisation
GCSE	General Certificate of Secondary Education
GDP	Gross Domestic Product
GGNB	General government net borrowing
GNI	Gross National Income
GOs	Government Offices
GSS	Government Statistical Service
GVA	Gross Value Added
HEIF	Higher Education Innovation Fund
HGVs	Heavy Goods Vehicles
HICP	Harmonised Index of Consumer Prices
HIPC	Heavily Indebted Poor Countries
HMRC	Her Majesty's Revenue and Customs
HSMP	Highly-Skilled Migrants Programme
IAG	Information, Advice and Guidance
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales
ICT	Information and Communications Technology
ICTA	Income and Corporation Taxes Act
IFF	International Finance Facility
IFFIm	International Finance Facility for immunisation
IHT	Inheritance Tax
ILA	Individual Learning Account
ILO	International Labour Organisation
IMF	International Monetary Fund
IMFC	International Monetary Fund Conference
IPT	Insurance Premium Tax
IRFFI	International Reconstruction Fund Facility for Iraq
ISA	Individual Savings Account
ISC	Institutional Shareholders Committee
IT	Information Technology
ITEPA	Income Tax (Employment and Pensions) Act
JSA	Jobseeker's Allowance

LABGI	Local Authority Business Growth Incentive
LASFE	Local Authority Self-Financed Expenditure
LEA	Local Education Authority
LFS	Labour Force Survey
LGA	Local Government Association
LHA	Local Housing Allowance
LMI	Labour market information
LPC	Low Pay Commission
LPG	Liquefied Petroleum Gas
LRUC	Lorry Road-User Charge
LSC	Learning and Skills Council
LTCS	Landfill Tax Credit Scheme
MA	Modern Apprenticeship
MA	Maternity Allowance
MBA	Master of Business Administration
MDGs	Millennium Development Goals
MDRs	Marginal Reduction Rates
MEW	Mortgage equity withdrawal
micro-CHP	Micro combined heat and power boilers
MIG	Minimum Income Guarantee
MPC	Monetary Policy Committee
MSW	Municipal solid waste
MtC	Million tonnes of carbon
NAIRU	Non-Accelerating Inflation Rate of Unemployment
NAO	National Audit Office
ND25+	New Deal for those aged 25 and over
ND50+	New Deal for those aged 50 and over
NDDP	New Deal for disabled people
NDLP	New Deal for lone parents
NDP	New Deal for partners
NDYP	New Deal for young people
NePAD	New Partnership for Africa's Development
NETA	New Electricity Trading Agreement
NETCEN	National Environmental Technology Centre
NG	Natural gas
NGO	Non-Governmental Organisation
NHS	National Health Service
NI	Northern Ireland
NICs	National Insurance Contributions
NICE	National Institute for Clinical Excellence
NIESR	National Institute of Economic and Social Research
NOMS	National Offender Management System
NOX	Oxides of nitrogen
NS&I	National Savings & Investment
NSFs	National Service Frameworks

NTNIC	Net taxes and national insurance contributions
NVQ	National Vocational Qualification
ODPM	Office of the Deputy Prime Minister
OECD	Organisation for Economic Co-operation and Development
OFCOM	Office of Communications
OFT	Office of Fair Trading
OFWAT	Office of Water Services
OGC	Office of Government Commerce
OMB	Office of Management and Budget
ONS	Office for National Statistics
OPEC	Organisation of Petroleum Exporting Countries
PAYE	Pay As you Earn
PCSPS	Principal Civil Service Pensions Scheme
PCT	Primary Care Trust
PDG	Planning Delivery Grant
PEP	Personal Equity Plan
PFI	Private Finance Initiative
PIF	Property Investment Fund
PMI	Purchasing Managers' Indices
PM PRA	Prime Minister's Panel for Regulatory Accountability
PNFCs	Private Non-financial companies
PPAF	Police Performance and Assessment Framework
PPG3	Planning Policy Guidance on Housing
PPF	Pension Protection Fund
PPPs	Public Private Partnerships
PRS	Private rented sector
PSA	Public Service Agreement
PSCR	Public sector current receipts
PSNB	Public sector net borrowing
PSNI	Public sector net investment
PSRC	Pension Statistics Review Committee
PSRE	Public Sector Research Establishments
QC	Queen's Counsel
R&D	Research and Development
RDA	Regional Development Agency
REDs	Regional Emphasis Documents
REITs	Real Estate Investment Trusts
RHMF	Road haulage modernisation fund
RIAs	Regulatory Impact Assessments
RO	Renewables Obligation
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
RRS	Rapid Response Service

RSP	Regional Skills Partnerships
RTFO	Renewable Transport Fuel Obligation
SARS	Severe Acute Respiratory Syndrome
SBC	Small Business Centre
SBIT	Small Business Investment Taskforce
SBS	Small Business Service
SDAs	Service Delivery Agreements
SDLT	Stamp Duty Land Tax
SERPs	State Earnings Related Pension Scheme
SFLG	Small Firms Loan Guarantee
SGP	Stability and Growth Pact
SITF	Social Investment Task Force
SMEs	Small and medium-sized enterprise
SMP	Statutory Maternity Pay
SRIF	Science Research Infrastructure Fund
SRO	Scientific Research Organisation
SVR	Standard Variable Rates
TESSA	Tax Exempt Special Savings Account
TfL	Transport for London
TIF	Transport Innovation Fund
TME	Total Managed Expenditure
TUPE	Transfer of Undertakings (Protection of Employment)
UK GAAP	UK Generally Accepted Accounting Practises
UKEP	UK Equivalent Profits
UN	United Nations
UNESCO	United Nations Educational, Scientific and Cultural Organisation
USD	United States Dollar
ULSD	Ultra-low sulphur diesel
ULSP	Ultra-low sulphur petrol
VAT	Value Added Tax
VCS	Voluntary Community Sector
VCT	Venture Capital Trust
VED	Vehicle excise duty
WFIs	Work-focused Interviews
WFTC	Working Families' Tax Credit
WTC	Working Tax Credit
WTO	World Trade Organisation

LIST OF CHARTS

LIST OF TABLES

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2004 Pre-Budget Report corrections

These tables are corrected for errors to asset sale and gross investment numbers that appear in the published version of Annex B of the 2004 Pre-Budget Report.

Table B8: Current and capital budgets (£ billion)

	Outturn	Estimate			Projections		
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Current budget							
Current receipts	418.7	451.0	487	520	552	582	612
Current expenditure	425.5	448.6	478	503	531	555	581
Depreciation	14.3	14.9	16	17	18	19	20
Surplus on current budget	**-21.1**	**-12.5**	**-7**	**1**	**4**	**9**	**12**
Capital budget							
Gross investment	34.6	42.5	48	51	54	56	58
Less asset sales	-6.6	-5.8	-5	-5	-5	-5	-4
Less depreciation	-14.3	-14.9	-16	-17	-18	-19	-20
Net investment	13.7	21.7	27	29	31	32	34
Net borrowing	**34.8**	**34.2**	**33**	**29**	**28**	**24**	**22**
Public sector net debt- end year	**375.7**	**414.6**	**452**	**484**	**517**	**546**	**574**
Memos:							
Treaty deficit[1]	34.9	33.5	34	29	28	24	23
Treaty debt[2]	441.2	480.6	520	554	587	616	644

1General government net borrowing on a Maastricht basis.

2General government gross debt on a Maastricht basis.

Table B9: Current and capital budgets (per cent of GDP)

	Per cent of GDP						
	Outturn	Estimate			Projections		
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Current budget							
Current receipts	37.5	38.3	39.2	39.8	40.2	40.4	40.5
Current expenditure	38.1	38.1	38.5	38.4	38.6	38.5	38.4
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Surplus on current budget	**-1.9**	**-1.1**	**-0.6**	**0.0**	**0.3**	**0.6**	**0.8**
Capital budget							
Gross investment	3.1	3.6	3.8	3.9	3.9	3.9	3.8
Less asset sales	-0.6	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3
Less depreciation	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Net investment	1.2	1.8	2.1	2.2	2.3	2.2	2.3
Net borrowing	**3.1**	**2.9**	**2.7**	**2.2**	**2.0**	**1.6**	**1.5**
Public sector net debt- end year	**32.9**	**34.3**	**35.4**	**36.2**	**36.8**	**37.0**	**37.1**
Memos:							
Treaty deficit[1]	3.1	2.8	2.7	2.2	2.0	1.6	1.5
Treaty debt ratio[2]	39.5	40.9	41.8	42.4	42.8	42.8	42.6

1General government net borrowing on a Maastricht basis.

2General government gross debt on a Maastricht basis.

Table B20: Public sector capital expenditure

	£ billion			
	Outturn	**Estimate**	**Projections**	
	2003-04	**2004-05**	**2005-06**	**2006-07**
Capital Budget DEL	23.2	26.2	29.1	31.5
Locally-financed expenditure	0.3	2.1	2.1	2.3
National Lottery	1.2	0.9	0.9	0.8
Public corporations' own-financed capital expenditure	2.5	2.3	2.2	2.2
Other capital spending in AME	0.8	4.7	7.8	8.7
AME margin	0.0	0.4	0.0	0.6
Public sector gross investment[1]	**28.0**	**36.6**	**42.3**	**46.0**
Less depreciation	14.3	14.9	15.8	16.7
Public sector net investment	**13.7**	**21.7**	**26.5**	**29.3**
Proceeds from the sale of fixed assets[2]	6.6	5.8	5.2	5.0

1This and previous lines are all net of sales of fixed assets.

Table B21: Loans and sales of assets

	£ billion			
	Outturn	**Estimate**	**Projections**	
	2003-04	**2004-05**	**2005-06**	**2006-07**
Sales of fixed assets				
Central government	1.1	1.0	1.0	1.0
Local authorities	5.6	4.8	4.2	4.0
Total sales of fixed assets	**6.6**	**5.8**	**5.2**	**5.0**
Total loans and sales of financial assets	**-2.3**	**-2.0**	**-2.1**	**-2.3**
Total loans and sales of assets	**4.4**	**3.9**	**3.2**	**2.8**