BUDGET 97

Equipping Britain for our Long-Term Future

July 1997

The Chancellor's Budget Statement 1997

The Financial Statement and Budget Report

News Releases

Financial Statement and Budget Report 1997

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The Financial Statement and Budget Report contains the Government's assessment of the medium-term economic and budgetary position. It sets 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. After approval by Parliament for the purposes of Section 5 of the European Communities (Amendment) Act 1993, this report will form the basis of submissions to the European Commission under Articles 103 and 104c of the Treaty establishing the European Union.

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1 Equipping Britain for our long-term future

The challenge

1.01 Britain is a nation full of talent and potential. At their best the British people demonstrate an unrivalled inventiveness and creativity. But too often in the past that potential has been squandered, with repeated cycles of boom and bust. Inadequate investment in education and training, and in the application of new technologies, has left Britain trailing the best in the world. British people have had too few opportunities to find jobs, start new businesses or become self-employed. The British industrial base is too narrow. And the old battles - public sector versus private sector, employee versus employer and state versus free market - have prevented the development of a sense of common economic purpose.

1.02 Moreover, the economic environment is changing more quickly than ever before. Technology is radically reforming the way we work. The development of the global marketplace is bringing new challenges and new opportunities. Old certainties such as jobs for life or even skills for life can no longer be taken for granted. In this ever more competitive world, the British economy and British people must be prepared to adapt continuously to change. The challenge for business and individuals is to work together to ensure that Britain is well equipped to meet these challenges and that everyone can play a full economic role.

1.03 The new Government's central economic objective is to achieve high and stable levels of growth and employment, goals which have proved elusive in the past. In meeting this objective, the Government wants to encourage a fair society in which everyone can share in higher living standards and greater job opportunities, and to see economic development taking place in a way which respects the environment. Achieving these aims in the new global economy will require a major re-equipping of the British economy.

The new Government's approach

1.04 In working towards its aims, the Government is putting in place a comprehensive and consistent set of economic policies designed to:

(i) **improve the underlying rate of growth and employment** by:

- **creating economic stability** based on low inflation and low government borrowing; and

- **improving the environment for long-term investment** in technology and in education and training; and encouraging a climate of entrepreneurship and competition;

(ii) **modernise the welfare state** so it provides an effective way of supporting people back into work rather than trapping them in poverty;

(iii) **ensure high quality public services are delivered in the most effective way**;

(iv) **develop a tax system which is fair and seen to be fair**; and

(v) **ensure that economic development takes place in a way which is consistent with high standards of environmental protection.**

The key to future economic success is investment - in infrastructure, in technology and in people. The measures in this Budget are the first step towards changing policy to reflect this approach.

Improving the underlying rate of growth

Britain's record

1.05 The performance of the British economy has for many years been poor by international standards. Over the past 25 years, Britain has experienced the slowest growth rate of GDP per head among the major industrial countries.

1.06 This poor economic performance is, to a large extent, a reflection of inadequate levels of investment in the British economy. The Government wants to increase the quantity of long-term investment. The climate for investment will be improved by:

- ensuring a stable economic environment. A major reason why business has held back from investing has been Britain's record of economic instability which has made it difficult for firms to plan ahead with confidence and discouraged investors from providing the necessary finance; and
- tackling the other obstacles holding back investment, productivity improvement and growth.

Economic stability

1.07 A successful strategy requires solid foundations. Too often in the past, the British economy has been subject to excessive swings in economic performance, so-called boom and bust. For over a decade no other major country in the European Union has suffered such large fluctuations in output or inflation as the UK.

1.08 Without stability, and the confidence of future stability, businesses and individuals cannot plan effectively for the long term. This damages investment and savings. And without higher levels of productive investment, the economy's full potential will not be realised. The Government is setting in place arrangements to ensure financial stability and sound public finances to underpin a stronger and more robust economy.

Financial stability

1.09 Inflation undermines the capacity for sustainable growth and employment. It distorts economic decisions by consumers and producers, and longer-term decisions by investors and savers. High inflation arbitrarily and unfairly redistributes income and wealth. The people who suffer most are typically those on fixed and low incomes. In the end, high inflation costs jobs and limits our potential to grow.

1.10 Over the last 18 years, the UK's record on inflation has been poor. Even in recent years, inflation in the UK has exceeded that of most of our major competitors. Measured by the retail price index excluding mortgage interest payments (RPI ex MIPs), inflation has averaged over 6 per cent since 1979 and has ranged from 2 per cent to 21 per cent. This performance has been one of the poorest among G7 countries.

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1.11 The previous arrangements for monetary policy were not generating the confidence that is necessary. That is one of the reasons why Britain has had higher long-term interest rates than most of our major competitors. The new monetary policy framework, introduced on 6 May, will remove the perception that monetary policy decisions are dominated by short-term political considerations.

1.12 Difficulties have, in the past, been due to a lack of clarity about roles and accountability. The new arrangements tackle this issue.

1.13 Under the new arrangements, the Government's role is to set the economic objectives and, in particular, the inflation target. The Bank of England's role is to take the operational decisions to meet the inflation target.

1.14 Without prejudice to the price stability objective, the Bank is required to support the Government's economic policy, including its objectives for growth and employment.

1.15 The goal of monetary policy is price stability. Low inflation is central to the Government's economic objectives. In his Mansion House speech, the Chancellor set the target for inflation (as defined by the 12-month increase in RPI ex MIPs) at 2 1/2 per cent. If the ability of the British economy to sustain growth with low inflation is strengthened, and if international conditions permit, a lower target might be set in due course.

Operational independence for the Bank of England

The Chancellor announced on 6 May that, with immediate effect, the Bank of England was to be given operational responsibility for setting short-term interest rates to achieve the Government's inflation target. This was followed by a remit to the Monetary Policy Committee (MPC) on 12 June.

The MPC will comprise the Governor, two Deputy Governors and six members, four of whom are recognised outside experts, appointed by the Chancellor. The Treasury is also represented on the Committee, in a non-voting capacity.

The MPC meets on a monthly basis. Decisions, which are announced at a fixed time and without delay, are made by simple majority vote. If necessary, the Governor will have the casting vote. The Committee is also responsible for taking full account of regional and sectoral information in its monetary policy decisions. Minutes of the meetings, including a record of votes, are published within six weeks.

Although the Government retains the right to override the operational independence of the Bank this can only happen in extreme economic circumstances and for a limited period. It is also subject to ratification by Parliament.

The MPC is accountable to the Government for meeting the inflation target, as set out in the Chancellor's letter to the Governor of 12 June. The Committee's performance and procedures will be reviewed by the reformed Court of the Bank on an ongoing basis (with particular regard to ensuring the Bank is collecting proper regional and sectoral information). The Bank is accountable to the House of Commons through regular reports and evidence given to the Treasury Select Committee. Through publication of the minutes of the MPC meetings and the Inflation Report, the Bank will be accountable to the public at large.

The new arrangements mean that while the Government retains clear responsibility to Parliament for defining the goals of monetary policy, the Bank will be accountable for their achievement. The well defined inflation target, publication of the minutes and the Bank's quarterly Inflation Report and the open letter system provide clear information against which the performance of the Bank in achieving price stability can be judged.

1.16 The inflation target applies at all times. By continually aiming at the inflation target, 2 1/2 per cent inflation, or very close to it, should become the norm. Temporary deviations from target may occur as a result of a range of unforeseen developments or `shocks' which affect the price level, such as sharp movements in commodity prices. But if such deviations do occur, the onus is on the Bank to justify them. The enhanced accountability arrangements - to the Government, to Parliament and to the wider public - have introduced an unprecedented degree of transparency into the interest rate decision-making process.

1.17 The Government recognises that the effectiveness of the inflation target in guiding the actions of the Bank will depend on the seriousness with which breaches of the target are treated. In this respect, inflation outcomes below the target should be viewed in the same way as outcomes above the target. If inflation is 1 percentage point higher or lower than the target, an open letter will be sent by the Governor to the Chancellor so that the public is fully informed as to:

- why the divergence has occurred;
- the policy action being taken to deal with it;
- the period within which inflation is expected to return to the target;
- how this approach meets the Bank's monetary policy objectives.

1.18 The new framework puts monetary policy on a credible, long-term footing to ensure that price stability is delivered in practice. Long-term interest rates fell after the Chancellor announced that the Bank was to be given operational responsibility for setting interest rates and have remained some 30 basis points lower since around that time, supporting the view that credibility has already been enhanced.

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Fiscal Policy

1.19 Stable public finances are the second key requirement for long-term economic stability. The Government's fiscal policy will be guided by two strict rules:

- the golden rule: over the economic cycle the Government will only borrow to invest and not to fund current expenditure; and
- public debt as a proportion of national income will be held over the economic cycle at a stable and prudent level.

1.20 These rules will ensure that borrowing will be kept under firm control. But the rules also make a proper distinction between public investment and current expenditure which will no longer be treated as if they are equivalent economic categories. The rules require that current taxpayers pay for current spending since it is the present generation which enjoys its benefits. Future generations gain from public investment so it is reasonable to borrow to finance investment, with future generations bearing the corresponding debt servicing and depreciation costs.

The golden rule, debt ratio and net wealth

Golden rule

The golden rule means that over the economic cycle the Government will borrow only to finance public investment and not to fund current expenditure. The golden rule will be met if current spending is paid for by taxation and other government receipts: in other words, if the public sector current account is in balance, or in surplus, over the economic cycle.

Over the last economic cycle, 1985-86 to 1996-97, the public sector current balance averaged a deficit of over 1 1/2 per cent of GDP. Performance thus did not accord with the rule. But this deficit (excluding windfall tax and associated spending) is set to fall this year and the current balance moves into surplus next year and thereafter, thereby meeting the golden rule.

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Debt ratio

Progress against the debt ratio objective can be judged by looking at the ratio of net public sector debt to GDP, which balances out most financial assets with liabilities; and by looking at the ratio of gross general government debt (GGGD) to GDP, which is the measure used in the European Union excessive deficits procedure. Both measures of the debt ratio have risen very sharply since 1990. The introduction of the Government's deficit reduction plan means the ratios fall steadily from this year onwards, with the gross general government debt ratio remaining comfortably below the 60 per cent Maastricht reference value.

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Net wealth

Net wealth is a more comprehensive measure of the public sector's position than the debt ratio. It includes tangible assets held by the public sector as well as net financial liabilities. At present, the data for tangible assets is subject to significantly wider margins of error than those for net financial liabilities. The National Asset Register and the development of resource accounting should help to improve the quality of data for public sector tangible assets, and therefore public sector net wealth.

The steady increase in government debt throughout the 1990s resulted in a sharp deterioration in the public sector's balance sheet. Public sector net wealth fell from over 65 per cent of GDP in the late 1980s to 14 per cent in 1995, the latest year for which information is available. The Government's fiscal framework will ensure this deterioration is halted.

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1.21 The deficit reduction plan set out in the Budget is intended to ensure sound public finances and builds in a margin to guard against future uncertainties.

Table 1.1 Changes to PSBR forecast(1)

	£ billion	
	1997-98	1998-99
PSBR in November 1996 Budget	**19.2**	**12.2**
Effects of:		
Changes in assumptions	0.6	3.2
Forecasting changes(2)	-3.3	-6.7
LA capital receipts initiative	0.2	0.7

Budget tax changes(3),4	-3.4	-4.1
Total changes(4)	-5.9	-6.8
PSBR in July 1997 Budget, excluding windfall tax & associated spending	**13.3**	**5.4**
Effects of:		
Windfall tax	-2.6	-2.6
Welfare to Work spending(5)	0.2	1.2
PSBR in July 1997 Budget	**10.9**	**4.0**

1 In this and other tables, the totals are based on unrounded figures. They may therefore differ from the sums of the rounded figures.

2 *Of which (see also Table 4.8):*

Estimated corporation tax yield from higher profits	-2.1	-3.3
Estimated other tax yield from higher money GDP	-1.8	-3.0
Other forecast changes (net)	0.6	-0.4

4 Excludes windfall tax and associated spending.
5 See Table 2.1.

1.22 This prudent approach aims to avoid the mistakes of the past. The last time the economy faced a similar cyclical conjuncture (in the mid to late 1980s) saw large policy errors. The costs, in terms of unemployment and lost output, were severe. Following the recession, the PSBR rose to a peak of 7 per cent of GDP. The Government regards it as important that no similar risks should be taken with fiscal policy again. The Budget tax measures, particularly the reduction in mortgage interest relief and increases in stamp duty, will help encourage stability in the housing market and the economy more generally.

1.23 The measures announced in this Budget, excluding windfall tax and associated spending, tighten fiscal policy by around 1/2 per cent of GDP by 1998-99. The PSBR (excluding privatisation proceeds, windfall tax and associated spending) is forecast to fall by 3 per cent of GDP between 1996-97 and 1998-99. A significant part of this reduction reflects tight control of public spending: the ratio of GGE(X) to GDP is expected to fall by 2 1/4 percentage points over this period. In addition, the planned real increases in road fuel and tobacco duties raise the projected ratio of tax receipts to GDP by between 1/4 and 1/2 percentage point by 1998-99.

1.24 Fiscal consolidation at a time of strengthening demand should help to encourage a more balanced recovery and help to offset some of the pressures on monetary policy. Successful deficit reduction should also help raise the level of national saving and increase resources for investment.

1.25 The Government's plans for spending over the next two years are set out in Chapter 2. The medium-term plans will be determined by the Comprehensive Spending Review. For the purposes of the medium-term public finance projections in the Budget arithmetic, three different illustrative assumptions have been used for the annual real growth of the Control Total after 1998-99: 3/4 per cent, 1 1/2 per cent and 2 1/4 per cent.

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1.26 On the basis of the projections, the Government is well on track to meet its fiscal policy objectives over the course of this Parliament. The golden rule is met from 1998-99 onwards, while both debt ratios fall from now on. Nonetheless, the uncertainties surrounding the assessment of the current conjuncture (see box) suggest that a prudent approach to tax and spending will continue to be necessary. Moreover, the decline in the debt burden is much less than the rise that took place during the first half of the 1990s; and the improvement in public sector net wealth is modest in comparison with its earlier deterioration.

1.27 The UK expects to meet the Maastricht reference values for the government deficit and debt. The general government financial deficit (GGFD) is forecast to be 2 per cent of GDP in 1997, well below the 3 per cent reference value; and the relevant debt ratio (GGGD) is also forecast to be well below the 60 per cent Maastricht level. Continuing improvements in the fiscal position will ensure the sustainability of the public finances in future years.

Uncertainties and the fiscal projections

In understanding the state of the public finances, it is helpful to adjust borrowing figures for the effects of the economic cycle, ie to measure the `structural' deficit (also excluding windfall tax and associated spending). According to the Treasury's calculations, a 1 per cent movement of the economy away from its estimated trend has an impact of 3/4 percentage point on the PSBR/GDP ratio in the following year. The estimated structural deficit in 1996-97 was over 2 per cent of GDP. The deficit reduction plan tackles the structural deficit and reduces it significantly.

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There is considerable uncertainty in estimating the position of output relative to its potential level. The Treasury's best view of the current conjuncture is that the economy is close to its trend level, ie that the output gap is close to zero. However, if the output gap were significantly different from this it would have implications for the estimates of the structural deficit. Moreover, the potential cost of being optimistic is likely to be greater than that of being pessimistic. Estimates of the structural PSBR, based upon the Treasury forecast and medium-term projections, are therefore shown with an alternative, more cautious, projection based on a level of trend output 1 1/2 per cent lower (i.e. a significant positive output gap) than our central view. The cautious case highlights the continuing need to keep borrowing under strict control to ensure the fiscal objectives are met.

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Building trust in fiscal policy

1.28 In keeping with actions already taken on monetary policy, the Government aims to rebuild public trust in fiscal policy by ensuring that it is conducted in a responsible, open and transparent way. The Government intends to strengthen the fiscal framework further over time. For the first time, in May, the National Audit Office (NAO) was invited to review a proposed more cautious approach in setting a number of key forecasting assumptions and conventions used in the Budget arithmetic. The NAO noted that the new assumptions were arrived at systematically on the basis of available data and by methods which interpret it in a reasonable way. The Budget forecast and medium-term projections are based on assumptions consistent with this more cautious approach. The NAO will have a continuing role in auditing the public finances in future Budgets.

1.29 The transparency of fiscal policy will be further underpinned by the planned introduction of resource accounting and budgeting. The Government is drawing up a full National Asset Register which it plans to publish in November, and full information about the assets and liabilities of central government departments will become available from resource accounts for the year 1998-99 onwards. Resource budgeting will be developed to provide a system of public expenditure planning and control which distinguishes clearly between current spending and capital investment.

Green Budget

1.30 As a further element of the commitment to greater openness, the Government plans to publish a consultative paper several months ahead of each Budget. This will spell out the state of the economy, the progress made towards the Government's objectives and the forecast for the coming year. In addition, it will encourage a wide-ranging debate about the policy action necessary, including on fiscal policy, over the coming period and the sustainable rate of wage inflation which can be afforded without a loss of competitiveness.

Key Budget measures - promoting economic stability

- new deficit reduction plan and long-term structure for fiscal policy

- new commitment to openness in public finances

- tax changes to encourage stability in the housing market and more balanced economic growth.

2 The Budget Measures

2.01 Chapter 1 describes the Government's overall approach to economic policy. This chapter summarises and explains the specific tax, national insurance contributions and spending measures announced in the Budget[1] and relates them to the key policy aims listed in paragraph 1.04.

2.02 Chapter 1 also describes the key principles that will underpin the tax system: fairness, and a tax system which is seen to be fair, encouraging employment opportunities and work incentives for all, and promoting savings and long-term investment. This Budget will make a start in meeting these objectives.

Promoting economic stability

2.03 In order to encourage stability in the housing market and balanced economic growth the Budget:

- reduces mortgage tax relief from 15 per cent to 10 per cent with effect from 6 April 1998. Relief will remain at the basic rate for those aged 65 and over who take out a loan to buy a life annuity (1); and
- increases the rate of stamp duty on transfers of property (except shares) from 1 per cent to 1 1/2 per cent if the price is more than £250,000, or to 2 per cent if the price is more than £500,000. The new rates will apply from 8 July, except where the transfer is made in pursuance of a contract made on or before 2 July (2).

Encouraging long-term investment

2.04 The Budget builds on the work of the corporate tax review the Government carried out whilst in Opposition and which has continued into Government.

Companies and shareholders

2.05 The Budget contains major changes to corporation tax. The Government's objective is to create an improved climate for long term investment. To achieve this objective, the following measures are proposed:

- ***reduction in the main corporation tax rate*** - the main rate of corporation tax will be reduced from 33 per cent to 31 per cent from 1April 1997, enhancing the UK's position as the major industrialised country with the lowest corporate tax rate, 50,000 companies will benefit (3).
- ***reduction in the small companies' rate*** - the small companies' rate of corporation tax will be reduced from 23 per cent to 21 per cent from 1April 1997, 400,000 companies will benefit (4).
- ***abolition of payments of tax credits*** (5):

  - payment of tax credits to pension schemes and UK companies (other than charitable companies) will be abolished for dividends paid on or after Budget day;

  - other shareholders will generally not be affected by changes to tax credits until 6April 1999, when tax credits will normally no longer be payable to other shareholders with no tax liability;

  - the rate of tax credits will halve to 10 per cent from April 1999. No individual shareholder paying tax at the lower, basic, or higher rates on all his or her dividends will face a higher income tax bill as a result of the changes, because dividend income within the lower or basic rate bands will be taxed at 10 per cent and higher rate income at 32.5 per cent (the halving of the rate of tax credits to 10 per cent reduces the amount of gross dividend income, so the 22.5 per cent extra tax payable at the higher rate is equivalent to the 20 per cent extra payable under the existing system);

  - the April 1999 change is timed to fit with the introduction of individual savings accounts which will be available for holders of TESSAs and PEPs as well as other individual shareholders and savers;

  - transitional relief for charities will be available from April 1999 through public expenditure over a five year period.

- ***advance corporation tax*** - will continue to be paid by companies at the same rate as now.
- ***abolition of foreign income dividends from April 1999*** - with the exception of the arrangements for international holding companies, the special rules for foreign income dividends will cease to apply from 6 April 1999. The change will protect the Exchequer yield of advance corporation tax once the abolition of payable tax credits has made shareholders indifferent whether they receive an ordinary dividend (which currently carries a payable tax credit) or a foreign income dividend (which does not)(6).
- ***temporary doubling of capital allowances for small and medium enterprises' plant and machinery*** - expenditure on plant and machinery by small and medium sized enterprises for 12 months after Budget day will qualify for a first year allowance at double the previous rate of writing down allowance, that is at 50 per cent, or 12 per cent if the long-life asset rules apply (7).
- ***restriction of loss carry back to one year*** - the period for which a company can carry back trading losses and certain other reliefs will be reduced from three years to one year, except for losses made in the 12months before a trade ceases. This reverses a change introduced in 1991 at the depth of the recession (8).

The film industry

2.06 To stimulate the production of British films and thereby promote employment, investment and opportunities in the film industry, the Budget will introduce:

- 100 per cent write-off for production and acquisition expenditure incurred after Budget day on British qualifying films costing £15 million or less to make and completed in a period of three years from Budget day (9).

Modernising the welfare state

Welfare to Work

2.07 The Budget introduces the Government's Welfare to Work programme, to attack youth and long-term unemployment and the low levels of employment among lone parents, and break the spiral of escalating spending on social security. A total of £5.2 billion will be invested in this programme.

- From January 1998, in 10-15 pathfinder areas, and from April 1998 nationally, the New Deal for young people will help those aged under 25 who have been unemployed for more than six months through four routes from welfare into work. The programme is described in more detail in the box on page 31.
- In a New Deal for the long-term unemployed, from June 1998 businesses will be offered a subsidy of £75 a week for six months if they employ anyone who has been unemployed for a period of two years or more. This will help business cover the increased costs it faces while the new employee's work skills are being upgraded. The Government will also reform the "16 hour" rule to help this group access full-time training and education where it improves their employability.
- Lone parents whose youngest child is in the second term of full-time school will be offered help with job search, training, re-skilling and if necessary childcare. The programme will be voluntary and will be delivered by designated Employment Service caseworkers. The Government's approach will be demonstrated in eight areas starting in July 1997, and will be available nationally from October 1998. The programme will be supported, as part of the Government's national childcare strategy, by extra help with childcare costs within Family Credit, Housing Benefit and Council Tax Benefit; by the use of lottery money to deliver after-school clubs; and by 50,000 new places for trainee child carers taken on under the New Deal for the unemployed.

Welfare to Work - a New Deal for the young unemployed

The New Deal for the young unemployed will begin in around 10 per cent of the country in January 1998. It will start nationally in April 1998. It will be delivered by the Employment Service, in partnership with a wide range of other government agencies and departments, and with the private and voluntary sectors. For each young person, the programme will start with a gateway period of careers advice and intensive help with looking for work, and with training in the skills required as entrants to the world of work. Young people will be helped towards the New Deal option that best suits their needs. Throughout the whole process they will be supported by a designated caseworker. As young people near the end of their option, further help and support will be provided to help them stay in work. Extra help will be focused on those with most disadvantages.

The employer option

Many young people will find they can move straight from welfare into a job. To encourage employers to play their part, the Government will offer a £60 a week subsidy payable for up to six months. The payment will be made with the minimum of bureaucracy, and will be accompanied by a national effort to engage the business community. In addition, £750 per person has been allocated to finance training towards accredited qualifications.

Full-time education or training

For some young people the most appropriate option will be full-time training in skills up to NVQ level 2. The method will vary from on-the-job training in vocational skills to a course at the local college. In each case the emphasis will be on improving employability. For this programme, the Government will reform the ""16 hours study rule"" which has prevented unemployed people from accessing full-time education and training.

A job with the voluntary sector

Voluntary organisations will be invited to come forward with innovative ideas to provide young people with the work experience and skills that will help improve their employability. The placement must have a training element. The Government is looking in particular for placements that help meet other social and economic objectives, for example tackling the causes of crime. Particular emphasis will be placed on voluntary sector placements to provide 50,000 new trained childcarers to support other aspects of the Welfare to Work programme.

The Environmental Task Force

The aim of the new Environmental Task Force will be to improve the employability of young people through projects of benefit to the whole community, including projects to help meet the Government's target for heat conservation and efficiency. It will be delivered by a wide variety of private and voluntary sector providers. Again, training for accredited qualifications will be an important element.

Under the New Deal, rights need to be balanced by responsibilities. Benefit sanctions will apply to young people who refuse an offer of help.

- While there is a pressing need to target spending on the problems of the existing young and long-term unemployed, a root of the unemployment problem lies in under-achievement at school. The New Deal for schools will start to tackle the run-down infrastructure of schools, so that youngsters will be educated in schools fit for the twenty first century, not the nineteenth. It will also cover IT equipment to equip school leavers with technology skills. In order to benefit, individual schools will have to commit themselves to improved performance.

2.08 For the programmes for the unemployed to be successful in breaking the cycle of despair, an enthusiastic response from employers and the voluntary sector will be essential. A task force, headed by Sir Peter Davis, Chief Executive of the Prudential Group, has been established to advise on the development of the programme and monitor its effectiveness.

2.09 These programmes are a first step. The Government aims to extend the approach adopted on behalf of the young and long-term unemployed and lone parents to other groups excluded from the labour market, including people on Incapacity Benefit. The Government also plans to improve skills and employability through a new University for Industry. Detailed proposals will be announced in due course. Provision has also been made within the resources provided by the windfall tax for future initiatives in support of the Welfare to Work strategy.

Windfall tax

2.10 The Welfare to Work programme will be funded by aone-off tax on the excess profits of the privatised utilities. The tax will apply to companies, privatised by flotation, and subject to economic regulation under specified Acts.

2.11 A company's windfall tax liability will be assessed as a proportion of the difference between the value placed on the company at the time of sale and a valuation figure derived by applying a single price-earnings ratio of 9 to its average annual post-tax profits for normally four full accounting years following privatisation.

2.12 The tax will be charged at a rate of 23 per cent. It will be paid in two instalments due on 1 December 1997 and 1 December 1998. Table 2.1 shows the profile of receipts from the tax, compared with the expected spending.

2.13 The yield from the windfall tax will be about £5.2 billion. Taking into account the change to the gas levy (see paragraph 2.30), which the Government considered appropriate in part because of its impact on Centrica, the yield of the two measures to the Exchequer is some £4.8 billion over the next three years.

Table 2.1 Financing Welfare to Work(1)

	£ million					
	1997-98	1998-99	1999-00	2000-01	2001-02	**1997-02**
Spending by programme:(2),(3)						
A New Deal for young people	100	700	830	770	740	**3 150**
A New Deal for the long term unemployed	0	100	80	80	80	**350**
Sub-total	**100**	**800**	**910**	**850**	**830**	**3 500**
of which - initially allocated to departments	100	700	800	700	700	3 000
- unallocated						500
A New Deal for Lone Parents(4)	0	40	50	60	60	**200**
A New Deal for Schools	100	300	300	300	300	**1 300**
Provision for Future Measures(5)	0	50	50	50	50	**200**
Total expenditure	**200**	**1 180**	**1 310**	**1 260**	**1 240**	**5 200**
Windfall tax(6)	**2 600**	**2 600**	**0**	**0**	**0**	**5 200**

1 The spending in this table, financed by the windfall tax, is outside the Control Total, see Table 2.4.

2 Illustrative levels of spending based on current levels of unemployment. Actual provision for any particular year will be decided in the light of the number of eligible people and the effectiveness of the programme.

3 Departmental breakdown of spending on the basis of these illustrative figures would be:

Department for Education and Employment	*160*	*900*	*1 010*	*920*	*920*	*3 900*
Department of Social Security	*20*	*50*	*50*	*60*	*60*	*240*
Scottish Office	*10*	*30*	*30*	*30*	*30*	*120*
Welsh Office	*0*	*20*	*20*	*20*	*20*	*60*
Northern Ireland	*10*	*40*	*40*	*40*	*40*	*180*

4 Plus extra help with child care through Family Credit and other in-work benefits.

5 Including the University for Industry and Welfare to Work help for people on Incapacity Benefit.

6 Forecast receipts.

2.14 The windfall tax will be complemented by a forward-looking review of utility regulation which will seek to ensure a long-term stable framework of regulation for the utilities, one which adequately protects consumers and provides the right incentives for the firms themselves. Any proposals from the review which have implications for companies will be introduced only after the windfall tax instalments are paid.

Individual Learning Accounts

2.15 ILAs could provide individuals with the incentive to invest in training to gain the skills they want. One model for an ILA would be a savings account dedicated to training with special rules controlling payments in and withdrawals. The Government will launch a consultation process for employers and other interested parties. Issues include what the rules should be, what sort of training should be covered and what incentives would be justified.

Moving towards a fairer tax system

VAT on fuel and power

2.16 One of the Government's key election pledges was to reduce the 8 per cent rate of VAT on fuel and power to 5 per cent, the lowest level allowed under European Community law. This will come into effect on 1 September 1997 in time for domestic, charity non-business and small-scale business users to get the benefit of the lower rate in their bills for the winter period (11).

2.17 The change will cost £220 million in 1997-98 and £485 million in the first full year (1998-99). To pay for it, the Budget contains the following tax changes, which are also designed to improve the fairness of the tax system.

Private medical insurance

2.18 Tax relief on premiums for private medical insurance for the over 60s, which is received by about 1/3 million people, is to be withdrawn in respect of contracts taken out on or after Budget day. Premiums on pre-Budget day annual contracts will continue to qualify for relief until these contracts come to an end and in certain circumstances relief will be given to those who have not finalised contracts by Budget day (12).

Anti-avoidance measures

2.19 The Budget contains the following measures designed to secure the tax base and combat avoidance by blocking tax loopholes and restricting the use of special reliefs:

Corporation tax

- ***taxing dividends on trading assets as trading profits*** - from Budget day, include dividend income as part of the holder's trading profits when shares are held as trading assets rather than investments (13).
- ***Finance Leasing: acceleration of capital allowances*** - from Budget day, prevent acceleration of capital allowances on machinery and plant through the use of finance leases and subsidiaries with different year ends(14).
- ***Finance Leasing: sale and leaseback, transfers of unused past allowances*** - prevent the sale of unused capital allowances through the sale of machinery and plant and finance leaseback on or after Budget day(15).
- "***Company Purchase schemes***" - from Budget day when a company is sold to avoid paying corporation tax liabilities, the Inland Revenue will be able to collect the unpaid tax from the previous owners of the company, or from other companies previously in the same group. This reinforces a similar measure in the 1994 Finance Act. The legislation will be included in the 1998 Finance Bill (16).

PAYE

- ***PAYE avoidance (trade debts)*** - prevent employers from avoiding their obligation to operate PAYE by paying their employees in trade debts. Legislation taking effect from Budget day will be included in the 1998 Finance Bill (17).

VAT

- ***Second-hand goods margin scheme*** - restrict the use of the special scheme for accounting for VAT on second-hand goods on the seller's margin, where the goods have been acquired tax-free under the transfer of a going concern provision, from 3 July ($).
- ***Cash accounting scheme*** - counter the use of the VAT cash accounting scheme for tax avoidance, from 3 July (18).
- ***Capital goods scheme*** - extend the scope of the VAT capital goods scheme to include building refurbishment and fitting out costs and civil engineering works, and to block other potential loopholes, from 3 July ($).

Insurance premium tax

- ***Health care insurance*** - reinforce the liability borderline between taxable and exempt health care insurance by applying the 4 per cent insurance premium tax rate to certain long-term health care insurance, from 1October 1997. This will also prevent distortion of trade (19).

Other anti-avoidance measures

2.20 ***Strengthening tax rules for multinationals*** - the Government intends to change and modernise the tax rules on transfer pricing and Controlled Foreign Companies in the Finance Bill following the next Budget. The purpose of the changes will be to make the tax provisions more effective, to allow them to be applied more fairly, and to protect UK tax revenue. This will strengthen the legislation and bring it into line with modern practice in other major countries. The Government proposes to publish draft legislation during 1997 and consult on the detail. This will build on existing work and comments already made by taxpayers and their representatives in their responses to consultations carried out by the Inland Revenue under the previous Government, which had itself announced its intention to legislate in these areas.

Protecting the environment and health

2.21 The Government places a high priority on use of the tax system to deliver environmental objectives. Where environmental taxes can make an efficient contribution to a cleaner environment, and where their distributional implications are acceptable, the Government will consider their use.

2.22 In line with this, the Budget includes further announcements:

- work is to be undertaken on the environmental costs associated with the **extraction of aggregates and other quarrying**. These costs include impacts on landscape, on local residents and effects of noise and dust. Results of this work will feed into consideration of policy measures. They will be considered alongside assessment of the operation and level of the landfill tax;
- the Department of the Environment, Transport and the Regions will be issuing, in time to inform the next Budget, a consultation document examining ways of improving **water quality**, by reducing discharges of pollutants and encouraging greater clean-up. There are a number of policy options, including economic instruments, and consultation will contribute to the choice of measures;
- vehicle excise duty is being indexed in November (see paragraph 2.26 below). The Government also intends to go ahead with the proposal, made by the last administration, to reduce **VED** by up to £500 for lorries which meet a low emission standard. Details are being worked up following recent completion of consultation. This will encourage the fitting of particulate traps or conversion to gas power. But the existing measure did not go far enough and it will be extended to buses, which also make a significant contribution to harmful urban emissions ($);
- the Government will review the structure of **bus fuel duty rebate**, including looking at its role in promoting lower emission vehicles;
- the changes to **excise duties on fuels** (see paragraph 2.24 below) signal the Government's commitment to placing the environment at the core of the tax system by discouraging environmental pollution by road users. The freeze on road fuel gases will give another signal to help encourage conversion of vehicles to use road fuel gases ($);
- the Government has stated that one of its objectives is to help those on low incomes to **save energy** and will consult on the best means to achieve this. Section 111 of the Finance Act 1997 requires the Treasury to produce a report on the consequences to the Exchequer of VAT relief for energy-saving materials by May 1998. This deadline has now been brought forward to the end of October 1997 and the scope has been extended into a wider consultation exercise which will also look at other options for meeting the objective.

Excise duties

2.23 Tobacco - The Government is committed to increasing tobacco duties on average by at least 5 per cent a year in real terms (compared to the previous Government's 3 per cent commitment) as one measure aimed at reducing tobacco consumption and dissuading young people from starting smoking. From 1December this year, cigarette duty will be increased by approximately 5.2 per cent in real terms, and the duties on cigars and on other smoking tobacco and chewing tobacco will be increased by 5 per cent in real terms. There will be no increase for hand-rolling tobacco (23).

2.24 Fuel duties - The tax (duty plus VAT) on leaded, unleaded and super-unleaded petrol, and diesel, will rise by 4 pence per litre from 6 pm on Budget day(20). The previous Government's commitment to future annual increases averaging at least 5 per cent in real terms will be raised to at least 6 per cent. Also from 6 pm on Budget day, the duties on gas oil and fuel oil will rise by 0.08pence per litre and 0.06 pence per litre respectively (22). The duty on road fuel gases (liquefied petroleum gas and compressed natural gas) will be held at current levels and the duty differential with diesel will be at least maintained for this Parliament.

2.25 Alcohol duties - The duties on all alcoholic drinks will be increased by 3 per cent, in line with inflation, from 1 January 1998 (26).

(1) *The effect of the tax and NICs measures on government revenues is set out in Table2.2. The number in brackets after each*

measure refers to the line in Table2.2 where its yield or cost is shown. The symbol "-" means that the proposal has no effect on revenue. "$" means it has negligible effects on revenue amounting to less than £3million a year. The overall effects of the public expenditure measures on the Control Total and General Government Expenditure are set out in Tables2.3 and 2.4. [Back]

Changes to excise duties

	Changes in duty (per cent)	Effect on tax(1) of typical item (increase in pence)	Unit
Tobacco			
Cigarettes	8.2(()2)	19	packet of 20
Cigars	8	8	packet of 5
Hand-rolling tobacco	0	0	25g
Pipe tobacco	8	10	25g
Fuel			
Leaded petrol	8.2	4	litre
Unleaded petrol	9.3	4	litre
Super-unleaded petrol	8.5	4	litre
Diesel	9.3	4	litre
Gas oil	3.2	0.08 exc VAT	litre
Fuel oil	3.1	0.06 exc VAT	litre
AVGAS	8.2	2	litre
Road fuel gas	0	0	kg
Alcohol			
Spirits	3	19	70cl bottle
Beer	3	1	pint
Table wine	3	4	75cl bottle
Cider	3	1	pint
Coolers	3	1	33cl bottle
Sparkling wine	3	5	75cl bottle
Fortified wine	3	5	70cl bottle

1 Tax refers to duty plus VAT unless otherwise stated.

2 Specific duty up by 9.2 per cent; ad valorem duty unchanged at 21 per cent of retail price.

Vehicle Excise Duty

2.26 Vehicle Excise Duty (VED) on private/light goods vehicles (PLG), chiefly cars, taxis and vans will rise by £5 to £150 (3.4 per cent) for licences taken out after 15 November 1997. Duty rates on goods vehicles will also rise by the same percentage (rounded to the nearest £10). (All linked rates will rise accordingly.) (21).

2.27 A measure will be taken to enable the Driver and Vehicle Licensing Agency (DVLA) to charge motor manufacturers and vehicle fleet operators for the setting up and use of computer links for registration and licensing ($).

Other tax measures

Gilt Interest

2.28 From 6 April 1998 anyone holding gilt-edged securities will be able to receive their interest gross rather than after deduction of tax if they want to. This simplifies and helps make the gilt market more attractive to investors (24).

VAT turnover thresholds

2.29 The annual turnover threshold above which traders must register for VAT will rise from £48,000 to £49,000 on 1 December 1997, and the deregistration threshold will rise from £46,000 to £47,000. The registration and deregistration thresholds for acquisitions from other Member States will rise from £48,000 to £49,000 on 1 January 1998 ($).

Gas levy reduction

2.30 The Government proposes to cut the gas levy to zero, with full effect from April 1998. Under present market circumstances the levy distorts the market and consumers suffer through higher prices. It also imposes an unreasonable handicap on those companies affected. In taking the decision, the Government has considered the tax burden on Centrica which would result from having to pay both the windfall tax and gas levy. Appropriate legislation to bring about this change will be introduced in the next year (25).

Tax policy reviews

North Sea taxation

2.31 The Budget also announces a review of the North Sea fiscal regime to ensure that an appropriate share of North Sea profits are being taxed while continuing to maintain a high level of oil industry interest in the future development of the UK's oil and gas reserves.

Capital Gains taxation

2.32 The Budget announces that the Government will consult industry widely on the reform of capital gains tax. The findings of the review will be reported in the next Budget.

Charities

2.33 The Budget announces a review of charities' taxation. The review aims to explore options for a simpler, more coherent system of tax reliefs which is better suited to the way charities work today. Charities will be asked to send initial views by 1 December 1997 and these will then be worked into a consultation paper for publication in spring 1998.

Anti-avoidance

2.34 The Budget announces a review of leakage and avoidance of direct taxes. This will include identifying situations in which significant amounts of tax are, or are at risk of, leaking from the Exchequer and how the Inland Revenue approaches the defeat and deterrence of tax avoidance schemes. One outcome of the review is expected to be proposals for legislation to counter tax leakage in future Finance Bills.

Alcohol and tobacco duties

2.35 The Budget announces a review aimed at reducing loss to Government and industry revenue through alcohol and tobacco fraud, smuggling and cross border shopping, to report by the end of 1997. It will also look at health and law and order issues. Trade associations and other interested parties will be consulted at an early stage and their views sought on the extent of the problem and practical ways in which it can be tackled.

EIS/VCT Scheme

2.36 Arrangements where a substantial part of the return to investors is guaranteed, or which are backed by property, will be excluded from the Venture Capital Trust scheme and Enterprise Investment Scheme. After taking views from interested parties, the Government will publish draft legislation on guarantee arrangements for the Finance Bill following the next Budget, taking effect from 2July 1997, and will lay regulations in Parliament on asset-backed arrangements.

Table 2.2 Revenue effects of Budget tax measures

£ million yield (+)/cost (-) of

	measure			
	Changes from a non-indexed base	Changes from an indexed base		
	1997-98	1997-98	1998-99	1999-00
Promoting economic stability				
1 Mortgage interest relief - restricted to 10 per cent	0	0	+900	+950
2 Stamp duty - increase in rate on transfers of property above £250,000	+240	+240	+490	+540
Encouraging long-term investment				
Companies and shareholders				
3 Reduce the main rate of corporation tax from 33per cent to 31per cent from 1April 1997	0	0	-1 400	-1 950
4 Reduce small companies' rate from 23per cent to 21per cent from 1 April 1997	0	0	-200	-250
5 Abolish payable tax credits for pension schemes and UK companies from Budget day; changes for everyone else from 6April 1999	+2 300	+2 300	+3 950	+5 400
6 Abolish foreign income dividends from 6 April 1999	0	0	+100	-200
7 Double capital allowances for small and medium enterprises' plant and machinery for one year	0	0	-230	-170
8 Limit carry back of trading losses to one year	0	0	+100	+250
Other measure				
9 Films: 100 per cent write-off for production costs	$	$	-5	-15
Funding the modernisation of the welfare state				
10 Windfall tax on privatised utilities	+2 600	+2 600	+2 600	0
Moving towards a fairer tax system				
VAT on domestic fuel & power				
11 Reduce rate from 8 per cent to 5 per cent from 1 September 1997	-220	-220	-485	-510
Private medical insurance				
12 End income tax relief	+25	+25	+115	+135
Anti-avoidance measures				
13 Corporation tax: block tax leakage by taxing dividends on trading assets as trading profits	0	0	+110	+190
14 Corporation tax: finance leasing: block acceleration of capital allowances	+250	+250	+300	+70
15 Corporation tax: finance leasing (sale and leaseback): block transfer of unused past allowances	0	0	+40	+40
16 Corporation tax: block tax leakage through company purchase avoidance schemes	$	$	+100	+100
17 PAYE: take action against trade debt schemes	+10	+10	$	$
18 VAT: cash accounting scheme	+10	+10	+15	0
19 IPT: extension of 4 per cent rate to certain long-term health insurance from 1 October 1997	$	$	+5	+5
Protecting the environment and health				
Excise duties on:				
20 Road fuels - increase escalator to 6per cent real(1)	+730	+730	+230	+440
21 VED indexed for licences after 15 November 1997	+35	+5	+20	+20
22 Fuel and gas oil indexed	+5	+5	0	0
23 Cigarettes duty up 5.2per cent real, hand-rolling tobacco frozen, other tobacco up 5				

per cent real; tobacco escalator increased to 5 per cent(1) from 1 December 1997	+5	+5	+160	+360
Other measures				
24 Gilt interest: simplification	0	0	-75	-30
25 Reduction on gas levy	0	0	-170	-190
26 Alcohol duties indexed from 1 January 1998	+20	0	0	0
27 Not indexing air passenger duty in November	0	0	-5	-5
Total cost (-)/yield (+)	**+6 010**	**+5 960**	**+6 665**	**+5 180**
Total cost (-)/yield (+) (excluding windfall tax)	**+3 410**	**+3 360**	**+4 065**	**+5 180**
$ *negligible*				
1 Tax increases previously announced and at a minimum confirmed in this Budget				
5 per cent real increase in road fuel duties	340	210	880*d*	965
3 per cent real increase in tobacco duties	15	10	250*d*	265
Total	355	220	1130	1230

d Yields in 1998-99 on a non-indexed base are £1 420 million and £500 million for road fuels and tobacco respectively.

Providing high quality public services

2.37 The Government's policy is to keep to the Control Totals announced by the previous Government in respect of 1997-98 and 1998-99. The Control Totals for those years are unchanged from previous plans. (See table 2.4.)

2.38 There will be no public expenditure Survey in 1997. Instead the Government is carrying out the Comprehensive Spending Review which it promised before the General Election. Paragraphs 1.60-1.65 describe the approach being taken to the Review. It will provide the basis for spending plans to be set for 1999-2000 onwards.

The Control Total

2.39 No change has been made to the departmental ceilings within the Control Total for 1997-98. Each department is expected to work within its existing ceiling.

2.40 For 1998-99 the Government has allocated part of the existing Reserve within the Control Total to its priorities of health and schools. Within the 1998-99 Control Total, the previous Government set a Reserve of £5 billion, part of which would normally be allocated to priority programmes, and part retained in the Reserve to deal with unforeseen contingencies. The Government has allocated part of the Reserve in this way to its priorities. It has made this allocation rather earlier than usual in order to allow the key public services to plan ahead. The details of the allocation are shown in Table 2.3.

Table 2.3 The 1998-99 Control Total and Reserve

	£ billion
Reserve set in 1996 Budget	5.0
Allocation to NHS	1.2
Allocation to schools	1.0
New Reserve	2.8
Control Total unchanged at:	273.6

2.41 An extra £1.2 billion has been allocated to the National Health Service, and £1 billion to schools. Scotland, Wales and Northern Ireland will receive shares of these allocations based on their relative populations, according to the long-standing Barnett formula.

2.42 This allocation provides an additional £1 billion for the NHS in England, and £835 million for schools in England. Correspondingly, Scotland has been allocated an extra £195 million, Wales an extra £110 million, and Northern Ireland an extra £60 million.

2.43 The Government intends to announce guideline budget increases for local authorities to ensure that councils do not increase spending excessively. If necessary the Government will use its capping powers to ensure councils stay within these limits. For the longer term, the Government is working on a number of measures to improve local authority accountability, so that it can abolish universal capping.

2.44 Other departments will be expected to work within their existing spending ceilings for 1998-99. If there are fluctuations in spending on demand-led programmes which would involve an excess of spending over departmental ceilings, then, first, departments will take policy measures to offset these, and secondly any excess will be borne on the Reserve. The Reserve for 1998-99 has been set at £2.8 billion.

2.45 No plans are being published for the Control Total for the years after 1998-99, because spending plans for these years will be set as part of the Comprehensive Spending Review. The fiscal arithmetic set out in Chapter 4 is based on illustrative projections of Control Total expenditure from 1999-00 onwards.

Table 2.4 The Control Total, GGE(X) and GGE(1)

	£ billion					
	Provisional Outturn	Plans/forecasts		Changes from previous plans/forecasts		
	1996-97	1997-98	1998-99	1996-97	1997-98	1998-99
Control Total	**260.4**	**266.4**	**273.6**	**-0.2**	**0.0**	**0.0**
Welfare to Work		0.2	1.2	0.0	0.2	1.2
LA spending under the capital receipts initiative		0.2	0.7	0.0	0.2	0.7
Cyclical social security	14.3	13.7	14.0	0.0	-0.5	-0.3
CG net debt interest	22.3	24.6	24.4	0.1	-0.2	0.0
Accounting adjustments	11.4	10.1	10.7	1.1	0.9	0.8
GGE(X)	**308.4**	**315.3**	**324.7**	**0.9**	**0.6**	**2.5**
Privatisation proceeds	-4.4	-2.0	0.0	0.1	0.0	1.5
Other adjustments	5.1	6.2	6.6	-0.5	-0.2	0.1
GGE	**309.0**	**319.4**	**331.3**	**0.5**	**0.4**	**4.1**
GGE(X) as a percent of GDP	41	39 1/2	38 3/4	- 1/4	- 1/2	- 1/4

1 See Annex B to Chapter 4 for conventions and definitions.

General Government Expenditure

2.46 Table 2.4 shows the components of General Government Expenditure up to 1998-99. The Control Total is unchanged. In addition to the Control Total, there are two new special, one-off elements of expenditure which the Government promised before the General Election:

- the Welfare to Work package financed by the windfall tax on the excess profits of the privatised utility companies. This provides a New Deal for the under 25s and long-term unemployed, lone parents, and for schools, beginning with £0.2 billion in 1997-98 and £1.2billion in 1998-99. Details of the Welfare to Work package are given in paragraph 2.07;
- investment in housing under the Capital Receipts Initiative. The Government has started to meet its commitment to reinvest capital receipts from the sale of council houses by allowing increased capital expenditure of £200 million in 1997-98 and £700 million in 1998-99. The investment will be used to improve local authority housing stock, to provide new social housing and to fund housing-related regeneration projects. The allocation of these sums between the different countries of the United Kingdom will be announced shortly.

2.47 Other components of General Government Expenditure have been newly forecast in the Budget:

- cyclical social security - the figures in Table 2.4 are new forecasts based on the Government's convention of assuming flat unemployment for planning the public finances, and taking into account measures to reduce the arrears of child maintenance payments and to limit backdating of social security claims;
- the figures for debt interest are new forecasts based on the Government's new market interest rate assumption;
- the accounting adjustments are new forecasts based on latest information from the Office of National Statistics.

2.48 The spending aggregate GGE(X) measures the share of national income taken by public expenditure. This aggregate is a measure of the combined expenditure of central and local government, based on national accounts aggregates: General Government Expenditure is adjusted to exclude privatisation proceeds, expenditure out of the proceeds of the National Lottery, and receipts of interest and dividends from public corporations and the private sector are also netted off. GGE(X) is the resulting aggregate. The ratio of GGE(X) to GDP is shown in Table 2.4.

Annex A to Chapter 2: Explaining the Tax Costings

2A.1 This annex explains how the effects of Budget measures on tax yield are calculated.

2A.2 The revenue effect of a Budget measure is generally calculated as the difference between the tax yield from applying the pre-Budget and post-Budget tax regimes to the levels of total income and spending at factor cost expected after the Budget. The estimates do not therefore include any effect the tax changes themselves have on overall levels of income and spending. They do, however, take account of other effects on behaviour where they are likely to have a significant and quantifiable effect on the yield, and any consequential changes in receipts from related taxes. These include estimated changes in the composition or timing of income, spending, or other tax determinants. For example, the estimated yield from increasing the excise duty on tobacco includes the change in the yield of VAT on that duty, and the change in the yield of VAT and other excise duties resulting from the new pattern of spending. Where the effect of one tax change is affected by the implementation of others the measures are costed in the order in which they appear in Table 2.2.

2A.3 The non-indexed base column in Table 2.2 shows the revenue effect of changes in allowances, thresholds and rates of duty from their pre-Budget levels (including any measures, such as the real increases in fuel and tobacco duties, previously announced but not yet implemented). The indexed base columns strip out the effects of inflation by increasing the allowances, thresholds and rates of duty in line with prices in this and in future Budgets (again taking account of measures previously announced but not yet implemented). Measures announced in this Budget are assumed to be indexed in the same way in future Budgets.

2A.4 In calculating the indexed base it is assumed that each year excise duties and VAT thresholds rise in November (January for alcohol) and allowances and other thresholds rise in April, in line with the assumed increase in the RPI over 12 months to the previous September. The assumed RPI increase in the year to September 1997 is 3 per cent. The commitments for real increases in fuel and tobacco duties of 5 and 3 per cent respectively are also built in.

Notes on individual Budget measures

Inland Revenue taxes

Mortgage interest relief

2A.5 The yield assumes interest rates are unchanged from current levels. There will also be a reduction in public spending of £50million in 1998-99 and 1999-2000 on mortgage interest relief for borrowers who are non-taxpayers.

Private medical insurance

2A.6 There will also be a reduction in public spending of £5million a year in 1998-99 and 1999-2000 on relief for policy holders who are non-taxpayers.

Tax Credit

2A.7 The yield is estimated from the pre-Budget forecast of dividends and allows for tax relief expected to continue through the use of individual savings accounts when they are introduced during 1999. Allowance is also made for an increase in 1997-98 and 1998-99 in foreign income dividends (which do not carry tax credits) and for a fall in corporation tax resulting from companies increasing their contributions to pension funds. From 2000-01 there will be a cost of £50million per year because individuals whose dividend income is partly but not taxed wholly at the higher rate will benefit from the changes.

Foreign Income Dividends

2A.8 The yield is expected to be £250 million from 2000-01. The costings allow for companies bringing forward some dividends to before 6 April 1999 to retain the benefits of foreign income dividends.

Double Capital Allowances

2A.9 There will be some increase in tax in later years as the balance of unrelieved capital expenditure carried forward is reduced by the higher allowances. The revenue effects include those for companies and unincorporated businesses.

Films

2A.10 There will be a cost in 2000-01 after which some companies may pay higher tax because their expenditure will have been relieved in earlier years.

Anti-avoidance measures

2A.11 The yields represent the estimated direct effect of the measures with the existing level of activity. Without these measures there could be a more significant loss of revenue in the future.

Company purchase schemes

2A.12 The changes strengthen those announced in the 1994-95 FSBR which are no longer producing the yield forecast at the time.

Annex B to Chapter 2: Tax changes announced before the Budget

Table 2B.1 Revenue effects of measures announced since the 1996 Budget

	£ million yield (+)/cost (-) of measure			
	Changes from a non-indexed base	Changes from an indexed base		
	1997-98	1997-98	1998-99	1999-00
Inland Revenue taxes				
1 Futures and options	*	*	+50	+50
2 Artificial annuities paid by insurance companies	+10	+10	+20	+20
Customs and Excise taxes				
3 Withdrawal of Finance Bill clause on attachment of debt	-5	-5	0	0
4 Information Technology Agreement	-95	-95	-270	-420
5 Remission of repayment of landfill tax	-5	-5	0	0
Total	**-95**	**-95**	**-200**	**-350**

* = *Negligible.*

Inland Revenue taxes

2B.1 An amendment to the Finance Bill 1997 countered avoidance devices which turned interest income into capital gains, thereby paying less tax. The devices worked by using combinations of options or futures which produced a certain overall return, irrespective of any changes in the price of the underlying commodity etc which was the subject of the future or option (1).

2B.2 An amendment to the Finance Bill 1997 denied tax relief to life insurance companies making payments under annuity arrangements which in substance last for a short period, but were dressed up to last for a much longer one (2).

Customs and Excise taxes

2B.3 Amendment 10 to the Finance Bill 1997 withdrew Clause 54 on attachment of debts. The provision, which was announced in the 1996 Budget as part of a package of measures to rationalise and consolidate Customs and Excise debt recovery legislation, would have allowed Customs to recover money from a third party that was owed to a tax defaulter, for example money in a tax defaulter's bank or building society account (3).

2B.4 The World Trade Organisation agreed in March 1997 the Information Technology Agreement (ITA), to take effect from 1 July 1997, which will progressively reduce tariffs on imports of IT products to zero by 1 January 2000. The table shows the effect on receipts of tax revenue, mainly customs duties; 90 per cent of customs duty revenues are subsequently passed to the European Union as Own Resources (4).

2B.5 An extra-statutory concession was announced on 27 May 1997 which provides, in certain cases, for the remission or repayment of landfill tax incurred between 1 October 1996 and 30 June 1997 by owners or developers of contaminated land. Claims must be made by 30 September 1997 (5).

Table 2B.2 Measures announced in 1996 Budget or earlier which take effect after the 1997 Budget

	£ million yield (+)/cost (-) of measure			
	Changes from a non-indexed base	Changes from an indexed base		
	1997-98	1997-98	1998-99	1999-00
Inland Revenue taxes				
1 Construction industry scheme	0	0	0	+300
2 PRP: withdrawal of tax relief	+200	+200	+800	+1 800
Customs and Excise taxes				
3 5 per cent real increase in road fuel duties	+340	+210	+1 115*	+2 135
4 3 per cent real increase in tobacco duties	+15	+10	+260*	+530
Total	**+555**	**+420**	**+2 175**	**+4 765**

**Yields in 1998-99 on a non-indexed base are £1 790 million and £520 million for road fuels and tobacco respectively.*

Inland Revenue taxes

2B.6 The changes to the construction industry scheme are expected to take effect no sooner than August 1999 (1).

2B.7 The 1997 Finance Act provides for the progressive withdrawal of the tax relief for profit-related pay. The measure will first affect schemes with profit periods beginning on or after 1 January 1998 (2).

Customs & Excise taxes

2B.8 The then Chancellor said in the November 1993 Budget that road fuel duties would be increased on average by at least 5 per cent in real terms in future Budgets (3).

2B.9 The then Chancellor said in the November 1993 Budget that tobacco duties would be increased on average by at least 3 per cent in real terms in future Budgets (4).

2B.10 The yields shown in lines (3) and (4) of Table 2B.2 include the effects of duty increases in future Budgets. The footnote to Table 2B.2 shows only the yield from implementing the commitments in this Budget.

2B.11 The 1997-98 Financial Statement and Budget Report contained incorrect estimates of the cost of an extra-statutory concession allowing vendors of commercial property for conversion to residential dwellings to opt to charge VAT on the sale. This concession had a revenue cost because it allowed the vendors to recover any associated VAT they had incurred in connection with the property, whereas the VAT charged on its sale would normally be recoverable by the purchaser. The revenue costs were shown in Table 6B.1 as £100 million in 1997-98, £110 million in 1998-99 and £120 million in 1999-00 but should have shown a cost of £5 million in each of the three years.

3 The economy: developments and prospects

Overview

Longer-term perspective

3.01 Despite the current position of above-trend growth and relatively modest inflationary pressures, the performance of the UK economy continues to suffer from a number of fundamental weaknesses:

- Over the past 25 years, GDP growth has been slower in the UK than in any of its major competitors. The level of GDP per head in the UK is below the level in all other major industrial (G7) countries, and the UK has failed to narrow the gap with the OECD average since the 1970s.
- The level of productivity in the UK has been lower than that in other G7 economies since the early 1970s.
- Weak growth performance has at least partly reflected under-investment. The UK's ratio of investment to GDP is low by both historical and international standards, and this has been associated over the cycle with similarly low domestic saving. The investment ratio gap with other industrialised countries has been widening in recent years.
- The economy has suffered from a high degree of instability. In the past 25years, the UK has suffered the two deepest and longest recessions in post-War history; its record on growth stability has been one of the worst in the G7; and inflation has been more volatile than in any other G7 country.

Recent developments

3.02 Output began to grow in the first half of 1992, following two years of continuous decline. But recovery has not been evenly spread across sectors. While total output is now 11 per cent above its pre-recession peak, manufacturing output is just 3 1/4 per cent above its previous peak and only 8per cent above the level reached during 1974. Whole economy investment is still 2 1/4 per cent lower than when the recession began.

3.03 GDP grew at an annual rate of 2-2 1/2 per cent in the second half of 1995 and for much of 1996. But it accelerated sharply last autumn, since when it has been rising at an annualised rate of 3 1/2 -4 1/2 per cent, driven by strong consumer spending growth. Unemployment has continued to fall, and the rate of decline appears to have gathered pace since the autumn (although the fall in the claimant count has been amplified by the introduction of the Jobseeker's Allowance). Underlying retail price inflation (i.e. excluding mortgage interest payments) has fallen from around 3 per cent at the end of last year to 2.5per cent at present, reflecting the effects of sterling's appreciation.

Prospects

3.04 GDP is forecast to grow by 3 1/4 per cent in 1997. Consumer spending is likely to remain buoyant. Investment growth over the past two years or so has undershot expectations, although survey evidence of strong service sector investment intentions and rising capacity utilisation point to business investment accelerating further this year. But GDP growth is forecast to slow from the second half of the year as the appreciation of sterling affects net export growth, and domestic demand growth moderates, partly in lagged response to the tightening of monetary and fiscal policy. GDP is forecast to rise by 2 1/2 per cent in 1998.

3.05 As lower producer prices continue to feed through to retail prices, underlying retail price inflation is forecast to remain at around 2 1/2 per cent during the second half of this year. It is forecast to edge up temporarily next year.

Table 3.1 Summary of short-term forecast

		Forecast	
	1996	1997	1998
Real GDP growth (per cent)	2 1/2	3 1/4	2 1/2

Inflation (RPI excluding MIPs, Q4)	3 1/4	2 1/2	2 3/4

Risks

3.06 However, there are substantial risks to the forecast. On the upside, the risk of heavier than expected spending from windfall payments poses the prospect of very strong consumers' expenditure growth. On the downside, investment could once again turn out weaker than expected, especially if the high exchange rate hit exports hard. Were the economy to evolve unchecked along these lines, there would be further imbalance in the composition of growth. The Budget strategy has been designed to counter this risk. But given the chances of output already being above trend and consumer spending continuing to grow rapidly, there is a risk of growth remaining unbalanced.

Developments and short-term prospects

Output and demand - overview

Growth and productivity performance

3.07 Since 1973, UK GDP has grown at only about two thirds of the rate achieved during the earlier post-War years. GDP growth over the past 25 years has also been slower in the UK than in any of its major competitors. Annual growth has averaged around 1 3/4 per cent in the UK since 1973, compared with an average of around 2 1/2 per cent for the major (G7) industrial economies.

3.08 The level of GDP per head in the UK is below the OECD average and the level in all other G7 countries. Despite some relative improvement since 1992, reflecting a cyclical upswing from a deep trough, the UK has failed to narrow the gap with the OECD average since the 1970s.

3.09 As in all other industrial countries, the growth of productivity (output per worker) slowed sharply after 1973. Following growth of close to 3 per cent a year between 1960 and 1973, productivity growth has since averaged around 1 3/4 per cent a year - similar to the European Union and OECD averages.

3.10 However, the level of output per worker in the UK has been lower than that in other G7 economies since the early 1970s. After widening during the second half of the 1960s and the 1970s, this productivity gap has remained broadly constant during the 1980s and 1990s.

3.11 Productivity performance has been mixed across the sectors of the economy over the 1980s and 1990s. In manufacturing and the privatised utilities, productivity has grown strongly, partly associated with substantial labour shedding. But in much of the service sector (where productivity is less well-measured) productivity growth has been comparatively low, both relative to manufacturing and to growth in the 1960s and early 1970s. This has contributed to comparatively fast growth of employment in the service sector.

3.12 The UK economy has also suffered from a high degree of instability. Over the past 25 years, the UK has experienced the largest boom and the two deepest and longest recessions in the post-War period. In the early 1980s recession, output fell by 5 1/4 per cent from peak to trough, while there was a peak-to-trough fall in output of 3 3/4 per cent in the early 1990s. Since 1973, fluctuations in GDP growth have been larger in the UK than in any other G7 economy apart from Canada. This has been associated with a relatively high degree of inflation volatility.

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Recent developments

3.13 The UK economy started a cyclical upswing in the first half of 1992, following a deep trough in output. GDP grew at an annualised rate of around 2 per cent between mid-1992 and mid-1993. But growth then picked up sharply to 4 1/2 per cent in 1994, as exports grew strongly in response to rapid world trade growth.

3.14 The growth of both domestic demand and exports slowed during 1995, the former reflecting a tightening of monetary policy and the latter a slackening of world trade growth. However, the impact on GDP was cushioned by higher stockbuilding, which was probably largely involuntary, and GDP rose by 2 per cent in the year to the fourth quarter of 1995.

3.15 Domestic demand has been strengthening again since the beginning of 1996, but lower stockbuilding at first held back GDP growth, which remained at an annual rate of 2-2 1/2 per cent over the first three quarters of the year. However, GDP accelerated sharply towards the end of the year, rising at an annualised rate of almost 4 1/2 per cent in the fourth quarter of 1996 and 3 1/2 per cent in the first quarter of 1997. On balance, it seems likely that the output gap is currently close to zero, though there is a significant risk that output could already be above its trend level (see box).

3.16 Over the past year, growth has been led by the service sector, where output increased at an annualised rate of 5 1/4 per cent in the first quarter, and by 4 1/4 per cent on a year earlier. Growth has been particularly strong in the financial and business services and transport and communication sectors. After showing little change for almost a year, construction output has been rising strongly since the middle of 1996, and in the first quarter of 1997 was 3 3/4 per cent higher than a year earlier. Manufacturing output remained broadly flat between late 1994 and mid-1996, but has picked up since last summer and in the three months to April was almost 2 per cent higher than a year earlier.

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Prospects

3.17 Consumers' expenditure should continue to expand quite strongly in response to rising incomes and wealth and increasing consumer confidence, with scope for very strong growth in the event of heavier than expected spending out of windfall payments. Business investment is expected to pick up further this year, though manufacturing investment is expected to remain weak. But whole economy investment has been sluggish in recent years, and forecasts of strong growth over the past two years or so have failed to materialise. Moreover, investment prospects could be adversely affected if the high exchange rate hit exports hard. So the investment forecast is particularly uncertain. The drag on growth from stock adjustment now appears to have passed, and stockbuilding is expected to make little contribution to growth over the next 18months. Total domestic demand is forecast to grow by 3 3/4 per cent this year.

3.18 However, export growth is expected to be slower from the second half of the year as the impact of the exchange rate appreciation begins to build up. Towards the end of the year and into next year domestic demand is also expected to decelerate, partly in lagged response to the tightening of monetary and fiscal policy, and as the effect of spending out of windfalls on growth recedes. GDP is forecast to grow by 3 1/4 per cent in 1997 as a whole, with growth slowing through the year. Growth of 2 1/2 per cent is forecast for 1998. Lower domestic demand growth and net trade are expected to contribute roughly equally to this slowdown.

SPARE CAPACITY AND THE OUTPUT GAP

The output gap is the difference between actual output and a measure of "potential" or "trend" output. It can be used as a measure of demand pressure - i.e. the degree of under or over-heating in the economy. If actual output were above trend - a positive output gap - for a sustained time, experience suggests there would tend to be upward pressure on inflation.

It is impossible to measure the output gap with any degree of certainty. Business surveys of capacity utilisation provide an indication of short-term capacity pressures in product markets. And surveys of skilled labour shortages, together with other labour market indicators - unemployment, vacancies and average earnings - can be used to estimate the degree of slack in the labour market.

Capacity utilisation

The most quoted measure of capacity utilisation, from the CBI survey of manufacturing, has been just above its long-run average since mid-1994. But it is unlikely that the economy as a whole was above trend in 1994, so soon after the early 1990s recession.

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Other surveys suggest that capacity utilisation may be tighter in the service sector. The British Chambers of Commerce (BCC) survey shows that it has continued to rise in services in recent quarters and is now above itslevel in 1989, when demand pressure was certainly high. The Building Employers' Confederation (BEC) survey indicates that capacity utilisation is also slightly above its long-run average in construction.

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Skilled labour shortages

Indicators of skilled labour shortages are more conflicting. The CBI survey suggests that they may still be slightly below average in manufacturing. However, the BCC survey suggests that skill shortages are back to their 1989 levels in both manufacturing and services.

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Labour market indicators

Other indicators suggest that the labour market has tightened in recent months and may now have little or no slack remaining. (If this were correct, the scope for further falls in unemployment, without putting upward pressure on inflation, would depend solely on structural reforms.) Unemployment has continued to fall, although part of the sharp decline in the claimant count since last autumn can be attributed to distortionary effects from the introduction of the Jobseeker's Allowance (JSA). Vacancies in early 1996, even before JSA had distortionary effects, were already back to the levels seen in the late 1980s. There has also been a pick-up in average earnings growth since mid-1995, with a steady rise in manufacturing and a sharper rise in service sector earnings growth.

Speed limits

It is possible that if the economy is growing fast enough, inflation could still rise even when the economy is operating below its supply potential, i.e. with a negative output gap. This is the so-called "speed limit" effect.

High levels of capacity utilisation, which may reflect the weakness of investment in recent years, began to show in the manufacturing sector as early as 1994. Since then manufacturing growth has slowed, but service sector output has accelerated, and this has been reflected in the acceleration in service sector earnings.

The output gap

These modest inflationary pressures probably reflect the economy running into speed limits in first the manufacturing and then the service sector, though they do not necessarily imply that the output gap in the economy as a whole has turned positive.

The evidence overall suggests that the output gap is now close to zero. But there is a significant risk that output could already be above its trend level (a positive output gap).

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3.19 The composition of demand growth over the next two years is likely to continue to be relatively favourable to the service sector. Manufacturing output is forecast to grow by just 1 1/2 per cent this year and 3/4 per cent in 1998.

3.20 Were the possible upside risk to consumer spending from windfalls and the downside risks to investment and exports from the high exchange rate to materialise, there would be further imbalance in the composition of growth. The Budget strategy has been designed to reduce the risks of growth remaining unbalanced.

Personal sector and the housing market

Longer-term perspective

3.21 The personal saving ratio (saving as a percentage of disposable income) was very low in the immediate post-War period. But it rose progressively during the 1960s and 1970s: higher rates of inflation required people to save more simply to maintain the real value of their savings, while it is likely that increasing unemployment led to greater job insecurity and higher precautionary saving. The saving ratio peaked in 1980 at 13 1/2 per cent.

3.22 However, fuelled by the expansionary impact of financial liberalisation, lower oil prices, and a relaxation of both fiscal and monetary policy, consumers' expenditure accelerated unsustainably in the second half of the 1980s and the saving ratio fell sharply. Between 1986 and 1988, consumer spending increased at an average rate of 6 1/2 per cent a year, and the saving ratio fell to 6 per cent in 1988. The housing market boomed - prices increased by around 90 per cent between 1986 and 1989 - and many homeowners borrowed for consumption on the back of rising house prices. With falling saving and a sharp increase in housing investment, the personal sector moved into financial deficit in the late 1980s for the first sustained period since the 1950s.

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3.23 The subsequent recession and housing market downturn left the personal sector with a high debt burden and many homeowners with negative equity (the value of the mortgage outstanding exceeding the market value of the property). Consumers' expenditure fell by 3 1/2 per cent from peak to trough and house prices fell on average by almost 13 per cent. The saving ratio peaked at almost 13 per cent during 1992 and, despite relatively low inflation, has remained at a high level since, partly reflecting increased consumer caution after the experience of the late 1980s.

Consumption, income and saving

3.24 Consumer spending is by far the largest expenditure component of GDP, accounting for over 60 per cent of the total. Having increased by 1 3/4 -2 3/4 per cent a year between 1993 and 1995, it grew by 3 1/2 per cent last year, with the annual growth rate picking up to 4 1/4 per cent in the final quarter. Spending on durable goods was particularly strong.

3.25 Strong growth continued in the first quarter of 1997. Recent monthly indicators also point to strong consumer demand. Retail sales (which account for about 40 per cent of total consumption) were 4.9 per cent higher in the three months to May than a year earlier. New car registrations in the three months to May were 4.1 per cent up on a year earlier. Consumer credit continues to grow strongly (up by 17.0 per cent in the year to May) and consumer confidence is now back to levels last seen in mid-1988.

3.26 Real personal disposable income grew by 3 3/4 per cent last year - well above its long-term trend rate of around 2 1/2 per cent - reflecting income tax cuts, rising employment, higher real average earnings growth and further strong growth of dividend receipts. Dividend receipts are unlikely to grow as quickly this year as last, but with lower inflation, real average earnings growth is likely to be higher. Real personal disposable income is therefore forecast to grow strongly again this year, by 3 per cent. It is forecast to increase by 1 3/4 per cent in 1998.

3.27 Net personal financial wealth has grown by 30 per cent over the past two years, as a result of high personal sector saving (particularly in pensions) and rapid increases in equity prices. The FT-SE All-Share index rose by around 30 per cent between the beginning of 1995 and the end of 1996, and has risen by a further 10 per cent so far this year. Rising house prices have also been boosting total wealth since mid-1995.

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3.28 Personal wealth is being further increased by "windfall payments". People have already received around £25 billion this year from the flotation of building societies and insurance companies, and this is likely to rise to over £30billion in the year as a whole. There is a further £5 billion from maturing TESSA accounts, which does not increase total wealth but makes existing wealth more liquid.

3.29 The forecast assumes that most of this money will be saved, and hence the effect on consumer spending will be relatively small - adding around 3/4 -1 per cent to consumption this year. Evidence from previous flotations and consumer surveys tends to support the view of relatively modest spending from these windfalls. However, it could be much larger, and this represents a significant upside risk to the forecast. For example, if a quarter of the windfalls were to be spent (compared with a central assumption of around 15 per cent), this would add a further 1/2 - 3/4 per cent to consumers' expenditure this year.

3.30 With consumption growth matching that of personal disposable income, the personal sector saving ratio remained at around 11 1/2 -12 per cent for most of last year. However, high levels of consumer confidence (at least partly associated with falling unemployment and rising house prices), high wealth and spending out of windfalls will all be tending to reduce the saving ratio. The forecast assumes that it falls to 8 3/4 per cent next year.

Table 3.2 Personal expenditure and income

	Percentage changes on a year earlier		
		Forecast	
	1996	1997	1998
Consumers' expenditure	3 1/2	4 1/2	4
Real personal disposable income	3 3/4	3	1 3/4
Saving ratio (level, per cent)	12	10 1/2	8 3/4

3.31 Reflecting the rise in real incomes and the fall in the saving ratio, consumer spending is forecast to grow by 4 1/2 per cent in 1997. But, as already noted, heavier than expected spending from windfalls could lead to much stronger consumption growth in 1997. In any case, as a matter of arithmetic, the effect of windfalls on the growth of consumer spending is likely to recede during the course of next year. Moreover, towards the end of this year consumer spending is expected to start decelerating under the influence of the tightening of monetary and fiscal policy. Growth in consumers' expenditure is therefore forecast to slow to 4per cent in 1998.

Housing market

3.32 House prices have been rising strongly since late 1995. The Halifax index shows prices in May 6.6 per cent higher than a year earlier, while the Nationwide index puts the increase in the year to June at 11.0 per cent. A shortage of properties on the market appears to be contributing to the upward pressure on prices. The May survey from the Royal Institute of Chartered Surveyors reported that the number of properties for sale was down 28 per cent on a year earlier. This now appears to be having an effect on turnover. The number of particulars delivered at the Land Registry has flattened off in the past few months, having risen sharply since early last year.

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3.33 In real terms, house prices remain well below their previous peak. With the house price-earnings ratio still low, housing remains very affordable. Higher demand and limited increases in supply are therefore likely to combine to put upward pressure on house price inflation for a time. However, thereafter the rate of increase in house prices should begin to moderate, damped by the reduction in mortgage interest tax relief, and with slower growth in real incomes in 1998 acting as a restraint on housing demand. On the supply side, the supply of new houses should increase as the rise in private sector housing starts over the past year feeds through into completions.

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Private housing investment

3.34 Private housing investment includes both new housebuilding and improvements to existing properties. It was virtually unchanged in 1996 as a whole, but picked up through the year, mainly led by higher investment in existing dwellings. However, investment in new dwellings also began to pick up in the second half of last year, and should increase further in 1997 as housing completions pick up. Investment in existing dwellings should grow quite quickly too: personal incomes are forecast to grow strongly and some of the windfalls are likely to be spent on home improvements.

Financial position

3.35 With little change in either saving or investment, the personal sector financial surplus remained at around 6 per cent of disposable income last year, well above its long-run average of around 3 1/2 per cent. But with a fall in the saving ratio and a pick-up in housing investment, this surplus is projected to decline to around 2 per cent of income in 1998.

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Costs, earnings and inflation

Longer-term inflation performance

3.89 The UK's inflation performance since the early 1970s has been poor. RPI excluding mortgage interest payments (RPI ex MIPs) inflation has averaged 8 1/4 per cent since 1970, compared with 4 per cent over the previous 20 years. Over the last full international economic cycle (1982-93), the UK's inflation rate was higher than that in any other G7 country apart from Italy, and was above the European average. Despite an improvement in inflation performance in recent years, the UK's inflation rate is still above the G7 average. UK inflation has also been volatile, ranging from around 2 per cent to 27 per cent over the past 25 years, and this volatility has been greater than that in any other G7 economy.

Recent developments

3.90 RPI ex MIPs inflation remained between 2 3/4 and 3 per cent during 1995 and most of 1996. It rose temporarily to 3.3 per cent last autumn, but has fallen back to 2.5 per cent in April and May.

Earnings

3.91 After remaining at 3 3/4 -4 per cent for most of last year, whole economy underlying average earnings growth has risen from 4 per cent in October to 4 1/2 per cent at present. This is close to what the economy in its present state could sustain in the medium term consistent with the inflation target. Most of the recent increase in earnings has occurred in the service sector, where earnings growth has risen from 3 1/2 per cent in the first half of last year to 4 3/4 per cent at present.

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Input and output prices

3.92 The large appreciation of sterling since last summer has been feeding through to producer input prices[3], which in May were 7.7 per cent lower than a year earlier. However, the latest monthly figures suggest that the falls in input price inflation may now be coming to an end. Although Brent oil prices have fallen back sharply since the beginning of the year, non-oil commodity prices have been rising, even in sterling terms, since the end of 1996.

3.93 The 12-month rate of producer output price inflation has fallen from around 4 1/2 per cent at the end of 1995 to just 0.5 per cent in May. This decline has been smaller than the fall in producer input price inflation, mainly because unit labour costs (the other major component of manufacturers' costs) have continued to rise. It is also likely that producers have been taking advantage of strong demand to rebuild domestic margins.

3.94 With producer input price inflation now probably close to its trough, output price inflation probably has little further to fall. It is forecast to remain broadly flat for the rest of the year, before increasing to around 2 1/2 per cent by the end of 1998, as import prices level out.

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Retail goods prices

3.95 Despite falling producer output price inflation and the falling prices of consumer imports, retail goods price inflation fell only a little through the course of last year. This is likely to have reflected both higher labour costs and some rebuilding of retail margins, following the squeeze on margins in the first half of the 1990s. The fall in retail goods price inflation from 2.7 per cent in December to 1.7 per cent in May suggests that the effects of the appreciation are feeding through to retail prices.

Retail services prices

3.96 Services prices, which make up around one third of the RPI, are less affected by falling input prices and less directly exposed to competitive pressures from the high exchange rate. A major factor behind the rise in retail services price inflation - from around 2 per cent in the middle of last year to 3.3 per cent at present - has been the increase in service sector earnings.

Table 3.6 Retail and producer output price inflation

	Percentage changes on a year earlier				
			Forecast		
	1996 Q4	1997 Q2	1997 Q4	1998 Q2	1998 Q4
RPI excluding MIPs	3 1/4	2 1/2	2 1/2	2 3/4	2 3/4
Producer output prices(1)	3/4	1/2	0	1	2 1/2

1 Excluding the food, beverages, tobacco and petroleum industries.

Inflation forecast

3.97 As the feed-through of lower input prices continues to exert downward pressure on retail price inflation, RPI ex MIPs inflation is forecast to remain at around 2 1/2 per cent during the second half of this year. But the effect from the exchange rate is by its nature temporary. With the output gap estimated to be close to zero at present and the economy growing at an above-trend rate, demand pressures are increasing. As the effects from lower input costs weaken, RPI exMIPs inflation is likely to begin to rise next year. It is forecast to rise to 2 3/4 per cent in the second quarter of 1998, and remain there in the second half of the year, before falling back to around 2 1/2 per cent by the middle of 1999 in response to slower output growth.

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GDP deflator

3.98 As an index of the price of domestic output, the GDP deflator includes the prices of UK exports but nets off the prices of imports; so it tends to decline if the terms of trade fall (export prices rise more slowly than import prices). The GDP deflator increased by 2 3/4 per cent in 1996-97 (similar to the RPI ex MIPs), as a rise in the terms of trade was offset by low investment and public procurement prices. The GDP deflator is forecast to rise by 2 3/4 per cent in both 1997-98 and 1998-99.

Independent forecasts

3.99 Table 3.7 shows the average and range of around 30 independent forecasts for 1997 and 1998. The Treasury forecasts for GDP growth and underlying retail price inflation are the same as the independent averages for 1997. The Treasury forecast for growth in 1998 is a little lower than the independent average. This mainly reflects outside forecasters, on average, expecting net trade to make less of a negative contribution to GDP growth, which can be largely attributed to the sizeable fall in the exchange rate that they typically assume. With slower growth in 1998, the Treasury forecast for inflation is correspondingly lower.

Table 3.7 Budget and independent(1) **forecasts**

	Percentage changes on a year earlier unless otherwise stated					
	1997			1998		
	Budget	Independent		Budget	Independent	
		Average	Range		Average	Range
Gross domestic product	3 1/4	3.3	2.6 to 4.3	2 1/2	2.7	1.7 to 4.2
RPI excluding MIPs (Q4)	2 1/2	2.5	1.9 to 3.6	2 3/4	3.1	2.0 to 4.2
Current account (£billion)	-6	-3.9	-10.0 to 1.2	-9	-8.6	-17.0 to -2.2

1 "Forecasts for the UK Economy: A Comparison of Independent Forecasts", June 1997.

Margins of error

3.100 As an indication of the margins of error around the forecast, Table 3.9 shows average errors from Treasury forecasts made over the past ten years. Errors usually increase with the forecast horizon, while errors on any individual forecast may be larger or smaller than the historical averages.

The economy in the medium term

3.101 This section sets out the medium-term economic projections which underlie the fiscal projections described in Chapter 4.

Trend growth

3.102 With output now close to its trend level, the scope for output to grow without putting upward pressure on inflation depends on the economy's trend rate of growth.

3.103 The trend rate of growth can be broken down into three components:

- trends in the labour force;
- changes in the underlying unemployment rate; and
- the trend in productivity.

3.104 Quantitatively, the most important of these is likely to be productivity, which grew at around 1 3/4 -2 per cent a year over the last economic cycle. With sufficient investment, such a rate of productivity growth should be sustainable, and might even be bettered, over the medium term.

3.105 The labour supply contracted during the early 1990s. This mainly reflected higher participation in further and higher education, early retirement, and more claimants of Incapacity Benefit. The population of working age was growing relatively modestly. But it is now growing almost twice as fast as in the early 1990s, and this is expected to continue. So with a resumption of past trends in participation, i.e. a small fall in male participation more than offset by a steady rise in female participation, the labour supply may be able to grow by as much as 1/2 per cent a year over the medium term.

3.106 A fall in structural unemployment would also add to trend growth. Measures such as the Welfare to Work programme are designed to bring currently under-utilised labour into productive use. This adds to the economy's productive capacity without exerting upward pressure on inflation. A fall in long-term unemployment to its 1990 levels could add around 1/4 per cent a year to the rate of trend growth.

3.107 Considering each of the component parts on their merits, it is plausible that growth of between 2 and 2 3/4 per cent a year might be sustained over the medium term. However, to use an estimate towards the upper end of this range would be to take credit in advance for success in bringing the young and long-term unemployed back into the workforce. Accordingly, a more prudent estimate of the trend growth rate would be 2 1/4 per cent, which is also broadly in line with the post-War average and the average over the last full cycle (between the estimated on-trend points in early 1986 and early 1997).

Medium-term projections

3.108 This growth rate is used in Chapter 4 in projecting the path of the public finances in the medium term.

3.109 With output close to trend and assumed to grow at its trend rate in the medium term, RPI ex MIPs inflation is projected to remain stable at the target rate of 2 1/2 per cent. The GDP deflator is projected to move in line with the RPI ex MIPs, and money GDP is projected to grow by 4 3/4 per cent a year.

Table 3.8 Medium-term economic projections (1)

	Percentage changes on previous financial year				
	1997-98	1998-99	1999-00	2000-01	2001-02
Output (GDP)	3 1/4	2 1/4	2 1/4	2 1/4	2 1/4
Prices					
RPI excluding MIPs	2 1/2	2 3/4	2 1/2	2 1/2	2 1/2
GDP deflator	2 3/4	2 3/4	2 1/2	2 1/2	2 1/2
Money GDP	6	5	4 3/4	4 3/4	4 3/4

1 Forecasts for 1997-98 and 1998-99 and assumptions thereafter.

Table 3.9 Summary of short-term economic prospects (1)

	Percentage changes on a year earlier unless otherwise stated				
		Forecast		Average errors from past forecasts (2)	
	1996	1997	1998	1997	1998
Output at constant prices (3)					
Gross domestic product (GDP)	2 1/2	3 1/4	2 1/2	3/4	1 1/2
Non-North Sea GDP	2 1/2	3 1/4	2 1/2	3/4	1 1/2
Manufacturing output	1/4	1 1/2	3/4	3/4	2 1/4
Expenditure components of GDP atconstant prices (3)					
Domestic demand	2 3/4	3 3/4	3 1/4	1	1 3/4
Consumers' expenditure	3 1/2	4 1/2	4	1	1 1/2
General government consumption	2 1/2	- 1/4	-1	1	1
Fixed investment	1 3/4	5	6	2 1/4	4 1/2
Change in stockbuilding (4)	- 1/4	0	0	1/4	1/2
Exports of goods and services	7	6 1/4	5	1 1/2	2
Imports of goods and services	8 1/2	7 1/4	7 3/4	2	3 1/4
Balance of payments current account					
£ billion	- 1/2	-6	-9	7 1/2	10 3/4
per cent of GDP	0	- 3/4	-1	1	1 1/4
Inflation					
RPI excluding mortgage interest payments (Q4)	3 1/4	2 1/2	2 3/4	1/2	1
Producer output prices (Q4) (5)	3/4	0	2 1/2	1/2	1 1/2
GDP deflator at market prices (financial year)	2 3/4	2 3/4	2 3/4	1	1 1/4
Money GDP at market prices (financial year)					
£ billion	752	798	838	11	16 1/2
percentage change	5 1/2	6	5	1 1/4	2

1 Data in this chapter are consistent with the output, income and expenditure estimates and other series for the period to the first quarter of 1997 released by the Office for National Statistics on 27June 1997.

2 Average absolute errors in summer forecasts over past ten years. The average errors for the current account are calculated as a percent of GDP. The £ billion figures are calculated by scaling the errors as a percent of GDP by money GDP.

3 Further detail on GDP and its components is given in Table 3.10.

4 per cent of GDP.

5 Excluding the food, beverages, tobacco and petroleum industries.

Table 3.10 Gross domestic product and its components

	£ billion at 1990 prices, seasonally adjusted										
	Consumers' expenditure	General govern-ment consump-tion	Total fixed invest-ment	Stock-building	Domestic demand	Exports of goods and services	**Total final expendi-ture**	*Less* imports of goods and services	*Less* adjust-ment to factor cost	*Plus* statistical discre-pancy(1)	**GDP at factor cost**
1996	376.6	122.4	104.1	2.6	605.8	179.8	785.6	184.7	77.2	0.8	524.5
1997	393.9	122.2	109.3	2.5	627.9	190.9	818.8	198.2	79.2	0.8	542.2
1998	409.2	121.1	115.9	2.5	648.7	200.4	849.1	213.5	80.7	0.8	555.8
1996 1st half	186.7	61.0	52.0	1.3	301.0	88.6	389.6	91.1	38.3	0.3	260.5
2nd half	190.0	61.4	52.1	1.3	304.8	91.2	396.0	93.5	38.8	0.5	264.1
1997 1st half	194.2	61.3	53.7	1.3	310.5	94.4	404.9	96.9	39.5	0.4	269.0
2nd half	199.7	60.9	55.6	1.2	317.4	96.5	413.9	101.3	39.7	0.4	273.2
1998 1st half	203.3	60.6	57.3	1.3	322.4	98.7	421.1	105.0	40.2	0.4	276.4
2nd half	205.9	60.5	58.6	1.2	326.3	101.7	428.0	108.4	40.6	0.4	279.4
	Percentage changes on a year earlier (2)										
1996	3 1/2	2 1/2	1 3/4	- 1/4	2 3/4	7	3 1/2	8 1/2	1 1/2	1/4	2 1/2
1997	4 1/2	- 1/4	5	0	3 3/4	6 1/4	4 1/4	7 1/4	2 1/2	0	3 1/4
1998	4	-1	6	0	3 1/4	5	3 3/4	7 3/4	2	0	2 1/2

1 Expenditure adjustment.

2 For stockbuilding and the statistical discrepancy, changes are expressed as a percent of GDP.

[3] All references to producer prices exclude the food, beverages, tobacco and petroleum industries. *Back*

Annex A to Chapter 3: The World Economy

Summary

3A.1 The world economy is growing solidly. Growth in the G7 overall was close to trend in 1996 and is forecast to pick up in 1997, led by above-trend growth in the US. Growth is expected to continue at a healthy pace in 1998, as the European and Japanese recoveries gain momentum and the US slows a little. The growth of world trade in manufactures slowed sharply in 1996, but it is expected to recover to more normal rates through 1997 and 1998. Despite recent increases in some non-oil prices, commodity prices overall seem unlikely to pose a threat to the subdued world inflation outlook.

Table 3A.1 The world economy

	Percentage changes on a year earlier		
		Forecast	
	1996	1997	1998
Major seven countries (1)			
Real GDP	2 1/4	2 3/4	2 1/2
Consumer price inflation (2)	2 1/2	2 1/4	2 1/2
World trade in manufactures	6 1/2	8	8
UK export markets (3)	6 1/4	7 1/2	7 3/4

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

2 Final quarter of each period. For UK, RPI excluding mortgage interest payments.

3 Other countries' imports of manufactures weighted according to their importance in UK exports.

Output

3A.2 Following growth of just 1 1/2 per cent in 1996, activity in the European Union as a whole is forecast to strengthen in 1997. Low interest rates and a weaker exchange rate against the US dollar should contribute to a pick-up in growth to around 2 1/4 per cent in 1997. However, domestic demand growth is likely to remain weak, partly reflecting the short-term impact of fiscal consolidation. Recovery should become more firmly established in 1998, with growth above trend at 2 3/4 per cent. However, with unemployment high and consumer confidence relatively weak, some risks to sustained recovery remain.

3A.3 Growth in the United States was close to trend in 1996, but it has accelerated recently - led by strong consumer demand. Although growth is expected to moderate later this year, it is likely to average above trend for 1997 as a whole. Unemployment has fallen to its lowest level for nearly 25 years, prompting fears of rising inflation. But there has been little evidence to date of upward pressure on prices, although these are uncharted waters. Growth in Japan was the strongest in the G7 in 1996, at 3 3/4 per cent. Continuing recovery in private demand is expected to be the main factor sustaining solid growth in 1997, despite this year's fiscal tightening. The yen's substantial fall over the past two years should also deliver a positive contribution from net exports.

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World trade

3A.4 World trade in manufactures grew rapidly in 1994 and 1995, before slowing sharply to 6 1/2 per cent in 1996. This slowdown reflected slower growth in continental Europe and a sharp fall in Asian trade growth. With some recovery expected in these regions and healthy demand growth in the US, world trade growth is expected to pick up to 8 per cent in both 1997 and 1998. UK export market growth slowed more sharply than world trade in the first half of 1996, but recovery in Europe should mean that UK market growth picks up in 1997 and 1998.

Inflation and commodity prices

3A.5 G7 consumer price inflation remained low in 1996, and is expected to edge up only slightly over the next 18 months - as US inflation rises a little. With some spare capacity in Europe and Japan and G7 growth expected to be only slightly above trend, global inflationary pressures are expected to remain subdued.

3A.6 In the commodity markets, non-oil commodity prices have picked up sharply since the start of the year, but this mainly reflects special factors including fears over coffee harvests. By contrast, oil prices have fallen sharply since the start of the year. They averaged $18 1/4 per barrel (Brent) in the second quarter of 1997, compared to $23 3/4 per barrel in the fourth quarter of 1996. The strength of oil prices through 1996 and their subsequent fall are difficult to explain, and their recent volatility means that any assumption about oil prices is particularly uncertain. However, the forecast assumes that the price falls since the start of the year are sustained, and that prices average around $18 1/2 -19 per barrel for 1997 as a whole.

Interest rates

3A.7 The Federal Reserve Board raised US short-term interest rates to 5 1/2 per cent in March - the first change since rates were cut at the end of 1995. With recovery not yet in full force and inflation remaining low, German rates have remained unchanged, while French rates have eased slightly further. Japanese short rates have been held at 1/2 per cent since September 1995. Long-term interest rates fell back slightly in the final quarter of last year amid diminishing fears of inflationary pressures in the US. US rates have edged up slightly since, while those in Japan and Germany have held steady.

Unemployment

3A.8 Unemployment has continued to decline in the US, falling to 4.9 per cent in April (standardised ILO definition). Unemployment is much higher in Europe. It stood at 9.6 per cent in Germany and 12.5 per cent in France in April. Japanese unemployment has also been increasing, and although much lower than elsewhere - at 3.2 per cent in March - is currently close to historically high levels.

4 The public finances

Summary

4.01 Sound public finances are essential for long-term economic stability. The deficit reduction plan introduced in this Budget is intended to ensure sound public finances. Its specific objectives, both over the economic cycle, are to enforce the "golden rule" (borrowing only to finance investment) and hold the burden of government debt at a stable and prudent level.

4.02 This chapter sets out forecasts for the public finances for 1997-98 and 1998-99, the period for which there are public expenditure commitments. It also includes some variant projections for 1999-2000 to 2001-02, based on a range of illustrative assumptions for public expenditure growth. The main features are:

- The budget deficit falls substantially over the next two years on all definitions. This partly reflects the measures in the Budget but also tight control of public spending.
- Since the windfall tax has only temporary effects, trends are clearer when it and the associated spending are excluded. On this basis, the current balance is forecast to swing from a deficit of 2 3/4 per cent of GDP in 1996-97 to a small surplus of 1/4 per cent in 1998-99. This implies that, from that time, the Government will be borrowing only to finance its investment and not its current spending, thereby meeting the "golden rule".
- The general government financial deficit (GGFD), the internationally comparable Maastricht definition, falls from 4 per cent of GDP in 1996-97 to only 1/4 per cent of GDP in 1998-99.
- The PSBR falls less than the GGFD because privatisation proceeds are assumed to fall to zero after the current financial year. But, excluding the windfall tax and associated spending, the PSBR is just 3/4 per cent of GDP in 1998-99.
- Three sets of projections are presented for years after 1998-99 which make different illustrative assumptions about the growth of public expenditure. The projections show a range of possible paths for the current account, government borrowing and debt for given tax rates and economic assumptions. In every case the Government's fiscal objectives are achieved. However, it should be emphasised that these projections are subject to considerable uncertainty; for example, they are heavily dependent on the view taken of the cyclical position of the economy.

4.03 The chapter starts by setting out key assumptions underlying the forecast and medium-term projections. It then describes in turn the forecasts for the budget deficit, public sector debt, government receipts and government expenditure, and goes on to describe the variant projections in a more summary form. Historical series and further detail on the forecasts for 1997-98 are presented in Annex A. Annex B provides a guide to accounting conventions.

Key assumptions

4.04 The projections of the public finances allow for the Budget measures and are consistent with the economic forecasts and assumptions set out in Chapter3.

4.05 A number of key assumptions have been changed since the last Budget. The new assumptions are deliberately more cautious and are intended to avoid any optimistic bias in the projections. The new assumptions are:

- Only the direct effects of the "Spend to Save" measures introduced in the last Budget to combat tax evasion have been taken into account. The indirect, deterrent effects, which are more difficult to estimate and monitor, are now excluded.
- Privatisation proceeds are now only scored for sales that have already been announced. Previously, credit had been taken for such proceeds in the later years of the projections even though no specific sales had been identified.
- Unemployment is assumed to remain flat, whereas the last Budget had assumed a continuous decline. This returns to the convention used for many years before the 1996 Budget.
- The assumed rate of output growth over the medium term has been reduced from 2 1/2 to 2 1/4 per cent a year.
- Following the transfer of responsibility for setting interest rates from the Chancellor to the Bank of England, the interest rate assumptions are based on expectations in financial markets.

4.06 These five assumptions have been examined by the Comptroller and Auditor General, the Head of the National Audit Office. His report was published on 19 June [1]. It concluded that the assumptions "have been arrived at systematically on the basis of the available data and by methods which interpret it in a reasonable way".

The budget deficit

4.07 Forecasts for the budget deficit are shown in Table 4.1 (see Annex B for definitions).

Table 4.1 The public sector's finances

	£ billion		
	Estimated outturn	Forecast	
	1996-97	1997-98	1998-99
Receipts(1)	285.4	310.9	329.6
Current expenditure(2)	306.6	316.4	325.2
Current balance	**-21.2**	**-5.5**	**4.4**
Current balance excluding windfall tax(3)	***-21.2***	**-8.0**	**2.7**
Net capital spending(4)	8.1	7.5	7.9
Financial deficit	**29.2**	**13.0**	**3.5**
Privatisation proceeds and other financial transactions	6.5	2.0	-0.5
PSBR	**22.7**	**10.9**	**4.0**
PSBR excluding windfall tax(3)	22.7	13.3	5.4
General government financial deficit(5)			
- £ billion	**30.4**	**11.2**	**1.6**
- per cent of GDP(5)	**4**	**1 1/2**	**1/4**
Money GDP - £ billion	752.2	797.6	838.0

1 On a national accounts accruals basis. Includes capital taxes.

2 Includes depreciation of fixed capital.

3 Excluding windfall tax receipts and associated spending.

4 Net of depreciation, less capital transfer receipts and including capital grants.

5 Definitions on a Maastricht basis.

The current balance

4.08 The current balance is the difference between government receipts and current spending, and represents the public sector's contribution to national saving. For most of the 1980s and 1990s the current balance has been in substantial deficit, and this has tended to reduce overall levels of saving and investment in the economy. The "golden rule" is met when the current balance is zero or positive, and the public sector borrows only to finance its investment. It is projected that the current balance, which was in deficit by 2 3/4 per cent of GDP in 1996-97, will be slightly in surplus by 1998-99. The Budget measures, other than the windfall tax and its associated spending, reduce borrowing by over 1/4 per cent of GDP by 1998-99. Most of the rest of the improvement in the current balance is accounted for by restraint in current spending.

The financial deficit

4.09 The financial deficit is the difference between receipts and total government current and capital expenditure, and represents the increase in the public sector's net financial indebtedness. There was a financial deficit of 4 per cent of GDP in 1996-97. Based on the spending plans set out in the last Budget, net capital spending falls in 1997-98, but it recovers the following year as a result of LA spending under the capital receipts initiative. So the trend in the financial deficit is very similar to that of the current balance.

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The Maastricht deficit

4.10 The general government financial deficit, which excludes the deficit or surplus of public corporations, is expected to be below the 3 per cent Maastricht reference level both for 1997-98 and the calendar year 1997. The calendar year forecast is a deficit of 2 per cent of GDP.

The PSBR

4.11 The PSBR has tended to be lower than the financial deficit for many years. This is mainly because of privatisation proceeds, which reduce the need for the public sector to borrow (and hence the PSBR) but do not change the public sector's net indebtedness (or financial deficit). The PSBR is projected to move in line with the financial deficit from 1998-99, when privatisation proceeds are assumed to be zero.

The windfall tax

4.12 In the short term, borrowing is reduced by the windfall tax, which is estimated to yield £2.6 billion both in 1997-98 and 1998-99, while the associated spending itfinances amounts only to some £0.2billion in 1997-98, rising to £1.2billion in 1998-99. However, the net (direct) effect on borrowing unwinds over the medium term, and the line in Table 4.1 which adjusts the PSBR for windfall tax receipts and associated spending represents a better estimate of the trend in borrowing.

4.13 Table 4.2 gives an alternative presentation of the PSBR in terms of general government expenditure and cash receipts and public corporations' borrowing. Adetailedpresentation of the forecasts for government expenditure and receipts is provided later in this chapter.

Table 4.2 Public sector borrowing requirement

	Outturn	Forecast	
	1996-97	1997-98	1998-99
£ billion			
General government expenditure	309.0	319.4	331.3
General government receipts(1)	286.3	308.3	327.2
General government borrowing requirement	22.7	11.1	4.1
PCMOB(2)	0.1	-0.2	-0.2
PSBR			
- £ billion	**22.7**	***10.9***	***4.0***
PSBR excluding windfall tax(3)	*22.7*	*13.3*	*5.4*
- per cent of GDP	*3*	*1 3/4*	*3/4*

1 On a cash basis.

2 Public corporations' market and overseas borrowing.

3 PSBR excluding windfall tax receipts and associated spending.

Public sector debt

4.14 Table 4.3 sets out projections for two measures of public sector debt. Net debt is approximately the stock counterpart of the PSBR, while gross general government debt is the Maastricht measure. (Definitions are given in Annex B.)

Table 4.3 Public sector debt(1)

	Outturn		Forecast
	1996-97	1997-98	1998-99
Net public sector debt			
£ billion(2)	350	363	368
per cent of GDP(3)	45	44 1/4	43
Gross general government debt			
£ billion(2)	408	418	426
per cent of GDP(4)	54 3/4	53	51 1/2

1 At end-March.

2 Rounded to the nearest £1billion.

3 GDP centred on end-March.

4 Ratios on a Maastricht-basis. GDP is on an ESA basis, year ending in March.

4.15 The debt burden has been rising steeply over the past five years. Between 1990-91 and 1996-97, net public sector debt rose from 27 to 45 per cent of GDP and gross general government debt rose from 34 to 55 per cent of GDP. The debt burden is projected to start falling from this year as government borrowing declines substantially. The gross debt ratio peaks comfortably below the Maastricht reference level of 60 per cent.

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4.16 The public sector's assets have fallen over the 1990s, reflecting privatisation and low levels of public investment. (The quality of the figures for public sector capital assets is poor in terms of both coverage and reliability, however, and the estimates may be significantly revised when the audited information on departmental assets becomes available from resource accounting.) With debt rising as well, the public sector's net wealth has fallen very steeply, from around 70 per cent of GDP during the 1980s to an estimated 10 per cent of GDP at end-1996. Annual movements in net wealth are very difficult to predict as they are affected by fluctuations in the market value of government securities, property values and the sterling value of foreign exchange reserves. However, the projected small current surplus in 1998-99 would be consistent with a levelling off in the net wealth ratio.

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General government receipts

4.17 Table 4.4 shows the outturn for 1996-97 and forecasts for 1997-98 and 1998-99 for general government receipts and its principal components. A more detailed breakdown for 1997-98 is shown in Table4A.1.

Table 4.4 General government receipts

		£ billion	
	Outturn		Forecast
	1996-97	1997-98	1998-99
Income tax	69.5	76.5	83.7
Corporation tax	27.7	30.1	32.0
Windfall tax		2.6	2.6
Value added tax	46.7	50.0	52.5

Excise duties(1)	30.6	33.4	35.4
Other taxes and royalties(2)	49.7	50.9	53.8
Social security contributions	47.4	49.5	52.0
Other receipts	14.8	15.3	15.2
General government receipts	**286.3**	**308.3**	**327.2**

1 Fuel, alcohol and tobacco duties.

2 Includes council tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.

The Budget tax measures

4.18 The Budget tax measures are set out in detail in Chapter2. (All estimates are on an indexed basis.) The windfall tax on privatised utilities is estimated to yield £2.6billion both in 1997-98 and 1998-99. The package of measures affecting companies and their shareholders is estimated to yield about £2.3billion both in 1997-98 and 1998-99. In 1998-99 the reduction in the VAT rate on domestic fuel and power is estimated to cost £485million (offset by a range of other tax measures), while the reduction in the rate of mortgage interest relief raises £950 million. Together with the other, smaller measures, the total net yield from the Budget tax measures is estimated to be about £6.0billion in 1997-98 and £6.7billion in 1998-99.

General government receipts

4.19 After allowing for the Budget measures, general government receipts (GGR) are expected to grow by 7 3/4 per cent in 1997-98. This is higher than the forecast increase in money GDP, and the ratio of receipts to GDP is expected to rise by over 1/2 percentage point. If the effects of the Budget measures were excluded, the GGR ratio would decline slightly in 1997-98, in part reflecting an expected temporary increase in government pension payments (which score as negative other receipts). GGR is forecast to grow by 6 1/4 per cent in 1998-99, compared with forecast growth of money GDP of 5 per cent.

Table 4.5 General government receipts as a percent of GDP

	Outturn	Forecast	
	1996-97	1997-98	1998-99
Income tax	9.2	9.6	10.0
Corporation tax	3.7	3.8	3.8
Windfall tax		0.3	0.3
Value added tax	6.2	6.3	6.3
Excise duties(1)	4.1	4.2	4.2
Other taxes and royalties(1)	6.6	6.4	6.4
Social security contributions	6.3	6.2	6.2
Other receipts	2.0	1.9	1.8
General government receipts	**38.1**	**38.7**	**39.0**
Total taxes and social security contributions(2)	35.8	36.9	37.4

1 For definitions see footnotes to Table 4.4.

2 On a national accounts (accruals) basis.

The tax burden

4.20 The tax burden - total accruals of taxes and social security contributions asa percentage of GDP - is forecast to increase by over 1 percentage point in 1997-98, of which the Budget tax measures account for about 3/4 percentage point. Normally,with unchanged tax policies, the tax burden is expected to increase by over 1/4 percentage point per annum, reflecting the effects of real fiscal drag and theannual real increases in fuel and tobacco duties.

4.21 The tax burden is forecast to increase by a further 1/2 percentage point in 1998-99. The Budget measures account for only a small part of this increase. The relatively strong growth of tax accruals in 1998-99 partly reflects the direct effects of the "Spend to Save" measures announced in the last Budget.

4.22 There has been a minor change to the definition of the tax burden since the last Red Book. Payments to the National Lottery Distribution Fund by Camelot had been previously scored as non-tax receipts. Reflecting their treatment in the national accounts, these payments will henceforth score as a tax on expenditure. This raises the level of the tax burden by about 1/4 percentage point from 1995-96 onwards. There is no effect on GGR.

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(1) *Audit of Assumptions for the July 1997 Budget Projections, Cm 3693*. Back

Annex A to Chapter 4: Further analyses of the public finances

4A.1 This annex contains a number of further analyses of the outturn for the public finances in 1996-97 and the forecast for 1997-98. There are also two tables setting out a historical series for different measures of the budget deficit, government expenditure and receipts.

4A.2 The following analyses are included:

(i) General government receipts - further tax by tax details (Table 4A.1);

(ii) Central government transactions on a cash basis - forecast for 1997-98 (Table4A.2);

(iii) Economic category analyses of local authority and public corporations transactions (Tables 4A.3 and 4A.4)

(iv) A full analysis of receipts and expenditure by economic category (Table 4A.5);

(v) Historical series for different measures of the budget deficit, government expenditure and receipts (Tables 4A.6 and 4A.7).

Table 4A.1 General government receipts(1)

	£ billion		
	1996-97	1997-98	
	Outturn	Last Budget Forecast	Latest Forecast
Inland Revenue			
Income tax	69.5	71.8	76.5
Corporation tax(2)	27.7	27.2	30.1
Windfall tax			2.6
Petroleum revenue tax	1.7	1.6	1.3
Capital gains tax	1.1	1.1	1.3
Inheritance tax	1.6	1.6	1.6
Stamp duties	2.4	2.7	3.3
Total Inland Revenue	**104.0**	**106.0**	**116.7**
Customs and Excise			
Value added tax	46.7	50.7	50.0
Fuel duties	16.9	19.6	19.2
Tobacco duties	8.0	8.4	8.5
Spirits duties	1.6	1.8	1.5
Wine duties	1.3	1.3	1.4
Beer and cider duties	2.8	3.0	2.9
Betting and gaming duties	1.4	1.6	1.5
Air passenger duty(3)	0.4	0.8	0.5
Insurance premium tax(3)	0.7	1.2	1.1
Landfill tax	0.1	0.4	0.4
Customs duties and levies	2.3	2.4	2.1
Total Customs and Excise	**82.1**	**91.2**	**89.2**

Vehicle excise duties	4.2	4.5	4.4
Oil royalties	0.7	0.6	0.6
Business rates(4)	15.3	14.6	14.5
Social security contributions	47.4	49.1	49.5
Council Tax	10.1	10.6	10.6
Other taxes and royalties	7.8	7.2	7.5
Total taxes and social security contributions	**271.5**	**283.8**	**293.0**
Interest and dividends	4.7	5.1	5.0
Gross trading surpluses and rent	5.0	4.9	4.9
Other receipts(5)	5.1	5.5	5.4
General government receipts	**286.3**	**299.4**	**308.3**
North Sea revenues(6)	3.5	4.1	4.0
(1) *On a cash basis. See Annex B.*			
(2) *Includes advance corporation tax (net of repayments):*	11.8	11.8	11.8
Also includes North Sea corporation tax and corporation tax on gains.			

3 Forecasts as published in the last Red Book. Errors to forecasts for APD and IPT in 1997-98 were corrected in a written parliamentary question (Hansard 16 January, column 380).

4 Includes district council rates in Northern Ireland.

5 Includes accruals adjustments for index-linked gilts.

6 North Sea corporation tax (before ACT set-off), petroleum revenue tax and royalties.

The tax burden

4A.3 There has been a minor change in the definition of the tax burden since the last Red Book. Payments to the National Lottery Distribution Fund by Camelot have been previously scored as non-tax receipts, but following a change to the ONS' treatment of these payments, they now score within the tax burden. This partly accounts for the upward revision to the tax burden in 1996-97 compared with the November 1996 FSBR forecast. This change in definition has little impact on the annual change in the tax burden in 1997-98, but it does raise the level of the tax burden by about 1/4 percentage point from 1995-96 onwards. There is no effect on total general government revenue.

Central government transactions on a cash basis

4A.4 The monthly outturns for central government borrowing are measured from the cash flows into and out of central government's funds and accounts, after consolidation. Table 4A.2 sets out the 1996-97 outturn and 1997-98 forecasts for central government borrowing in terms of this cash flow presentation.

Table 4A.2 Central government transactions on a cash receipts and outlays basis

	£ billion		
	1996-97	1997-98	
	Outturn	Last Budget Forecast	Latest Forecast
Receipts			
Inland Revenue(1)	104.0	106.0	116.7
Customs and Excise(1)	82.4	91.5	89.4
Social security contribution (GB)	45.1	47.5	47.8

Interest and dividends	8.3	8.5	8.2
Other	21.4	20.7	20.1
Total receipts	**261.1**	**274.3**	**282.3**
Outlays			
Interest payments	26.6	27.7	27.0
Privatisation proceeds	-4.4	-2.0	-2.0
Net department outlays	263.9	268.0	268.5(2)'
Total outlays	**286.1**	**293.8**	**293.5**(2)'
Net own account borrowing(3)	**24.9**	**19.5**	**11.2**(2)'
Net lending to local authorities and public corporations	0.1	0.4	1.2
Net borrowing	**25.1**	**20.0**	**12.4**(2)'

(1) *Payments to the Consolidated Fund*.

(2) *Assumes Reserve allocated to central government sector.*

(3) *Excludes net lending to local authorities and public corporations*.

Public finances by economic category

4A.5 Table 4A.5 shows a full analysis of receipts and expenditure by economic category with a breakdown between central government, local authorities and public corporations. Annex B explains the conventions used, which follow in most respects those in the UK national income and expenditure accounts.

4A.6 The table makes the assumption that the Reserve for 1997-98 is spent entirely on transactions that fall above the financial deficit line, although in practice allocations from the Reserve can also affect financial transactions.

4A.7 Tables 4A.3 and 4A.4 summarise the information on local authorities and public corporations transactions in Table 4A.5.

Table 4A.3 Local authority transactions

	£ billion	
	Outturn	Forecast
	1996-97	1997-98
Receipts		
Council Tax(1)	10.3	10.8
Current grants from central government	59.2	58.8
Other receipts(2)	7.9	8.1
Capital grants from central government	2.8	3.3
Total receipts	**80.1**	**80.9**
Expenditure		
Current expenditure on goods and services	55.1	55.5
Current grants and subsidies	13.9	14.1
Interest payments	4.3	4.4
Capital expenditure before depreciation	6.4	6.7
Total expenditure	**79.6**	**80.7**(3)
Financial deficit	**-0.5**	**-0.2**
Net financial transactions	-0.3	-0.1

Net borrowing	**-0.9**	**-0.3**

1 Net of rebates and council tax benefit. Includes district council rates in Northern Ireland, shown in "Taxes on expenditure" in Table 4A.5 (line 2).

2 Includes interest receipts, rent and gross trading surplus.

3 Assumes no allocation from the Reserve.

Table 4A.4 Public corporations'transactions

		£ billion
	Outturn	Forecast
	1996-97	1997-98
Receipts		
Gross trading surplus (including subsidies)	3.3	3.6
Other current grants	1.3	1.4
Capital grants from general government	3.6	1.9
Total receipts	**8.2**	**6.9**
Expenditure		
Interest, dividends and taxes on income	2.6	2.7
Capital expenditure before depreciation	4.5	4.1
Total expenditure	**7.1**	**6.9**(1)
Financial deficit	**-1.1**	**0.0**
Net financial transactions	-0.2	0.0
Net borrowing	**-1.3**	**0.0**

1 Assumes no allocation from the Reserve.

Annex B to Chapter 4
Conventions used in presenting the public finances

4B.1 The FSBR presents the public finances in two main ways; on a cash basis and on a national accounts, or accruals, basis. This annex briefly describes the two approaches.

4B.2 The key expenditure and receipts aggregates, general government expenditure (GGE) and general government receipts (GGR), are concepts derived from national accounts definitions. But they can be disaggregated on both a national accounts basis and on a largely cash basis.

Cash basis

4B.3 The cash approach concentrates on the actual cash transactions between the public sector and the rest of the economy. It is particularly useful for analysing the components of the PSBR, which is itself largely a cash concept. A cash basis also corresponds closely to the way public expenditure is planned, controlled and accounted for at present.

Tables 4.2, 4.4, 4.5, 4.6 and 4A.1

4B.4 A summary presentation of the public finances on a cash basis is given in Table 4.2. Supporting disaggregation of general government expenditure is given in Table 4.6, while Tables 4.4, 4.5 and 4A.1 provide further breakdowns of general government receipts.

4B.5 As far as possible, the figures in these tables relate to actual cash flows. The estimates of taxes, for example, are for tax payments received during the year, rather than for liabilities incurred. There are, however, a number of items which are not on a cash basis:

- "social security contributions" are scored gross of amounts netted off by employers as reimbursement in respect of statutory sick pay and statutory maternity pay. These payments count as expenditure rather than negative receipts;
- VAT refunds are included in "other taxes and royalties" (Table 4.4, Table 4.5 and Table 4A.1);
- an imputed flow for capital consumption by general government is included in "other receipts" (Table 4.4, Table 4.5 and Table 4A.1).

These latter two flows have no impact on the PSBR as they also appear on the expenditure side of the account in "accounting adjustments". This line also includes various other adjustments needed to get back to the national accounts basis required for GGE.

4B.6 The final departure from a cash basis is the "central government debt interest" line of Table 4.6, which scores the capital uplift on index-linked gilts as interest at the time it accrues. Because the PSBR is on a cash basis, an offset is made in the form of an accruals adjustment to "other receipts" (Table 4A.1, Table 4.4, Table 4.5). This removes the accrued uplift scored and adds back any actual payments of uplift on redemptions.

Table 4A.2

4B.7 The other cash-based table is Table 4A.2, which shows the finances of central government. Unlike the earlier tables this is genuinely a cash presentation based on information from central government funds and accounts. The imputed flows for refunded VAT, social security contributions and capital consumption are all excluded, and the "interest payments" line takes account of actual payments of capital uplift on index-linked gilts, rather than the accrued uplift.

4B.8 Similar tables cannot be produced for local authorities or public corporations because the available cash data are not comprehensive. The finances of these sectors, shown in Tables 4A.3 and 4A.4, are presented on the national accounts basis described below.

National accounts basis

Table 4A.5

4B.9 Table 4A.5 gives a detailed national accounts presentation of the short-term forecasts for the public finances. Under the measurement conventions used in the national accounts:

- most transactions, including most taxes (although not corporation tax), are recorded on an accruals rather than a cash payment basis;
- transactions are grouped by economic category. So, for example, transfer payments are distinguished from expenditure on goods and services;
- the value of some transactions is imputed where no money changes hands (for example, non-trading capital consumption).

4B.10 The public sector financial deficit is the balance between expenditure and income in the combined current and capital accounts (line 30 of Table 4A.5). Unlike the PSBR, the financial deficit is not wholly a measure of cash transactions because certain items above line 30 are measured on an accruals basis. The appropriate accruals adjustments are made in lines 34 and 35. Certain other financial transactions, notably net lending and privatisation proceeds, are also excluded from the financial deficit, but included in the PSBR.

4B.11 As the national accounts distinguish between current and capital transactions, they provide the natural framework in which to identify the current balance and capital spending. The current and capital breakdown shown in Table 4A.5 differs from the usual national accounts conventions in two respects. First, capital taxes (line 3) are counted as current rather than capital receipts on the grounds that they are not strictly speaking capital transactions but affect the public sector's net wealth. And second, an estimate of depreciation is deducted from capital expenditure and added to current expenditure.

4B.12 GGE can be derived from the general government column of Table 4A.5 by taking current expenditure (line 20) plus capital expenditure (line 29) and adding:

- the Reserve (lines 19 and 28, all assumed to be general government);
- net lending to the private sector and abroad (line 31);
- cash expenditure on company securities (line 32);
- and net lending by central government to public corporations.

4B.13 GGE(X) excludes privatisation proceeds and lottery financed expenditure, and nets off interest and dividend receipts.

Tables 2.4 and 4.6

4B.14 The Control Totals shown in Tables 2.4 and 4.6 for 1997-98 and 1998-99 are as published in the FSBR last November. There have been a number of classification changes since then, with the overall effect of reducing the Control Total by about £30 million in each year. The most important change has been the inclusion of certain licence fee receipts within the Control Total (following a review begun in February 1997). The changes from previous plans shown in Table 2.4 adjust for these changes.

4B.15 GGR comprises general government current receipts (line 11) plus capital transfers (line 22), less:

- transactions concerning public sector pension schemes (line 33);
- accruals adjustments (lines 34 and 35);
- miscellaneous financial transactions (line 36).

Table 4.1

4B.16 A summary of the public sector column of Table 4A.5 provides the framework for Table 4.1. So, for example, receipts and current expenditure in these tables correspond to lines 11 and 20 of Table 4A.5. "Public sector net capital spending" represents the balance on the capital account: that is, total capital expenditure (line 29 of Table 4A.5) net of capital transfers (line 22). Table 4.2 also shows as a memorandum item the general government financial deficit, which appears as line 30 of the general government column of Table 4A.5. (See paragraph 4B.21)

4B.17 Table 4.1 shows the current balance in the same way as Table 4A.5. Tables 4A.3 and 4A.4 are also on a national accounts basis.

Table 4A.7

4B.18 An accruals basis is used to calculate taxes (and social security contributions and council tax) as a percent of GDP (Table 4A.7).

Tables 4A.3 and 4A.4

4B.19 Table 4A.5 shows local authorities' self-financed expenditure (net of their receipts from central government - line 17) and their receipts from outside the public sector (net of debt interest payments to central government - line 9). Table 4A.3, in contrast, provides figures for total local authority expenditure and receipts. It also gives a summary presentation of the income and expenditure flows in the local authority accounts, which it is not practical to put together from any other sources.

4B.20 Table 4A.4 serves the same purposes for public corporations as Table 4A.3 does for local authorities. Because public corporations are trading bodies, the national accounts presentation is a little different from that for general government. Most current expenditure is netted off from income to leave the gross trading surplus (shown under receipts). The expenditure side of the account only shows interest, dividend and tax payments, plus capital spending.

Financial deficit and current balance

4B.21 The public sector financial deficit (PSFD) represents the balance of expenditure less revenues on the consolidated current and capital accounts in the national accounts. Forecasts for the financial deficit are presented in Tables 4.1 and 4A.5 (line 30), and in Table 4A.6, which also shows historical outturns for this series.

4B.22 The general government financial deficit (GGFD), which excludes the financial deficit of public corporations, is the most internationally comparable measure of the budget deficit and that used in the excessive deficits criterion of the Maastricht Treaty. However, GGFD as measured in UK national accounts, differs slightly from the Maastricht measure in Table 4.1. The Maastricht measure scores the capital uplift on index-linked gilts at the time of the gilt's redemption (as in the PSBR), whereas the UK measure of GGFD scores the uplift payment on an accrued basis over the lifetime of the gilt.

4B.23 The current balance measures the balance of current account revenue over current expenditure. The measure of current balance presented in Tables 4.1 and 4A.5 (line 21) differs slightly from the national accounts concept in two respects: it includes taxes on capital in current receipts, and an estimate of depreciation in current expenditure.

Borrowing requirements

4B.24 The PSBR can be disaggregated into component borrowing requirements in different ways. Table 4.2 shows the PSBR as the sum of the general government borrowing requirement (GGBR) and market and overseas borrowing by public corporations (PCMOB). An alternative is to split it, Table 4A.5 (line 37), between central government borrowing on its own account (the CGBR(O)), and borrowing by local authorities and public corporations (the LABR and PCBR respectively). The borrowing requirement shown in the general government column of Table 4A.5 is not in fact the GGBR, but the GGBR(O). The GGBR can be calculated by adding in public corporations' borrowing from central government (given in paragraph 4B.12).

Public sector debt

4B.25 Table 4.3 sets out projections for two different measures of public sector debt. Net public sector debt is the stock analogue of the PSBR. It measures the public sector's financial liabilities to the private sector and abroad, net of short-term financial assets.

4B.26 General government gross debt is the measure of debt used in the European Union's excessive deficits procedure. As a general government measure, it excludes the debt of public corporations. It measures general government's total financial liabilities before netting off short-term financial assets.

Public sector net wealth

4B.27 Public sector net wealth represents the public sector's net balance sheet position. It is equal to the sum of the public sector's tangible and financial assets less its financial liabilities at market value. The estimates of tangible assets are however subject to wide margins of error, because they depend on broad assumptions, for example about asset lives, which may not be appropriate in all cases. The introduction of resource accounting for central government departments will lead to improvement in data quality as audited information compiled from detailed asset registers becomes available.

List of abbreviations

ACT	Advance Corporation Tax
AEF	Aggregate External Finance
BCC	British Chambers of Commerce
BEC	Building Employers' Confederation
Blue Book	UK national accounts
BNFL	British Nuclear Fuels Limited
BSE	Bovine Spongiform Encephalopathy
CAA	Civil Aviation Authority
CAP	Common Agricultural Policy
CBI	Confederation of British Industry
CGBR	Central Government Borrowing Requirement
CGBR(O)	Central Government Own Account Borrowing Requirement
CGT	Capital gains tax
CSR	Comprehensive Spending Review
DETR	Department of Environment, Transport and the Regions
DFEE	Department for Education and Employment
DFID	Department for International Development
DSS	Department of Social Security
DTI	Department of Trade and Industry
DVLA	Driver and Vehicle Licensing Agency
ECGD	Export Credits Guarantee Department
ECOFIN	Economic and Financial Council of Ministers, European Union
ECU	European Currency Unit
EEA	European Economic Area
EFL	External Financing Limit
ERI	Effective exchange rate index
EU	European Union
FCO	Foreign and Commonwealth Office
FE	Further Education
FSBR	Financial Statement and Budget Report
FT-SE	Financial Times All Share index
G3	Major three industrial countries comprising: US, Japan and Germany
G7	Major seven industrial countries comprising: Canada, France, Italy, Germany, Japan, UK and US
G10	Group of industrial countries comprising: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland UK and US
GDP	Gross Domestic Product
GGE	General Government Expenditure
GGE(X)	General Government Expenditure (excluding items described in Chapter4, Annex B)
GGR	General Government Receipts

GGBR	General Government Borrowing Requirement
GGBR(O)	General Government Own Account Borrowing Requirement
GGFD	General Government Financial Deficit
GGD	Gross General Government Debt
GM	Grant maintained
HGV	Heavy Goods Vehicle
ICCs	Industrial and commercial companies
IHT	Inheritance tax
IT	Information Technology
JSA	Job Seeker's Allowance
LABR	Local Authority Borrowing Requirement
LASFE	Local authority self-financed expenditure
LFS	Labour Force Survey
MIPs	Mortgage Interest Payments
MOD	Ministry of Defence
Money GDP	Gross Domestic Product at current market prices
MPC	Monetary Policy Committee
M0	Narrow measure of money stock
M4	Broad measure of money stock
NAR	National Asset Register
NHS	National Health Service
NICs	National insurance contributions
NPSD	Net Public Sector Debt
ODA	Overseas Development Administration (now DFID)
OECD	Organisation for Economic Cooperation and Development
ONS	Office for National Statistics
OPS	Office of Public Service
PCBR	Public Corporations Borrowing Requirement
PCMOB	Public Corporations' Market and Overseas Borrowing
PFI	Private Finance Initiative
PH	Property Holdings
PLG	Private/Light Goods Vehicle
PPP	Public/Private partnership
PSA	Property Services Agency
PSBR	Public Sector Borrowing Requirement
PSFD	Public Sector Financial Deficit
PSNW	Public Sector Net Worth
PWR	Pressurised Water Reactor
PX	Ministerial Committee on Public Expenditure
RPI	Retail Prices Index
SDR	Special Drawing Right
TSS	Total Standard Spending
VAT	Value added tax
VED	Vehicle excise duty

List of tables

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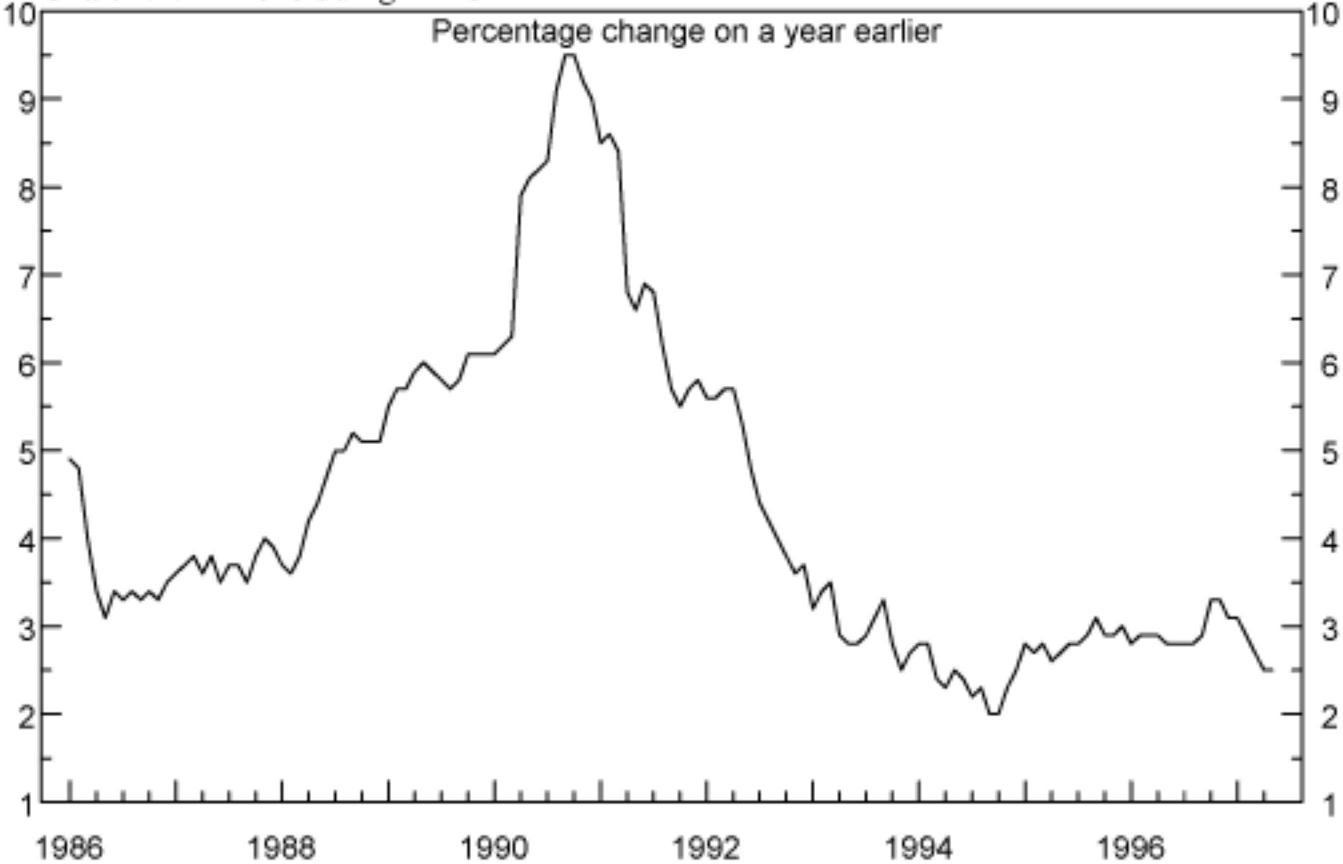
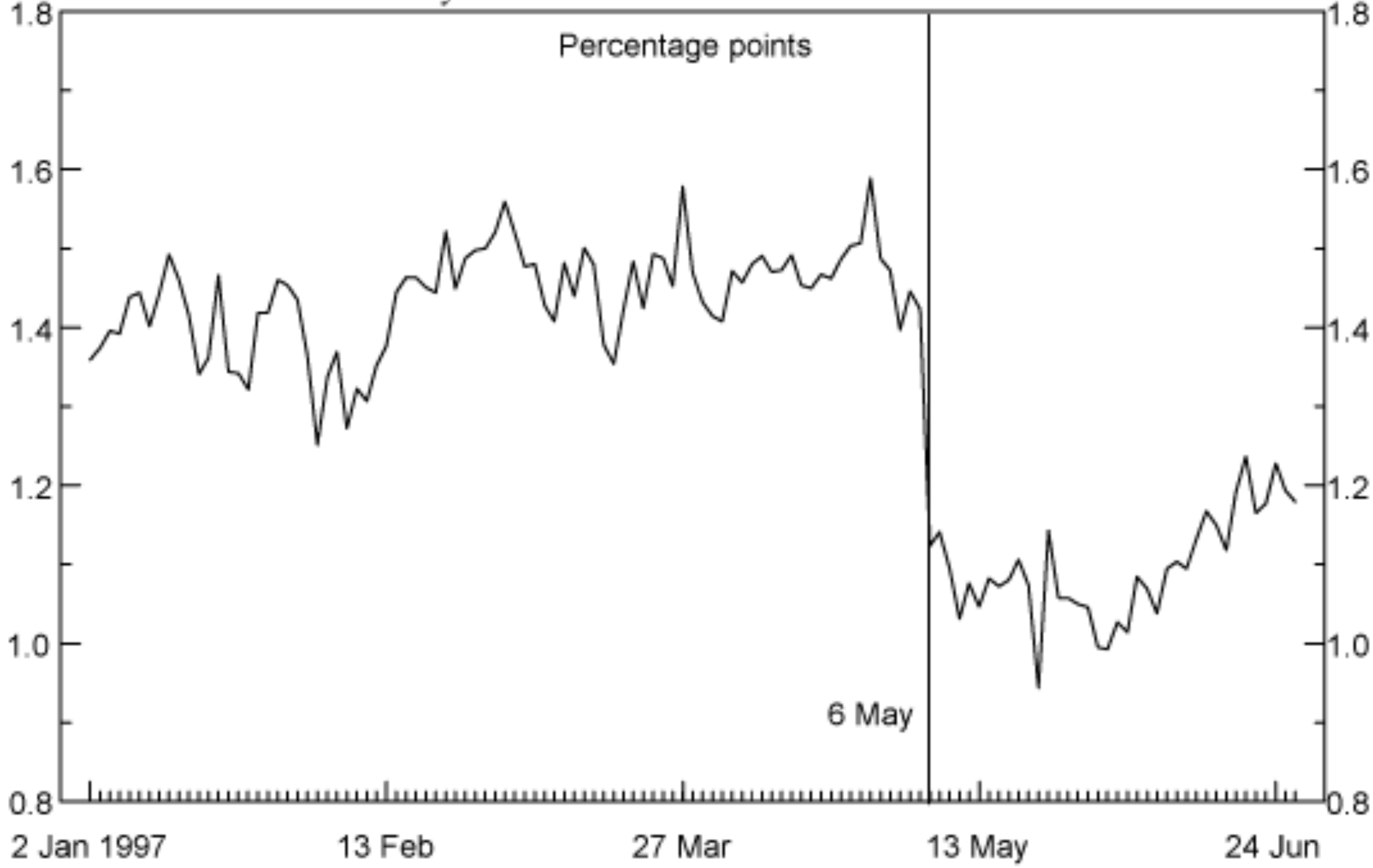
Chart 1.1: RPI excluding MIPs[1]

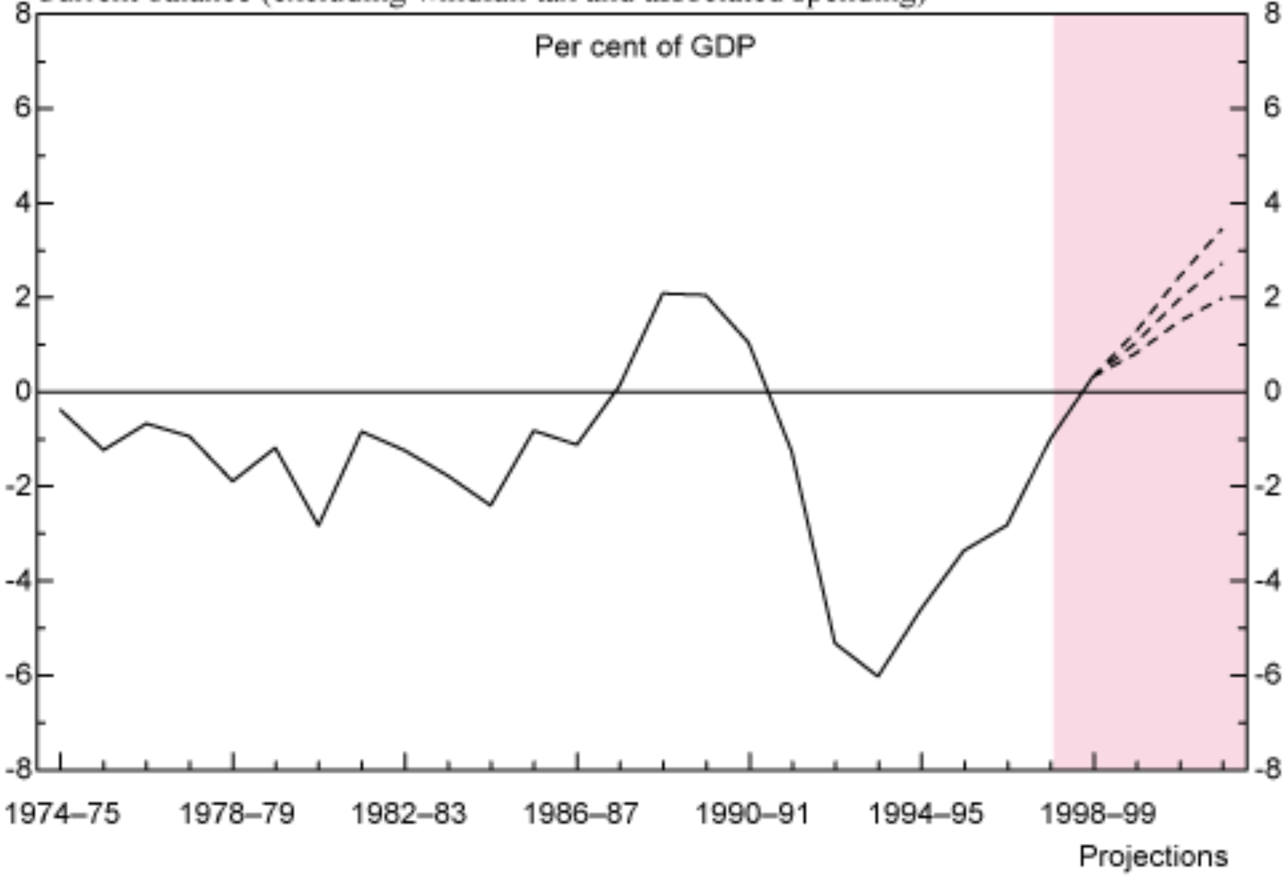


[1]Retail price index excluding mortgage interest payments.

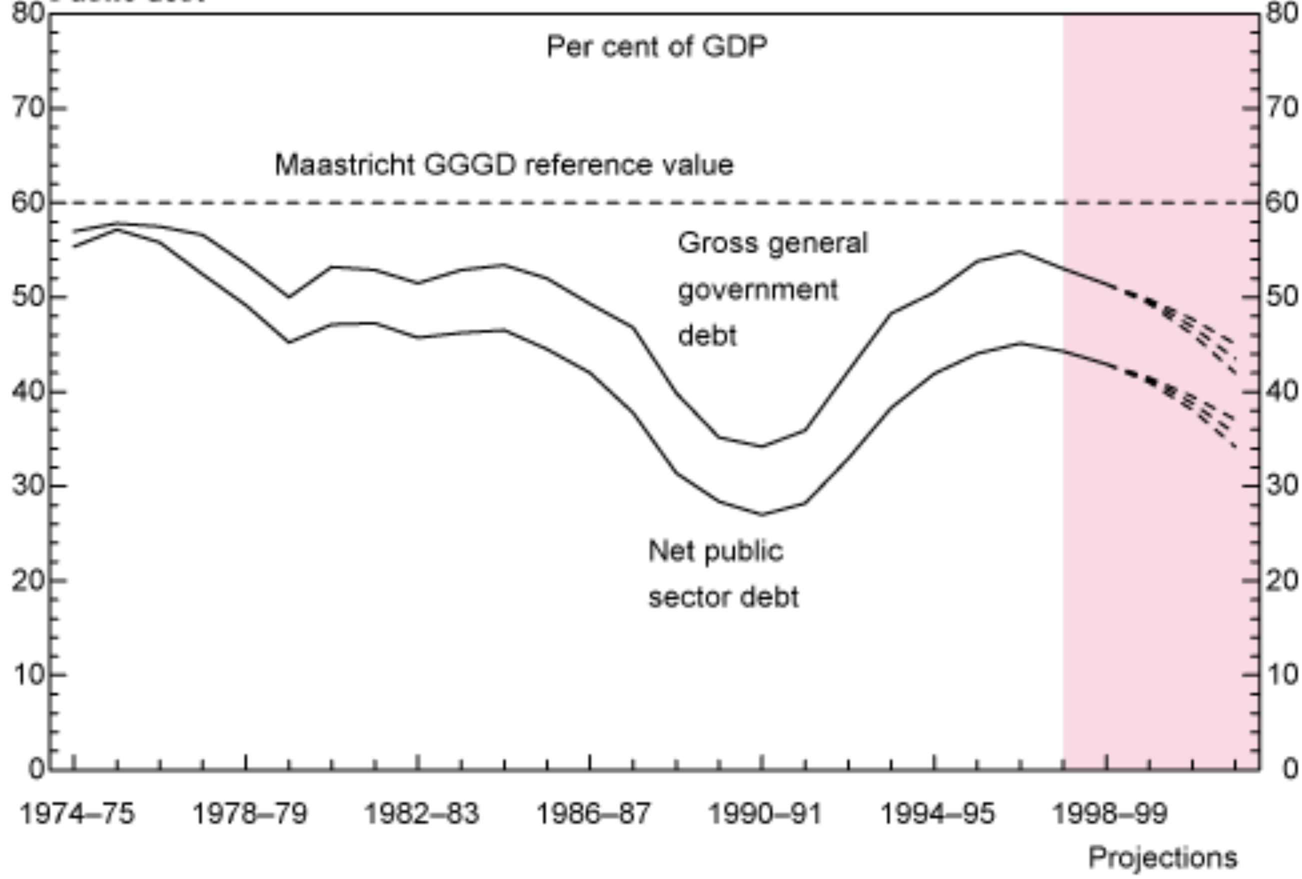
Chart 1.2: UK-German 10 year bond differential



Current balance (excluding windfall tax and associated spending)



Public debt



Per cent of GDP
Maastricht GGGD reference value
Gross general
government
debt
Net public
sector debt
80
70
60
50
40
30
20
10
0
1974–75
1978–79
1982–83
1986–87
1990–91
1994–95
1998–99
Projections

Public sector net wealth

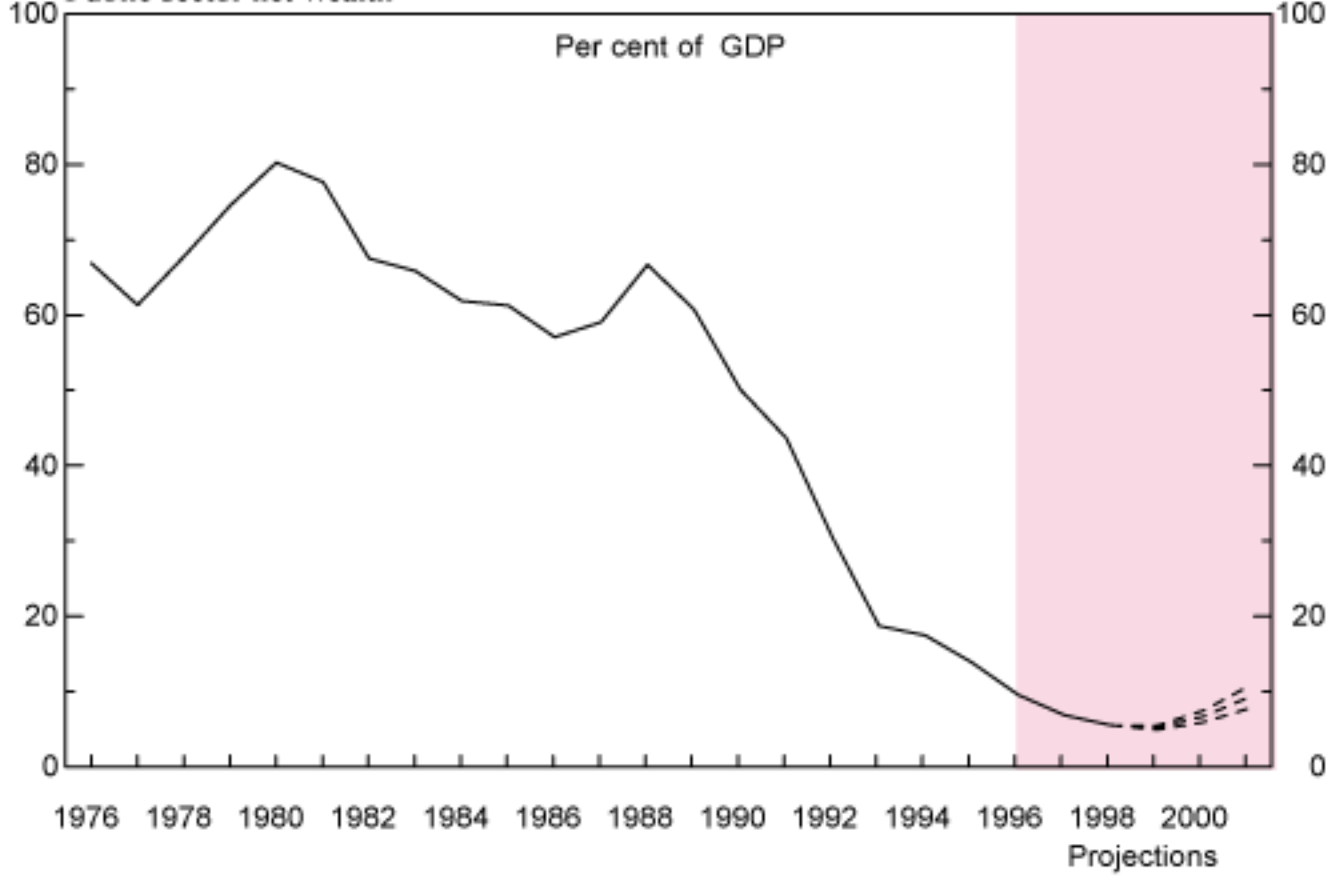
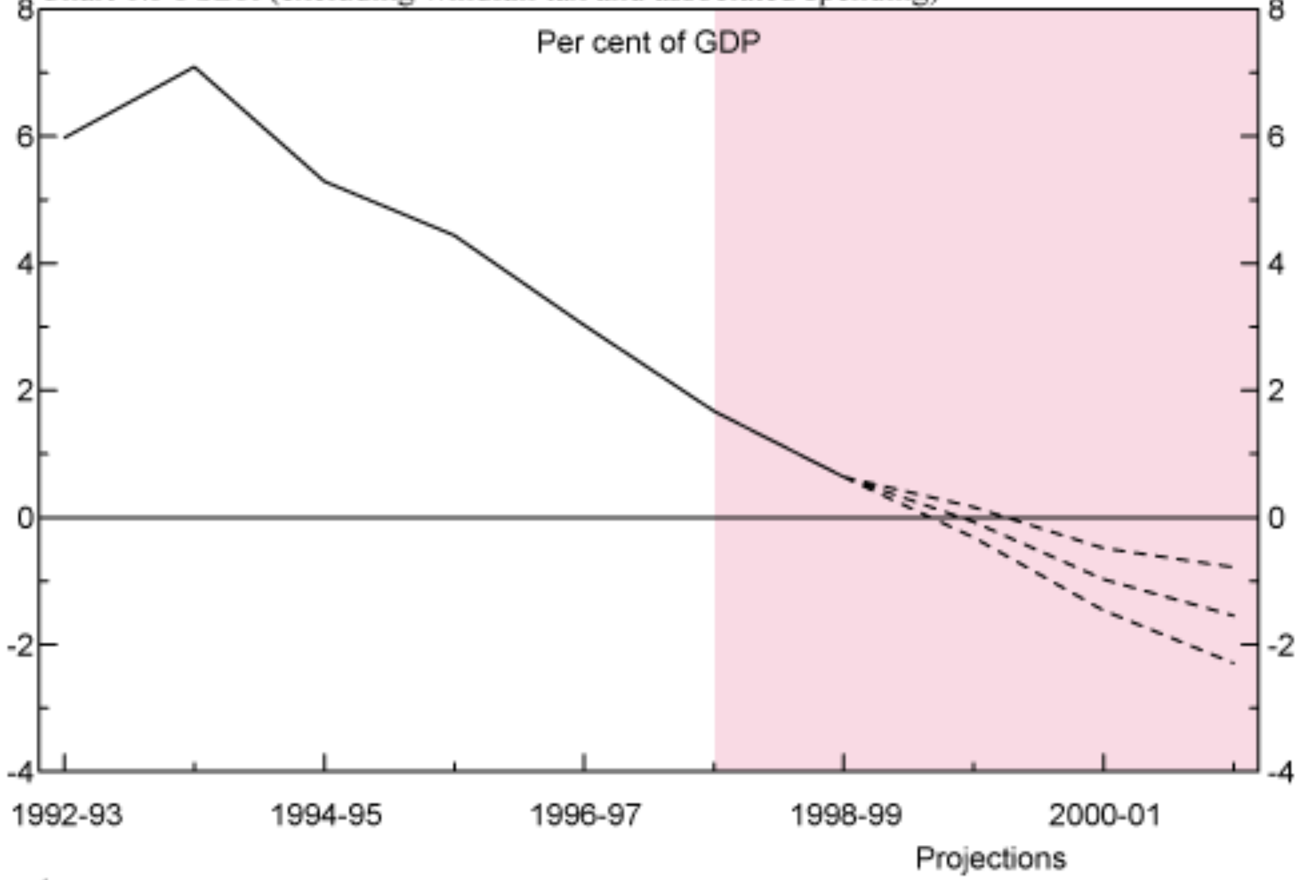
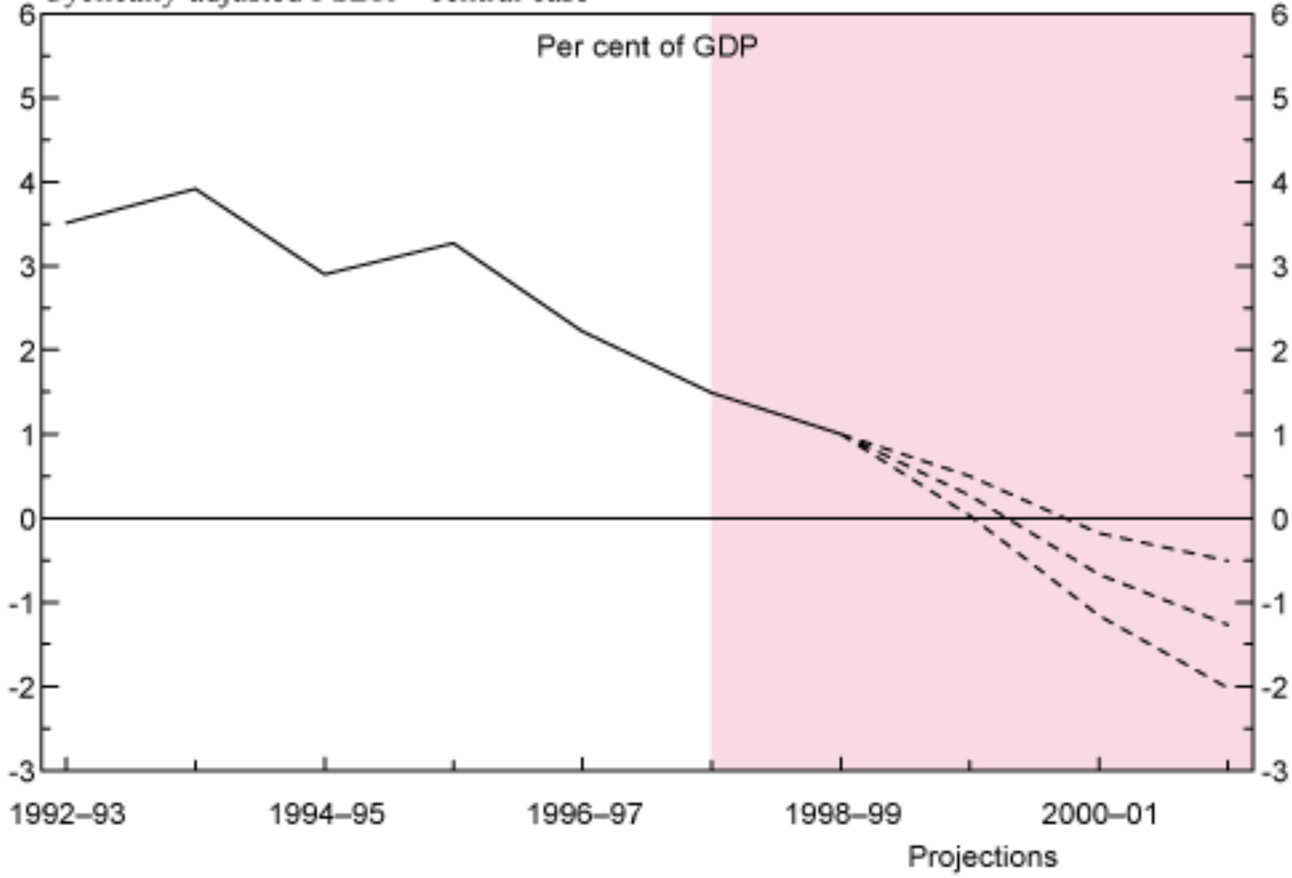


Chart 1.3 PSBR (excluding windfall tax and associated spending)[1]



[1]Variants after 1998–99 reflect different spending assumptions, see paragraph 1.25.

Cyclically-adjusted PSBR – central case



Cyclically-adjusted PSBR – cautious case

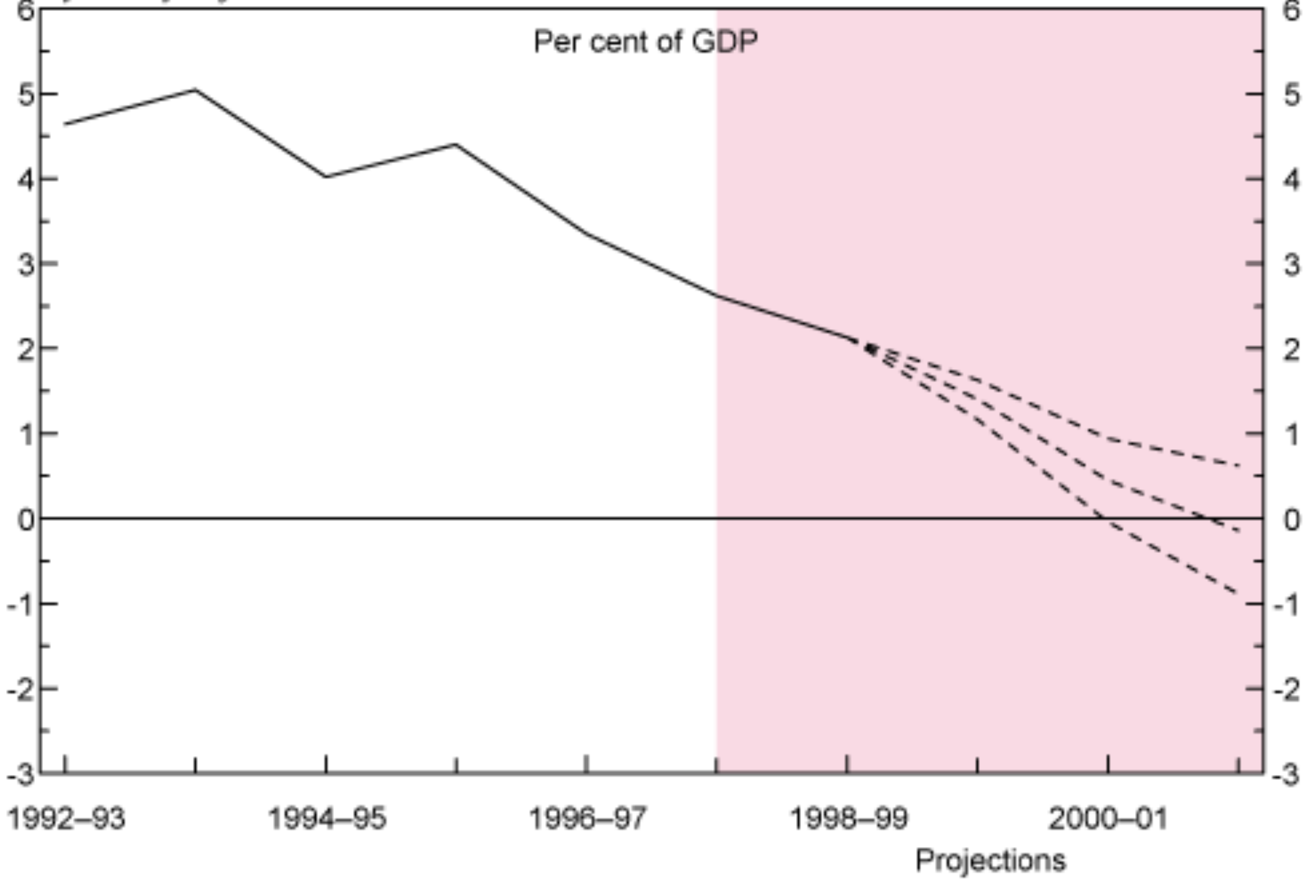


Chart 3.1: UK GDP

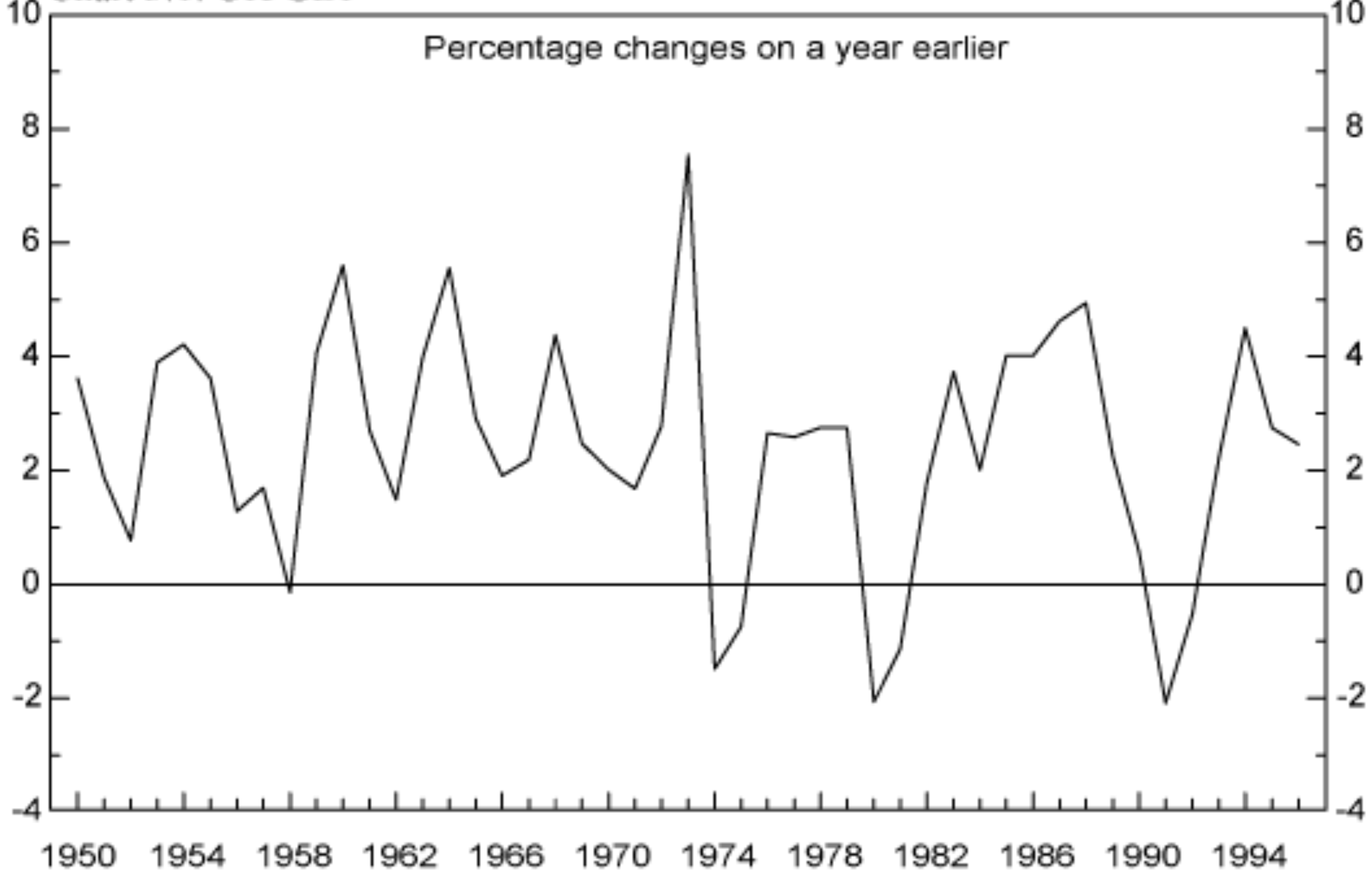
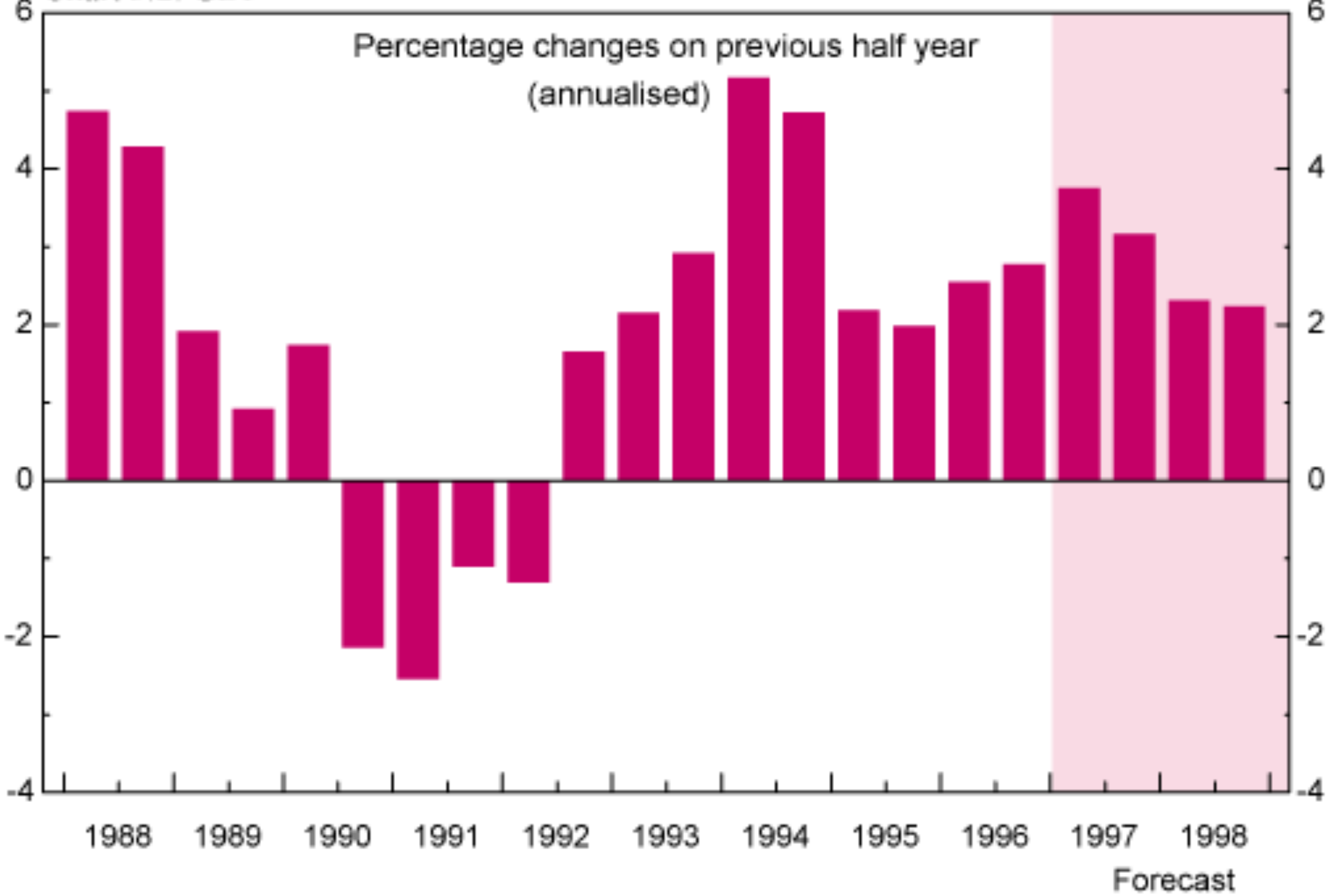
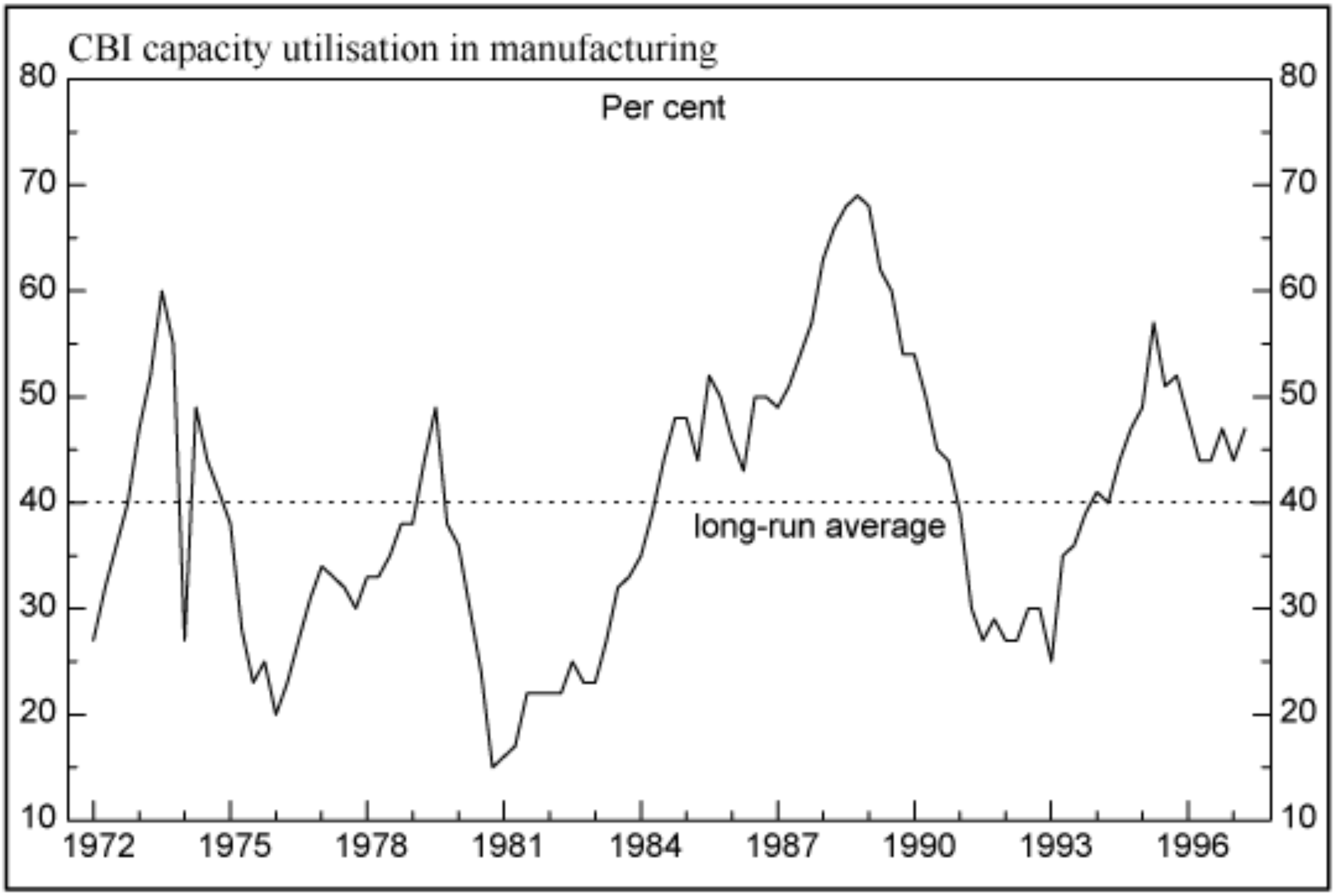
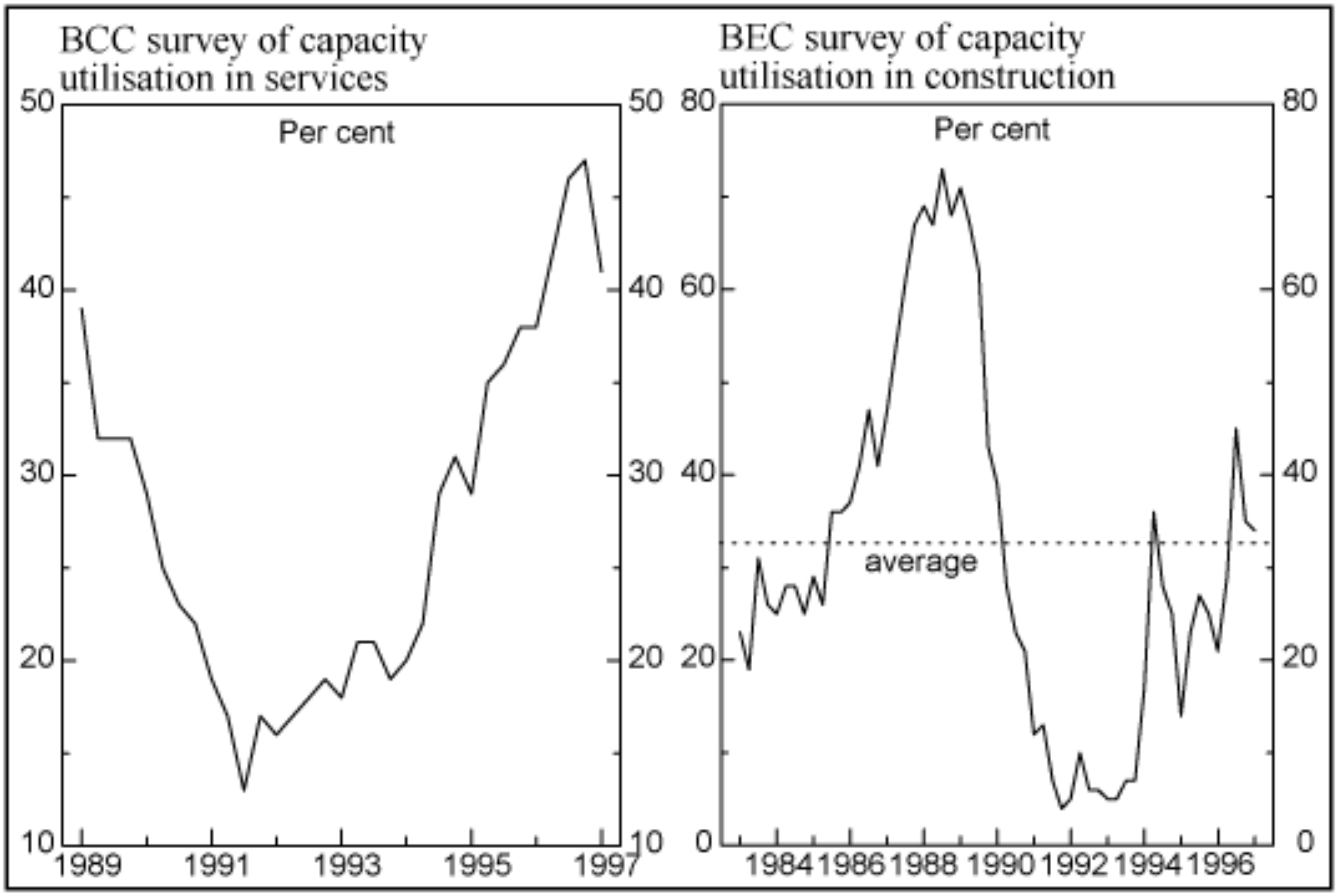


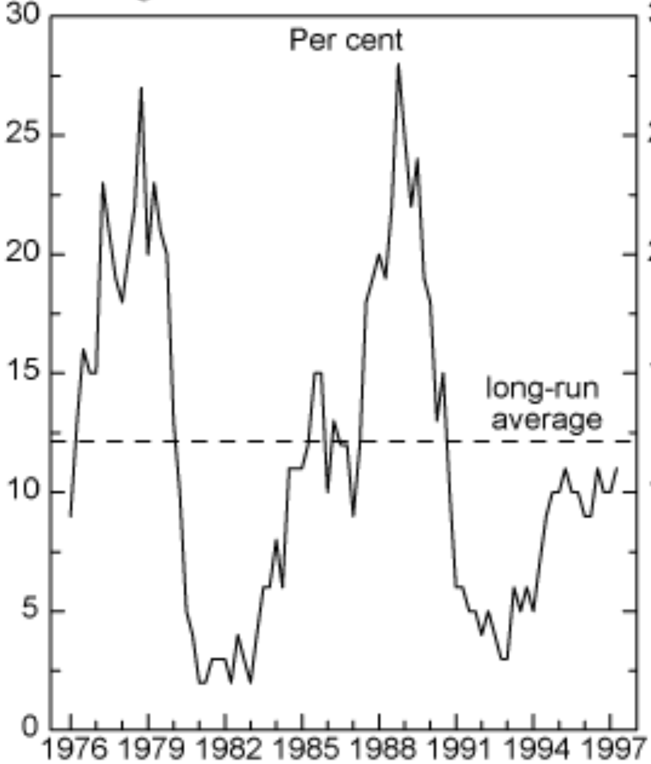
Chart 3.2: GDP


Percentage changes on previous half year
(annualised)
6
4
2
0
-2
-4
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
Forecast

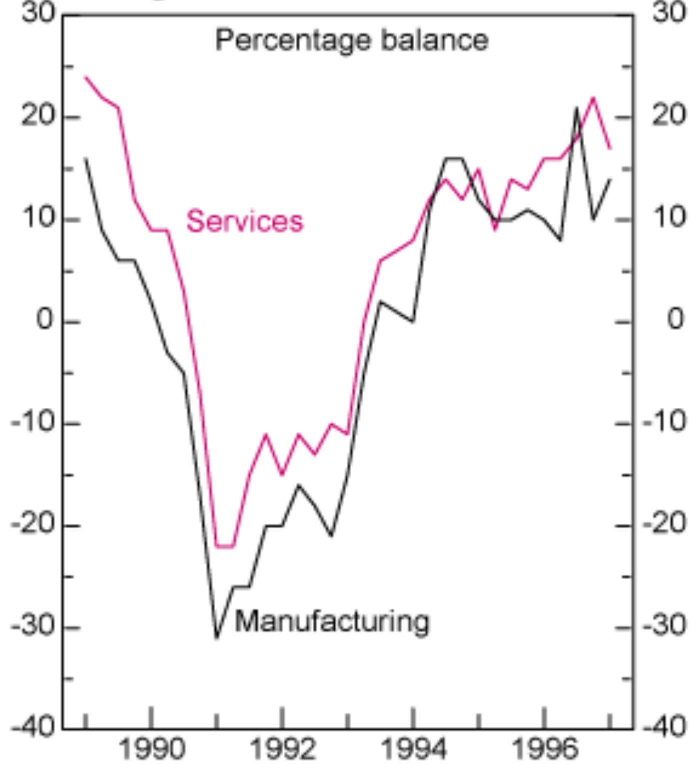

CBI capacity utilisation in manufacturing
Per cent
long-run average
80
70
60
50
40
30
20
10
1972
1975
1978
1981
1984
1987
1990
1993
1996

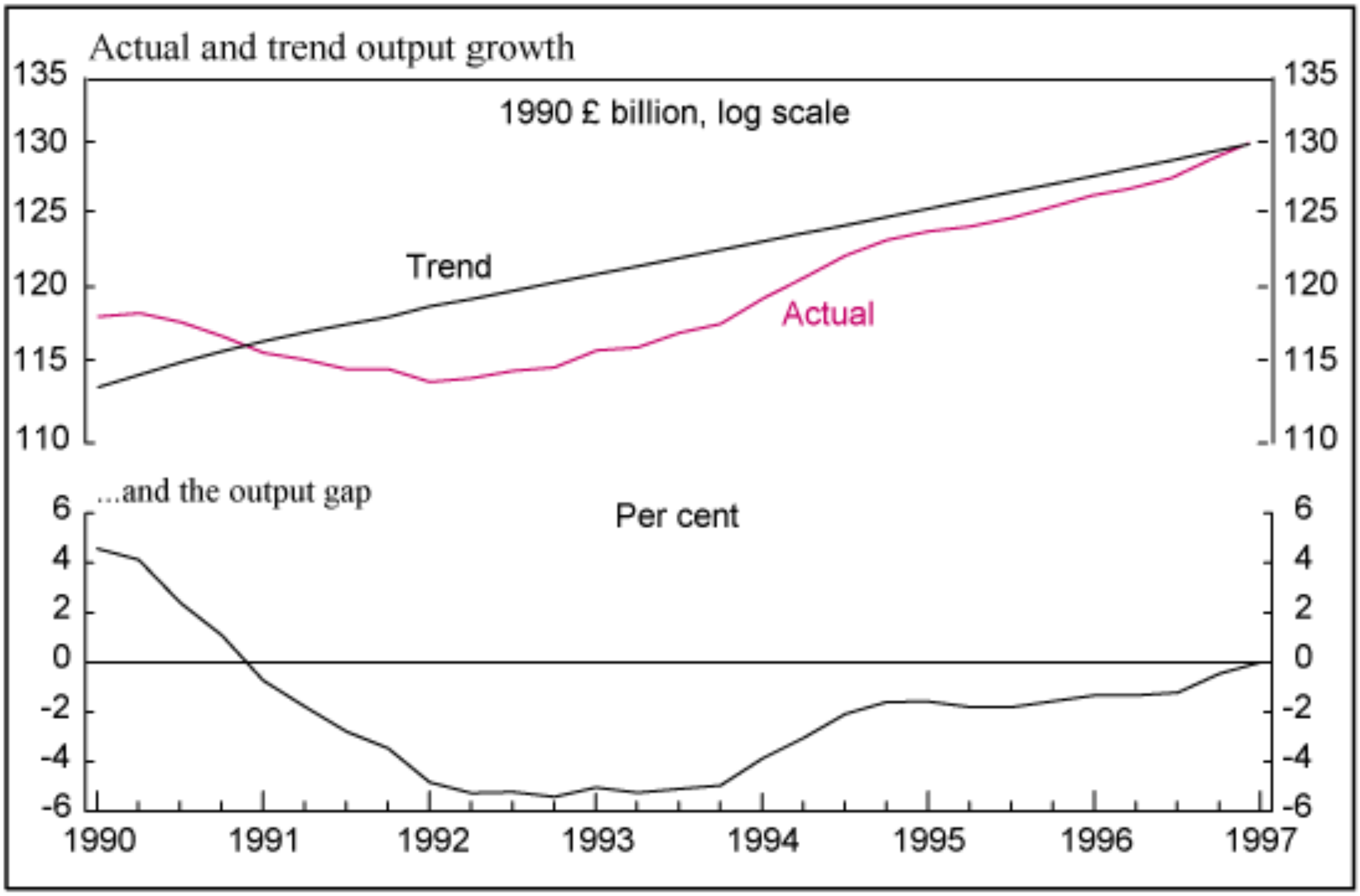

BCC survey of capacity utilisation in services
Per cent
50
40
30
20
10
1989
1991
1993
1995
1997
BEC survey of capacity utilisation in construction
Per cent
80
60
40
20
0
average
1984
1986
1988
1990
1992
1994
1996

CBI survey of skilled labour shortages



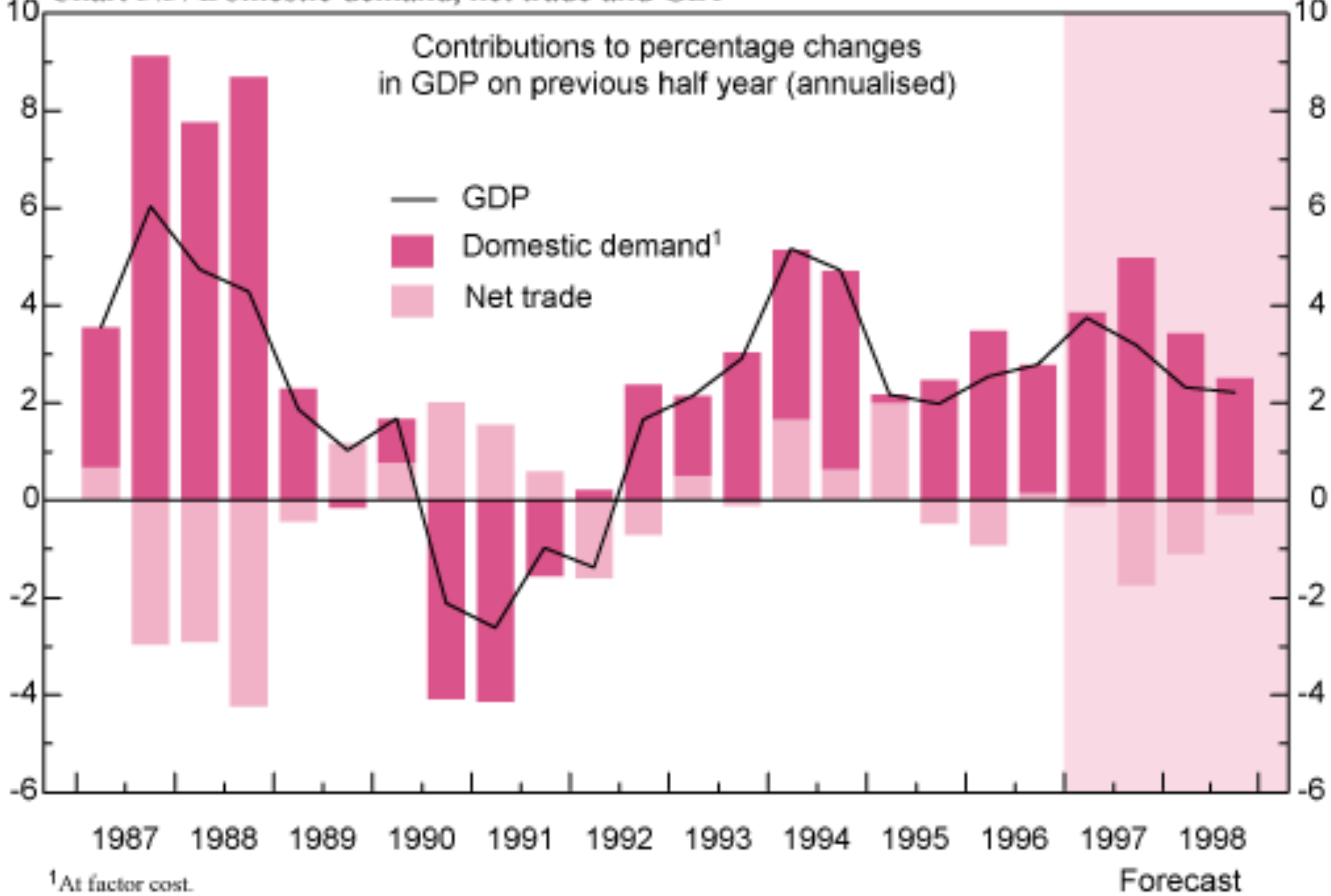
BCC survey of skilled labour shortages





Actual and trend output growth
1990 £ billion, log scale
Trend
Actual
135
130
125
120
115
110
...and the output gap
Per cent
6
4
2
0
-2
-4
-6
1990
1991
1992
1993
1994
1995
1996
1997

Chart 3.3: Domestic demand, net trade and GDP



[1]At factor cost.

Chart 3.4: Personal sector consumption, income and saving

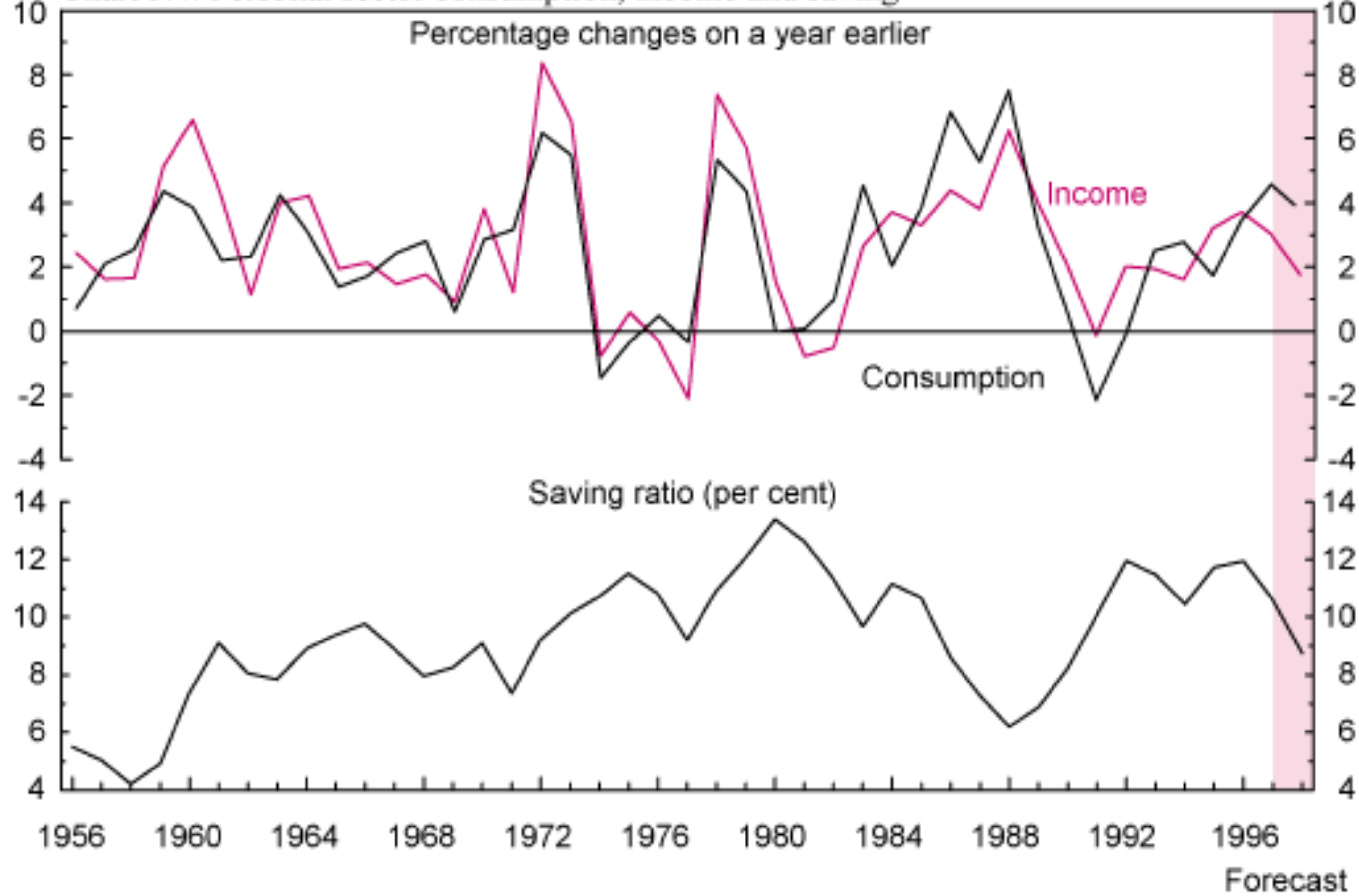


Chart 3.5: Personal sector wealth-income ratios

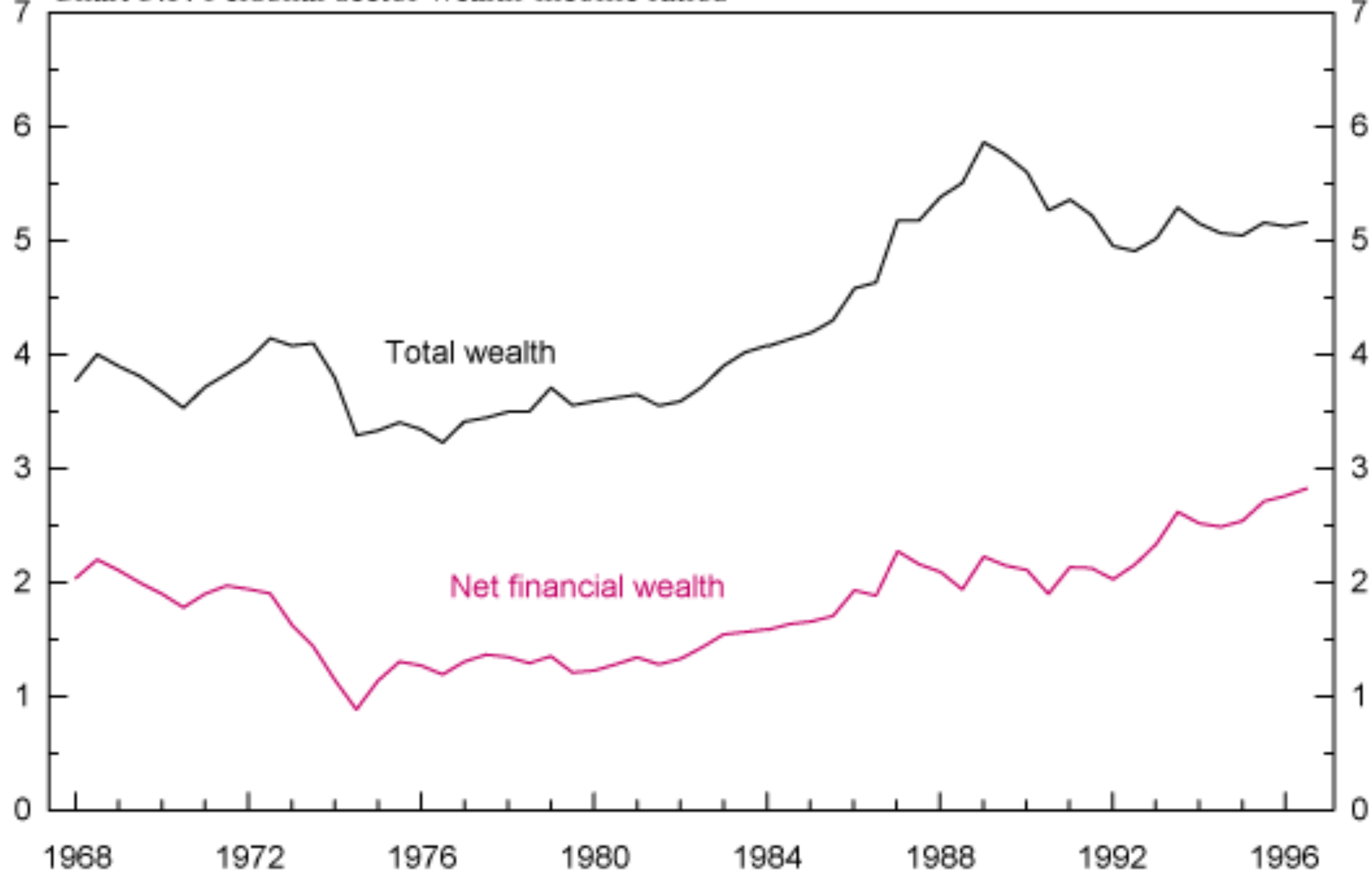
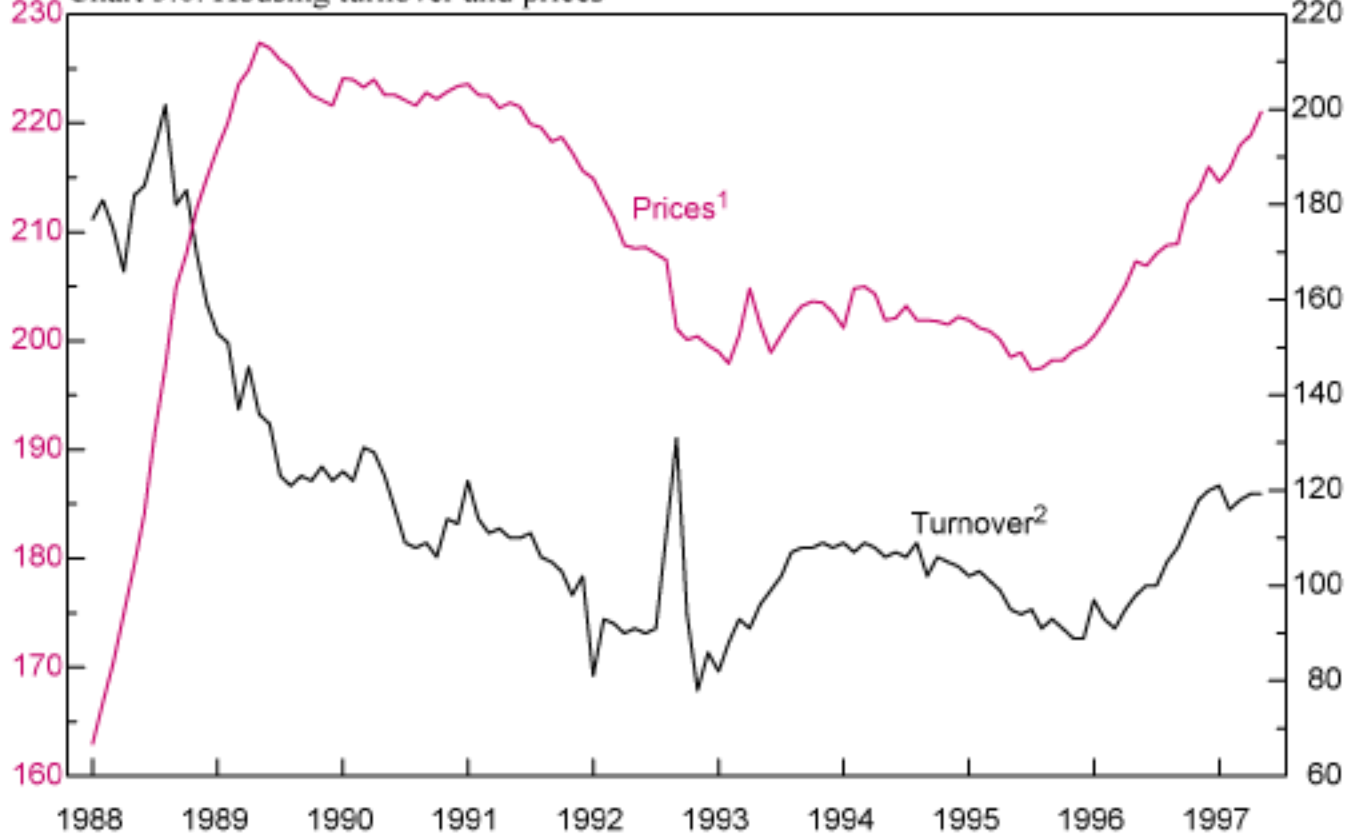


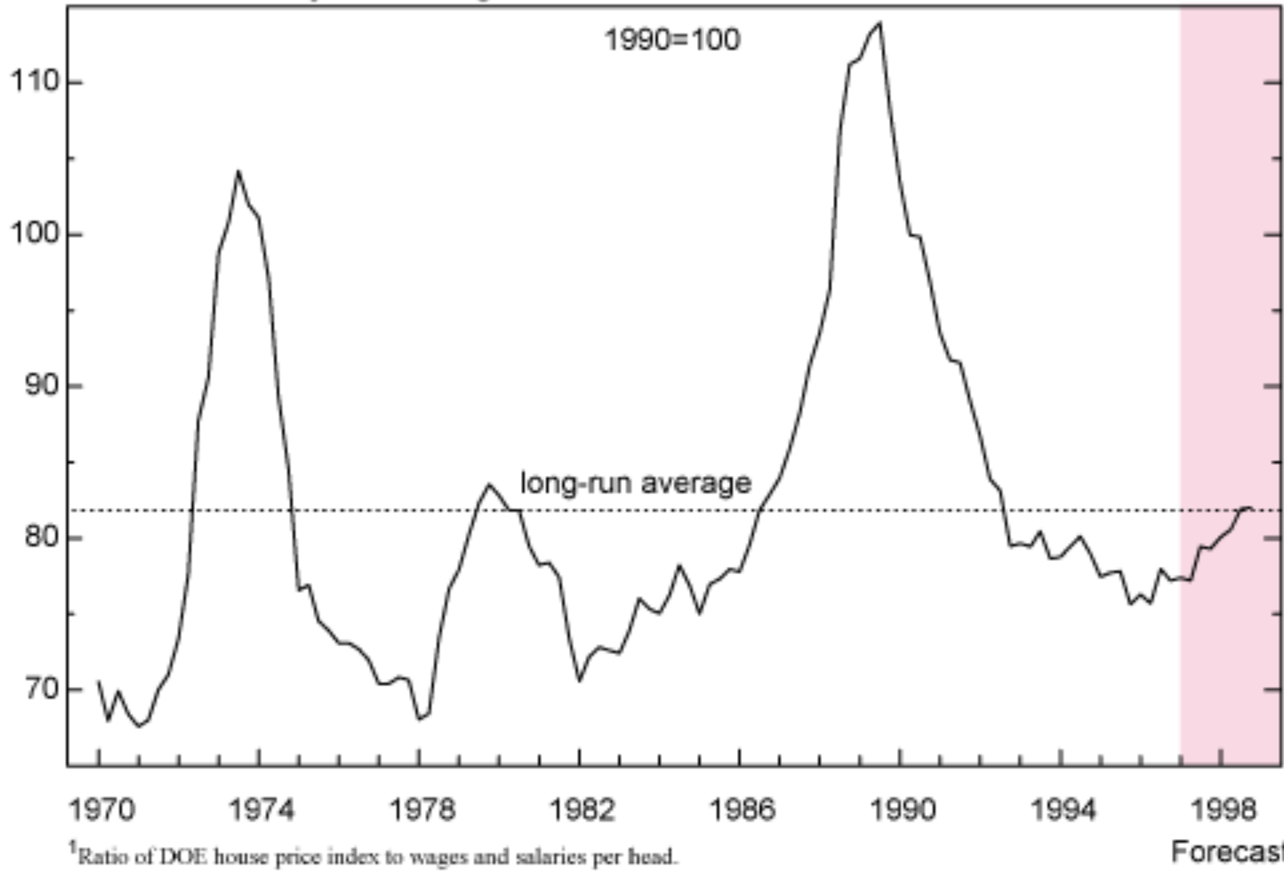
Chart 3.6: Housing turnover and prices



[1]Halifax index, 1983=100, left-hand scale.

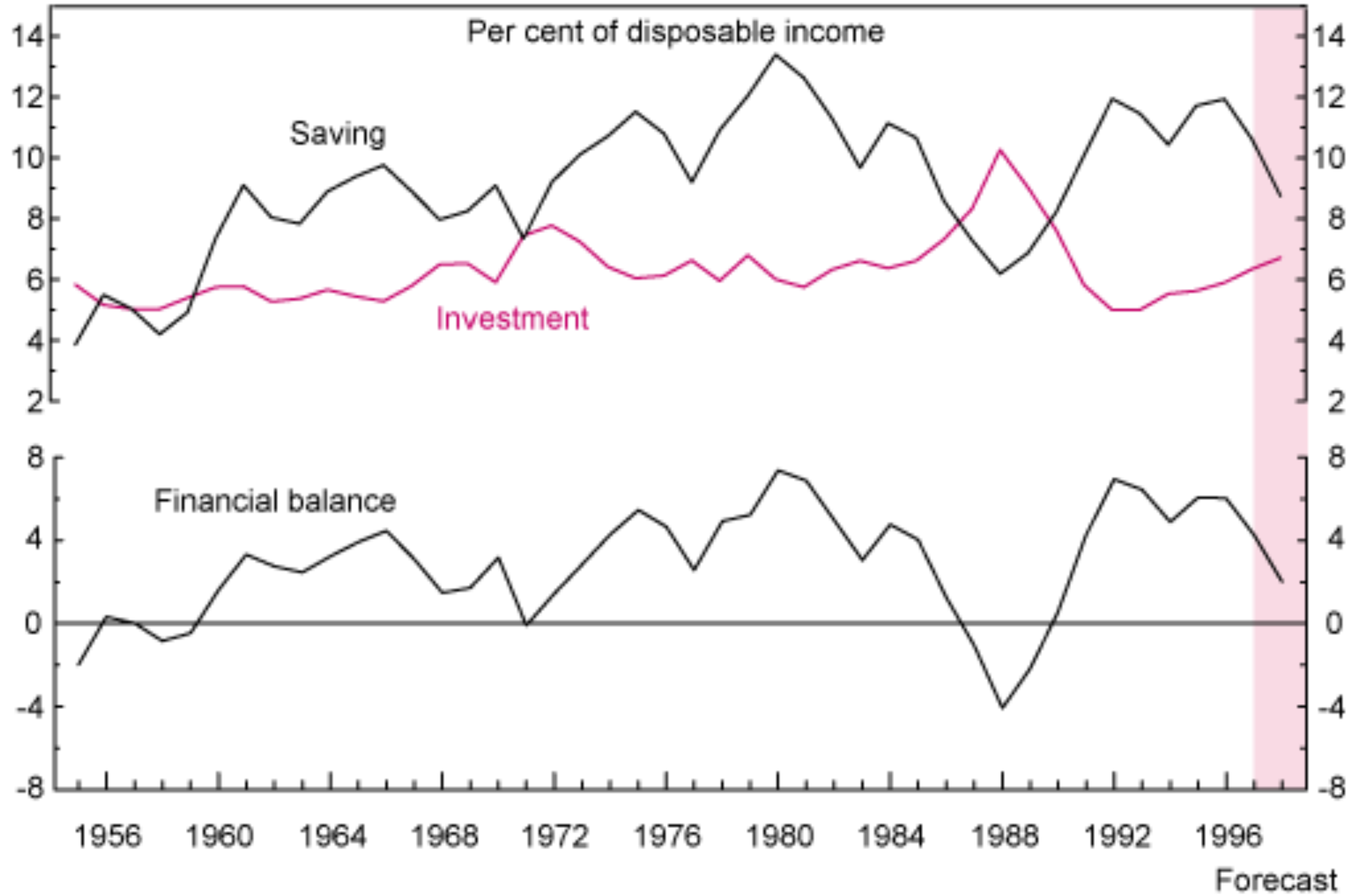
[2]Particulars delivered, thousands, right-hand scale.

Chart 3.7: House price-earnings ratio[1]



[1]Ratio of DOE house price index to wages and salaries per head.

Chart 3.8: Personal sector financial balance



Corporate sector and investment

Investment performance

3.36 The UK's relatively weak growth performance over the past 25 years partly reflects under-investment. The UK's ratio of investment to GDP is low by both historical and international standards.

3.37 The ratio of whole economy fixed investment to GDP has consistently been well below the OECD average since at least 1960, and the gap has been widening in recent years. Since 1960, the investment-GDP ratio for the OECD as a whole has averaged around 21 per cent, compared with a UK figure of 18 per cent. Between 1960 and 1994, the UK invested a lower share of GDP than any other OECD country. On the other hand, the UK's record on plant and machinery (and business) investment has not been so clearly out of line with other industrial countries. However, it seems unlikely that the UK can catch up, or at least narrow the gap, with its main competitors in terms of the level of GDP per head without a significant rise in the ratio of investment to GDP.

3.38 Whole economy saving has also been low relative to income by the standards of the rest of the industrialised world. The difference between domestic saving and investment is equivalent to the balance of payments current account balance. Despite international capital mobility, the current account has not tended to drift a long way from balance for protracted periods of time. In other words, there has been a fairly close association between domestic saving and investment over the cycle.

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3.39 The investment recovery over the past five years has been weak by historical standards. During the current economic upswing, the ratio of whole economy investment to GDP has fallen continuously, in contrast to the 1980s recovery, though this time round it has fallen from an historic high rather than rising from an historic low. In 1996, it was lower than for most of the past 30years. While output has increased by 15 1/4 per cent from its trough at the beginning of 1992, total investment has increased by only 10 1/4 per cent.

3.40 Sluggish whole economy investment mainly reflects falling general government investment. Business investment, which accounts for around 65 per cent of the total, has been stronger; but it has still grown at a slower pace than in the 1980s recovery. From the trough of output, total business investment has increased by 17 1/2 per cent compared to the increase in GDP of 15 1/4 per cent. (In contrast, while GDP increased by around 15 per cent in the first five years of the last upswing - between early 1981 and the end of 1985 - the increase in business investment was 23 1/2 per cent.)

3.41 Manufacturing investment has been relatively weak. It remains almost 13 per cent below its 1990 peak, and last year its ratio to GDP fell to the lowest level since at least 1955.

Profits

3.42 The profits of industrial and commercial companies (ICCs) rose by over 10 per cent last year. However, dividend payments also rose strongly - they were 13 1/2 per cent up on 1995 - and there was therefore only a small increase in ICCs' undistributed income. Nevertheless, the rate of return on investment remains high by historical standards, and while a balance of 20 per cent of manufacturers in the April CBI survey cited a lack of internal finance as a constraint on investment, this is no higher than the long-run average for the series.

Business investment

3.43 Manufacturing investment bottomed out at the end of 1993, and recovered strongly in 1994 and 1995 as activity strengthened and capacity utilisation increased. But it then fell again last year, by 5 1/2 per cent, despite business surveys consistently showing strong investment intentions. It appears that this fall partly reflected firms' uncertainty about the strength of demand. Over the past year, an increasing proportion of manufacturers in the CBI survey have been reporting uncertainty about demand as a factor likely to limit investment, and in recent years this has been a more significant constraint than in the 1980s recovery. Despite a sharp increase on the previous quarter, in the first quarter of 1997 manufacturing investment was 4 1/2 per cent lower than a year earlier.

3.44 While domestic demand is expected to continue growing strongly through this year, the high exchange rate is likely to hit profitability, especially in the traded goods sector, and lead some manufacturers to postpone investment plans. Manufacturing investment is therefore expected to rise only modestly over the next 18months.

3.45 Non-manufacturing business investment (which includes investment in private sector services, construction and the utilities) grew by 9 3/4 per cent last year, and by a further 7 1/4 per cent in the first quarter of this year. But it is still only 3 3/4 per cent above its level at the pre-recession peak. According to the British Chambers of Commerce survey, investment intentions in services remain strong, while capacity utilisation has continued to rise over the past year and is now back to 1989 levels. Service sector firms are more sheltered from the effects of sterling's appreciation than manufacturers, and it is likely that they will need further to increase investment to meet higher domestic demand. Investment will also be boosted by the growing number of Private Finance Initiative projects and projects aided by the National Lottery and Millennium funds.

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3.46 With North Sea investment also strong, total business investment is forecast to grow by 9 1/4 per cent in 1997 and 6 1/4 per cent in 1998. However, growth in business investment has undershot expectations in the past two years or so. For example, the November 1994 Budget forecast showed a rise of 10 3/4 per cent in 1995, and the November 1995 Budget forecast showed a rise of 9 per cent in 1996. In the event, the increases were just 4 1/4 per cent and 5 3/4 per cent respectively. This experience suggests that once again there must be a clear downside risk to the forecast for business investment, especially if the high exchange rate hit exports hard, though the Budget is designed to improve the climate for long-term investment.

Government and whole economy investment

3.47 General government investment is expected to stabilise in 1998-99, partly as a result of additional spending under the local authority Capital Receipts Initiative. The large fall and rise in general government investment projected for calendar years 1997 and 1998 respectively (Table 3.3) result from an abnormally low outturn for the first quarter of this year.

3.48 Despite the expected pick-up in housing investment, whole economy investment is likely to continue to grow more slowly than business investment in 1997, reflecting the expected fall in general government investment. Although business investment growth is forecast to slow in 1998, whole economy investment is expected to accelerate on the back of higher general government investment.

Table 3.3 Gross domestic fixed capital formation

	Percentage changes on a year earlier		
			Forecast
	1996	1997	1998
Whole economy(1)	1 3/4	5	6
of which:			
Business(2),3	5 3/4	9 1/4	6 1/4
Housing(2)	- 1/4	7	5
General government(2),4	-13 1/2	-15 1/2	9 1/4

1 Includes transfer costs of land and existing buildings.

2 Excludes net purchases of land and existing buildings.

3 Private sector and public corporations (except National Health Service Trusts) non-residential investment. Includes investment under the Private Finance Initiative.

4 Includes National Health Service Trusts.

Stockbuilding

3.49 The ratio of stocks to output has been on a downward trend since the early 1980s, reflecting improvements in stock management techniques, particularly in manufacturing.

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3.50 The stock-output ratio rose during 1995, as heavy stockbuilding cushioned the impact on output of slackening demand growth. But it then fell back again as lower stockbuilding in the middle of last year held back output growth at the time when final demand was strengthening.

3.51 Stock adjustment now appears to be largely complete: both manufacturers and distributors destocked in mid-1996, but there has been a return to stockbuilding in these sectors since the fourth quarter. In manufacturing, a rise in stocks of work in progress in the first quarter of 1997 is consistent with manufacturers expecting recent increases in output to continue (while a fall in manufacturers' stocks of finished goods suggests that actual demand may have been stronger than expected). In retailing, although the ratio of stocks to sales is relatively high, there is little survey evidence that retailers are carrying excess stocks, and increases in stocks probably reflect expectations of strong domestic demand.

3.52 The forecast assumes a resumption of the long-run downward trend in the stock-output ratio, with movements in stockbuilding making little contribution to the forecast of GDP growth over the next 18 months.

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Trade and the balance of payments

Longer-term trade performance

3.53 The UK's share of world trade in manufactures has been falling over time, at least partly reflecting developing countries "catching up" with industrialised countries such as the UK and also trading more amongst themselves.

3.54 But the decline was particularly rapid during the second half of the 1960s and the 1970s. This decline was accelerated in the late 1970s and the early 1980s by the loss of price competitiveness associated with the appreciation of the exchange rate. In terms of the proportionate loss of market share, the UK's performance in the 1970s was the worst of the major six industrialised economies.

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3.55 Since the early 1980s, the UK's share of world trade has continued to trend downwards, though at a slower rate than in previous decades. It is likely that this relative improvement in export performance reflected a number of factors, including a shift in the geographical and product mix of world trade growth in favour of the UK, an improvement in the relative quality and variety of UK exports, and an increase in foreign direct investment in high-technology, export-orientated industries.

3.56 However, at around the time when these more favourable developments in export performance started to emerge, the trend in import growth picked up and the balance of trade in manufactures moved into deficit. Exports are dominated by a relatively small number of large companies, while imports compete against a wider front of domestic industry and so give a more representative indication of competitive strength. The relatively rapid growth of imports during the 1980s and the persistence of the trade deficit since then suggest ample scope for improvement in the underlying strength of British industry.

Competitiveness

3.57 As a result of sterling's appreciation since last summer, cost competitiveness has deteriorated sharply. The deterioration in export price competitiveness appears to have been smaller, as manufacturers have allowed their profit margins to be squeezed.

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3.58 There is likely to be some considerable delay before the appreciation has its full effect on export volumes:

- Many exporters have long order books and forward contracts and hedge against foreign exchange exposure.
- Some exporters are in niche markets, where non-price factors such as quality and service are particularly important, and may be relatively insulated from the appreciation.
- Until they feel more certain about whether the appreciation is likely to persist, exporters may be willing to accept a temporary cut in profit margins, rather than make permanent reductions in employment and capacity.

World background

3.59 UK export market growth slowed sharply in the first half of last year, reflecting the slowdown in activity in Europe. But with Europe picking up and healthy demand growth expected in the US, UK export market growth is forecast to increase to 7 1/2 per cent this year and 7 3/4 per cent in 1998. Details of world economic developments and prospects are set out in Annex A.

Export volumes of goods and services

3.60 There is little evidence that the appreciation as yet has had an adverse impact on export volumes. The volume of exports of goods and services continued to expand through the second half of last year, and in the fourth quarter they were still over 7 per cent higher than a year earlier. Export volumes have increased further so far this year - rising by 1 1/2 per cent in the first quarter.

3.61 However, there is increasing survey evidence that the high exchange rate is now beginning to reduce export orders. The May CBI survey reported that manufacturing orders had fallen to their lowest level relative to normal for three and a half years, and although they improved slightly in June they remain below their long-run average. And the latest BCC survey reported a slowdown in the growth of export orders in both manufacturing and services. Despite the expected pick-up in the growth of UK export markets, export volume growth for goods and services is forecast to slow to an annualised rate of around 4 1/2 per cent in the second half of this year and the first half of 1998.

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Import volumes of goods and services

3.62 Import volumes have been rising on the back of strengthening domestic demand, though they have been erratic from quarter to quarter. The decline in import price competitiveness appears to have been modest in relation to the exchange rate appreciation, reflecting only partial downward adjustment of import prices combined with downward pressure on the prices of domestic manufactures. Import volumes of goods and services are forecast to grow by 7 1/4 per cent in 1997 and 7 3/4 per cent in 1998, as the effects of the higher exchange rate feed through against the background of still buoyant consumer demand.

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Balance of trade in goods and services

3.63 The terms of trade are likely to improve both this year and next as import prices continue to grow more slowly than export prices. However, the deficit on trade in goods and services is projected to widen next year as the effect of the loss of competitiveness on trade volumes progressively dominates the terms of trade effect.

Table 3.4 Trade in goods and services

	Percentage changes on a year earlier										£ billion
	Volumes (1)				Prices (1),2						Goods and services balance
	Exports		Imports		Exports		Imports		Terms of trade (3)		
1996	7	(7 1/2)	8 1/2	(9)	1 3/4	(1/2)	1/2	(- 1/2)	1 1/4	(1)	-5 1/2
Forecast											
1997	6 1/4	(6 3/4)	7 1/4	(7)	-5	(-5 3/4)	-6 1/4	(-6 1/4)	1 1/4	(3/4)	-5
1998	5	(5 3/4)	7 3/4	(8 1/2)	1 1/2	(1 1/4)	1/4	(- 1/2)	1 1/2	(1 3/4)	-8 1/4

1 Non-oil goods in brackets.

2 Average value indices.

3 Ratio of export to import prices.

Net investment income

3.64 The appreciation of sterling would normally be expected to have a large and relatively rapid impact on net investment income, as the sterling value of income from abroad falls. The geographical pattern of the UK's ownership of assets should tend to moderate this effect: around 40 per cent of overseas investment is in the US, and sterling has risen by only around 6 per cent against the US dollar since lastsummer. Nevertheless, net investment income is forecast to fall from £9 3/4 billion in 1996 to £5billion in 1997 and £5 1/2 billion in 1998.

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Current account

3.65 The current account was close to balance in 1996, with surpluses on services, net investment income and oil offsetting deficits on non-oil goods and transfers. It is projected to move into larger deficit over the next two years, reflecting the widening non-oil goods deficit and lower net investment income. Acurrent account deficit of around 3/4 per cent of GDP is projected for 1997, increasing to 1 per cent of GDP in 1998.

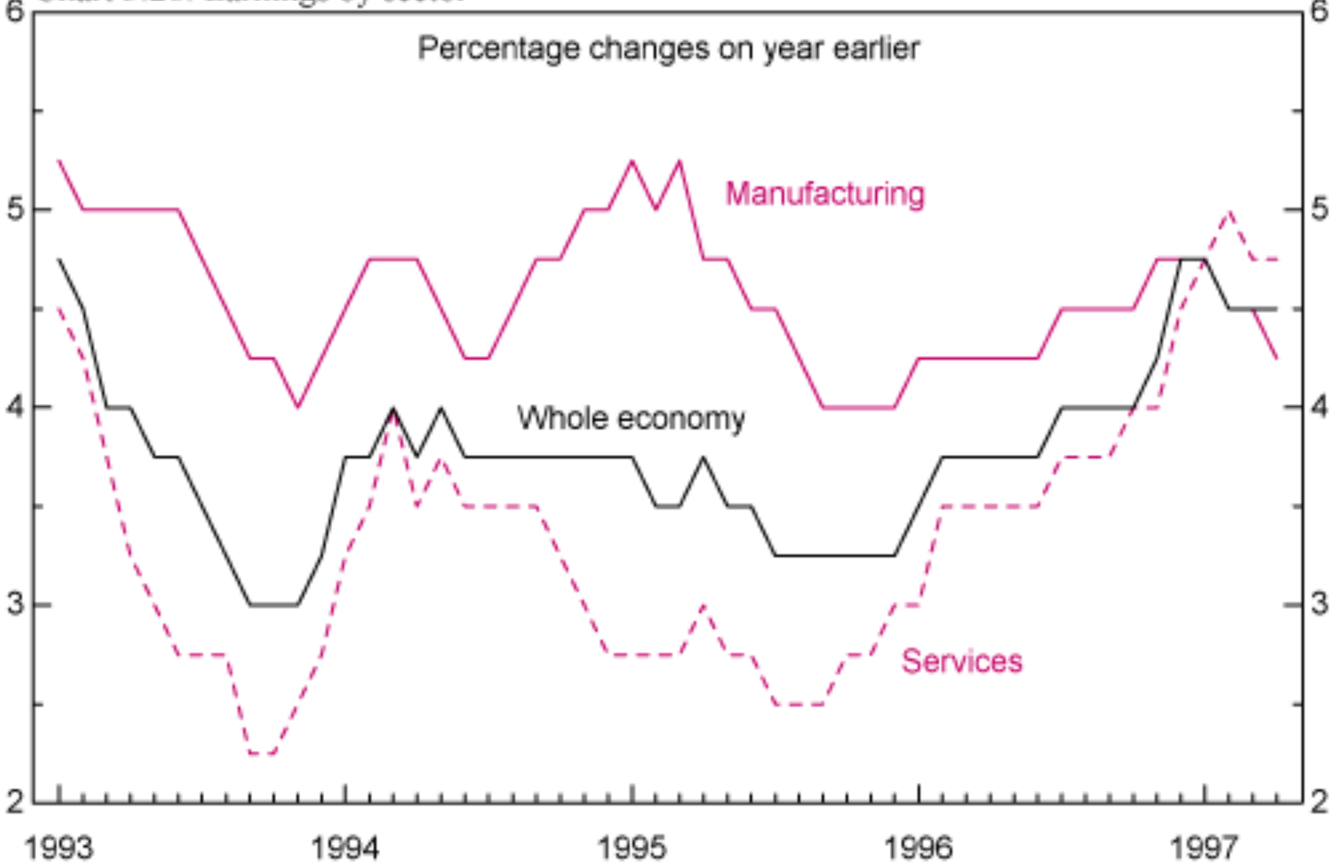
Table 3.5 The current account

				£ billion			
	Non-oil goods	Oil	Services	Total goods & services	Transfers	Net investment income	Current balance
1995	-16	4 1/4	7	-4 3/4	-7	8	-3 3/4
1996	-17 1/2	5	7 1/4	-5 1/2	-4 3/4	9 3/4	- 1/2
Forecast							
1997	-16 3/4	5 1/4	6 3/4	-5	-6 1/2	5 1/2	-6 3/4
1998	-19 1/2	5 1/2	5 3/4	-8 1/4	-6 1/4	5 1/2	-9 3/4

Overseas assets

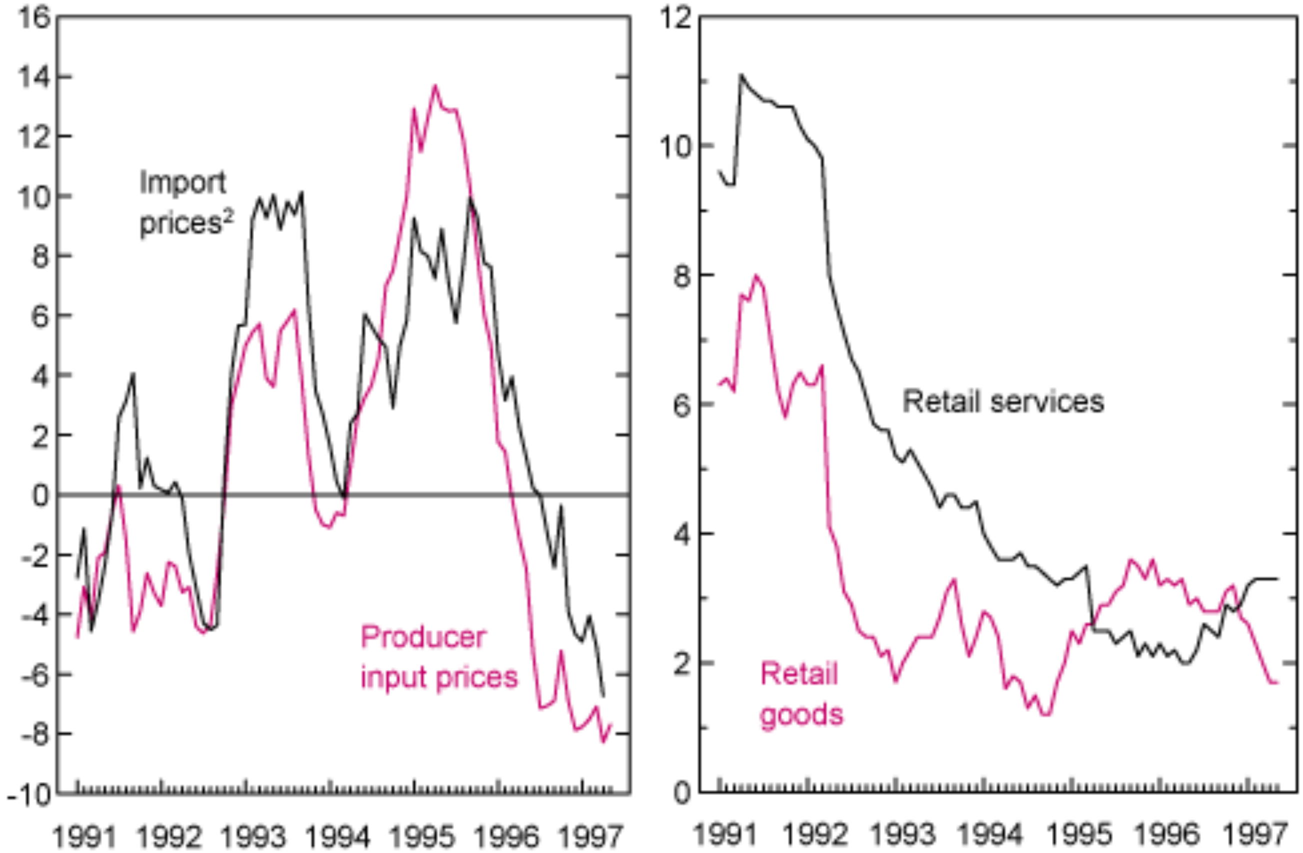
3.66 The sterling value of the UK's stock of net overseas assets is estimated to have been around £40 billion (5 1/2 per cent of GDP) in the first half of 1996, up from around £26 billion at the end of 1995. However, reflecting the adverse effect of the appreciation on the sterling value of overseas assets, the net stock is provisionally estimated to have fallen sharply to under £5 billion (around 1/2 per cent of GDP) in the final quarter of last year. Largely due to an increase in net portfolio investment, the UK's stock of net overseas assets is estimated to have risen to around £14 billion in the first quarter of 1997. But difficulties in measuring certain capital flows - reflected in the large balancing item in the overseas account - means that estimates of net overseas assets are subject to a wide margin of error.

Chart 3.26: Earnings by sector[1]



[1]Underlying average earnings.

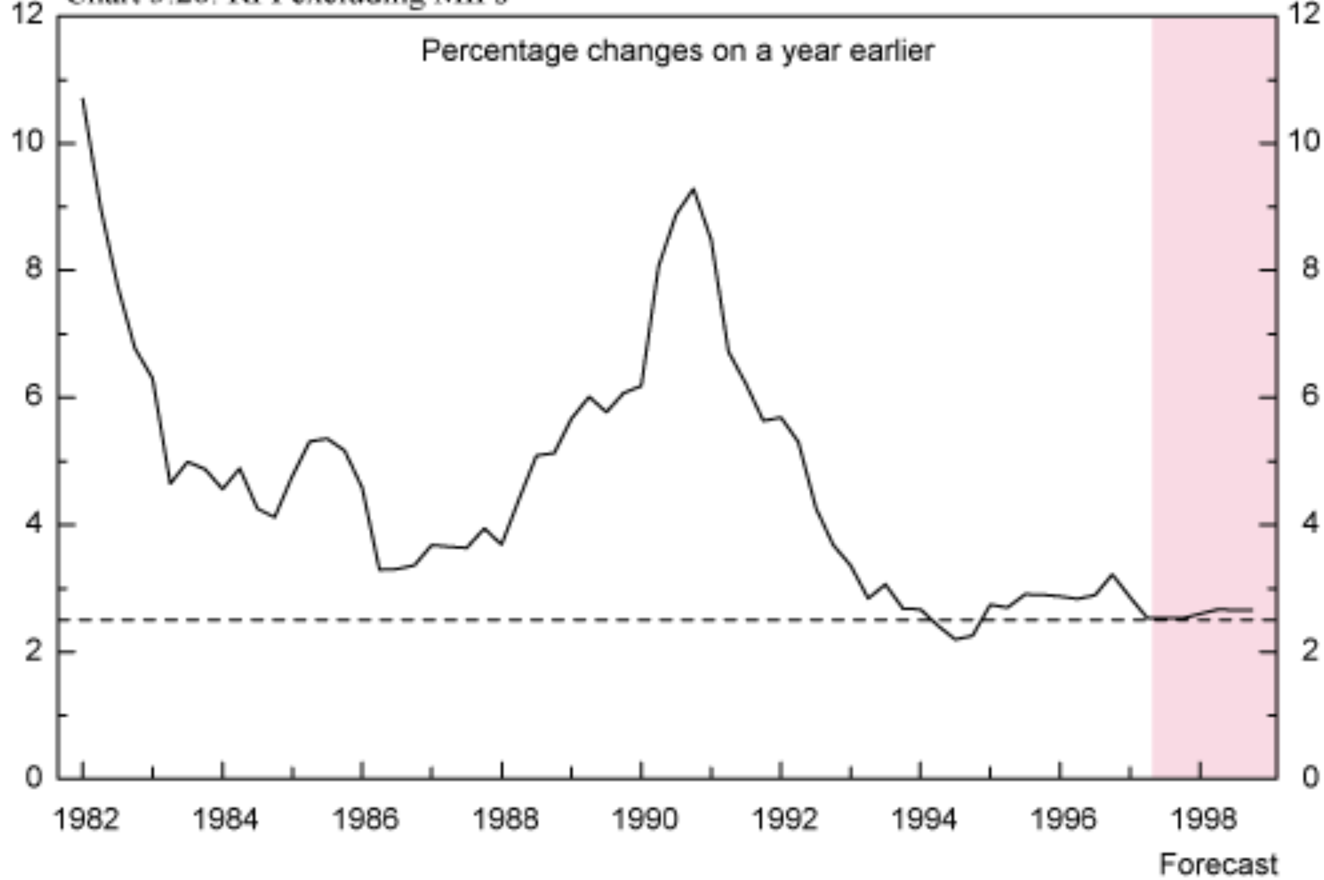
Chart 3.27: Import, input and retail prices[1]



[1]Percentage changes on a year earlier.

[2]All goods.

Chart 3.28: RPI excluding MIPs[1]



[1] Outturns until 1997Q1; forecasts for 1997Q2, 1997Q4, 1998Q2 and 1998Q4.

Pattern of financial balances

3.67 As a result of falls in both the personal and company sector surpluses, the private sector financial balance is projected to decline from a surplus of 4 3/4 per cent of GDP in 1996 to close to zero in 1998. The main counterpart to this is a continued fall in the public sector deficit.

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Labour market

Longer-term perspective and concepts

3.68 Unemployment remains well above the levels seen throughout the 30 years to the end of the 1970s, despite falling sharply since the end of 1992. Around one in five working-age households have no-one in work. Long-term and youth unemployment are particularly serious concerns. The Welfare to Work programme (details of which are set out in Chapter 2) is designed to address these problems.

3.69 The quarterly Labour Force Survey (LFS) provides a more comprehensive measure of unemployment than the claimant count measure. It covers all those without a job who are available for, and have been actively seeking, work [1], whereas the claimant count excludes unemployed people who are not eligible for, or simply not claiming, benefits.

3.70 Although the claimant count includes some people who are not classified as unemployed in the LFS, the LFS records consistently higher levels of unemployment. For example, the latest LFS shows GB unemployment of 2.11million (7.5 per cent of the workforce) in winter 1996-97 (December to February), which is over 350,000 higher than the equivalent claimant count figure. The LFS measure, like the claimant count, is affected by changes in the eligibility criteria for unemployment benefit (such as those associated with the introduction of the Job Seeker's Allowance (JSA)). But whereas the claimant count is affected both directly and indirectly, the effect on the LFS measure comes only through the impact on people's labour market behaviour, in particular job search activity.

3.71 Unemployment remains high. It was exceptionally high in the mid-1980s and early 1990s, and the share of long-term unemployment (12 months or more) has been related, usually with a lag, to the level of total unemployment. This reflects the association between higher unemployment and higher average duration of unemployment, together with rising unemployment reducing average duration for a while if it comes about through increased inflows.

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3.72 The LFS shows the long-term share recently standing at about 40 per cent (over 800,000), compared to previous peaks of around 45 per cent in spring 1994 and 48 per cent in spring 1985, and a trough of 27 per cent in spring 1991. The claimant count shows a similar pattern, with the long-term share currently around 37 per cent, compared to peaks of 39 per cent in October 1994 and 43 per cent in October 1987, and a trough of 25 per cent in July 1991.

3.73 At 633,000 in winter 1996-97, youth unemployment (those under 25) accounts for about 30per cent of total LFS unemployment, while long-term youth unemployment (around 150,000 in winter 1996-97) accounts for around 19 per cent of total long-term unemployment. The LFS youth unemployment rate stands at over 14 per cent (and is higher amongst the under 20s), almost double the total LFS unemployment rate.

3.74 Even though the LFS gives a conceptually reasonable, and internationally accepted, measure of unemployment, it does not capture the full extent of labour under-utilisation. The latest LFS identifies a further 2 1/2 million economically inactive people who say they want a job. However, less than 1 million of those said they were available to start work. Inadequate work incentives are a major cause of economic inactivity. Nevertheless, the total number of people saying they want work (over 4 1/2 million) is still likely to overstate the potential pool of non-employed labour that could be drawn into the labour force. On the other hand, over 3/4 million part-time workers (about one in eight) work part time only because they could not find a full-time job.

3.75 Despite LFS employment increasing by over 1 million since its trough in winter 1992-93, it is still over 400,000 below its pre-recession peak in spring 1990. From peak to trough it fell by almost 1 1/2 million, or 6 per cent (and the alternative employer survey-based measure recorded an even larger fall). The increase in employment since winter 1992-93 has exceeded the fall in unemployment of 850,000, implying some increase in the numbers of economically active people. But this rise in participation (employment plus unemployment) started only in early 1995: until then, participation had continued to edge down, and it has still not regained its pre-recession levels.

3.76 Moreover, the participation rate (the proportion of the working age population who are economically active) remains well below 1990 levels. It has done little better than stabilise since early 1995, as growth in the population of working age has picked up to around 125,000 a year. Economic inactivity carried on rising through to last summer, and is still over 650,000 above its 1990 trough.

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3.77 Changes in demographic trends and participation rates do much to explain the relative peaks in unemployment between the 1990s and the 1980s, because it takes time for the labour market to absorb changes in labour supply. Had the population of working age been increasing in recent years as rapidly as in the early and mid-1980s, and the participation rate not continued to fall, it seems very likely that the peak in unemployment in the 1990s would have exceeded that in the 1980s. So the lower 1990s peak does not in itself provide convincing evidence of improved labour market performance.

3.78 Nevertheless, the proportion of working age people in work throughout the 1990s has been higher than in the mid-1980s. On the other hand, the proportion of working-age households with nobody in work has increased from around one in six in the mid-1980s and early 1990s to around one in five in 1996. The number of non-pensioner workless households in Great Britain in 1996 was over 3 1/2 million, up by around a third since the mid-1980s.

Recent developments

3.79 Labour market activity appears to have accelerated since the middle of last year. Employment increased by around 1/4 million in the second half of the year on both the LFS and employer survey-based measures, compared to a much weaker performance in early 1996. The employer survey showed a further rise in employment, of almost 90,000, between December and March. Faster growth in employment has led to faster rates of decline in unemployment.

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3.80 But while both the LFS and claimant count measures were falling at a similar rate in the first half of 1996, claimant unemployment has fallen particularly sharply since last autumn. Between September 1996 and May 1997, GB claimant unemployment has fallen by over 50,000 a month on average, to 1.57 million (5.8 per cent), compared to a fall of less than 20,000 a month between January and September 1996. Moreover, LFS unemployment fell by 110,000 in the quarter to winter 1996-97, but the comparable fall in the claimant count was over 180,000.

3.81 It seems clear that the decline in the claimant count between September 1996 and May 1997 was amplified by the introduction of JSA [2], not least through tighter eligibility rules and deterred benefit claims. Nevertheless, the evidence overall suggests that the underlying rate of decline in unemployment has gathered pace as economic activity more generally has accelerated.

3.82 However, the extent of the rise in employment (and fall in unemployment) since mid-1996 has been surprising. More typically employment responds with a lag to changes in output, so that productivity - output per person employed - accelerates with output. Productivity slowed, particularly in manufacturing, from late 1994 as output growth slackened. Subsequently non-oil productivity growth has been fairly subdued, and has not picked up significantly since last autumn, despite accelerating output. This may be partly explained by changes in hours worked. Average hours worked fell in the second half of 1996, and total hours were more or less flat. So output per hour worked did accelerate in line with output.

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Financial developments

Exchange rate

3.83 The sterling exchange rate index, which measures the sterling exchange rate against a basket of currencies, rose by 12 1/2 per cent over the final four months of 1996, and has risen by a further 7 1/2 per cent over the first six months of this year. The appreciation has been mainly against the deutschemark and the yen rather than the US dollar. The forecast is based on the conventional assumption that the sterling index remains close to recent levels.

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Interest rates

3.84 Base rates have moved within a relatively narrow range of 5 1/4 -6 3/4 per cent over the past four years. In pursuit of the Government's inflation objective, they were increased by 1/4 percentage point, to 6 1/4 per cent, in early May. The Monetary Policy Committee increased rates by a further 1/4 percentage point on 6 June.

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Long rates

3.85 Long rates fell during the second half of last year and into this year, largely reflecting a fall in inflation expectations. Yields on ten-year gilts troughed at just over 7 per cent in February. After picking up to over 7 1/2 per cent, they fell sharply following the Government's announcement on 6 May that it was giving operational responsibility for setting interest rates to the Bank of England. Long rates are now a little over 7 per cent. *This fall has resulted in a sharp narrowing of the differential between UK yields and those of other G7 countries*.

Monetary indicators

3.86 The strong outlook for domestic spending is consistent with the recent monetary indicators.

3.87 The notes and coin component of M0 (which excludes bankers' balances at the Bank of England) grew by 0.8 per cent in June, above the average monthly growth rate of 0.5 per cent over the past year. This is consistent with buoyant retail sales growth.

3.88 The 12-month growth rate of M4 has risen from around 4 per cent at the end of 1994 to 11.1 per cent this May. Strong growth of industrial and commercial companies' deposits, up by over 10 per cent in the year to the first quarter of 1997, points to higher investment spending this year. Strengthening personal sector deposits suggest that consumer spending is likely to remain robust.

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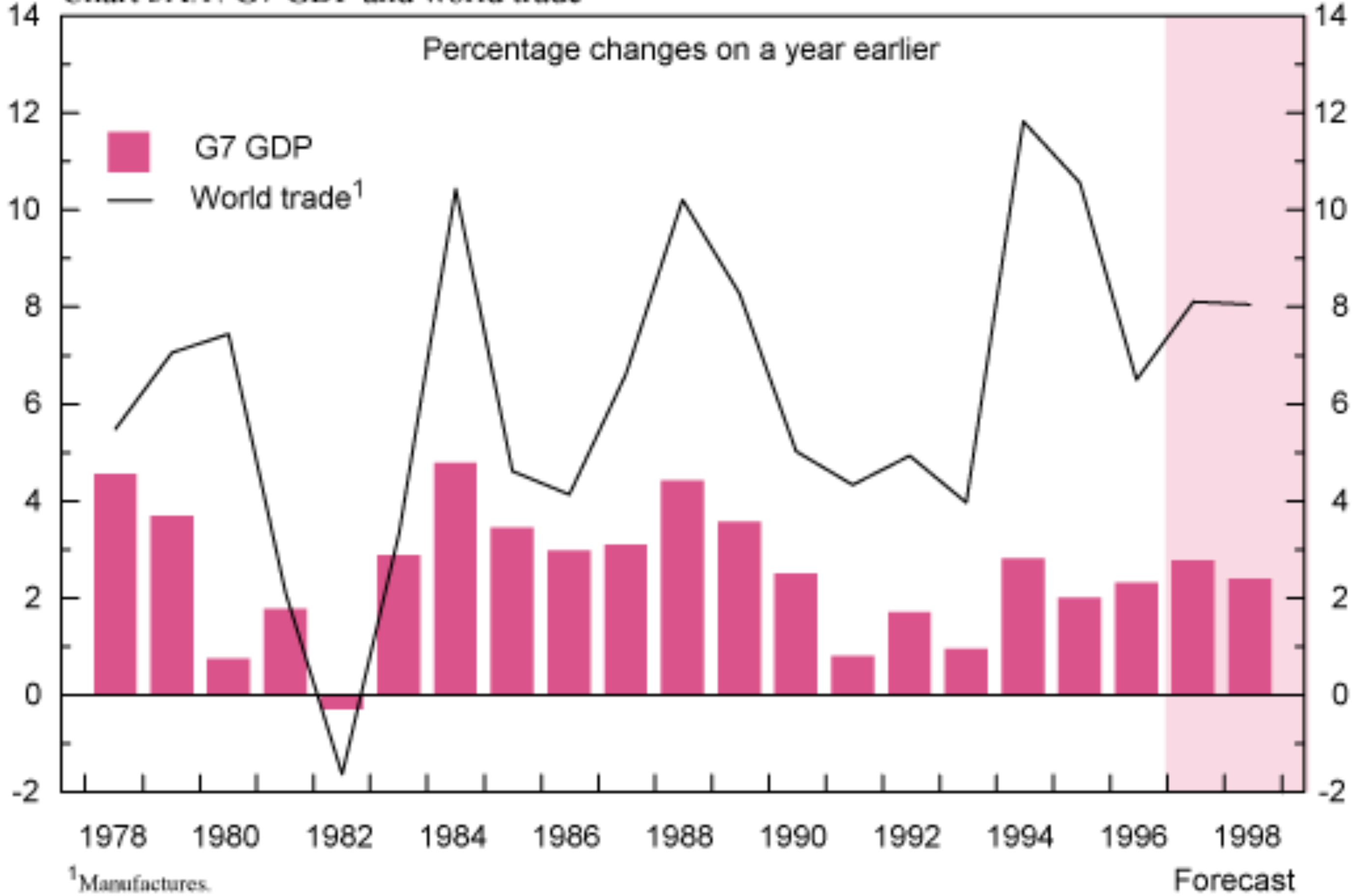
Note

(1)*The LFS measure accords with the International Labour Organisation (ILO) definition of unemployment, which refers to people without a job who are available to start work within two weeks and who have either looked for work in the previous four weeks or are waiting to start a job already obtained*. back

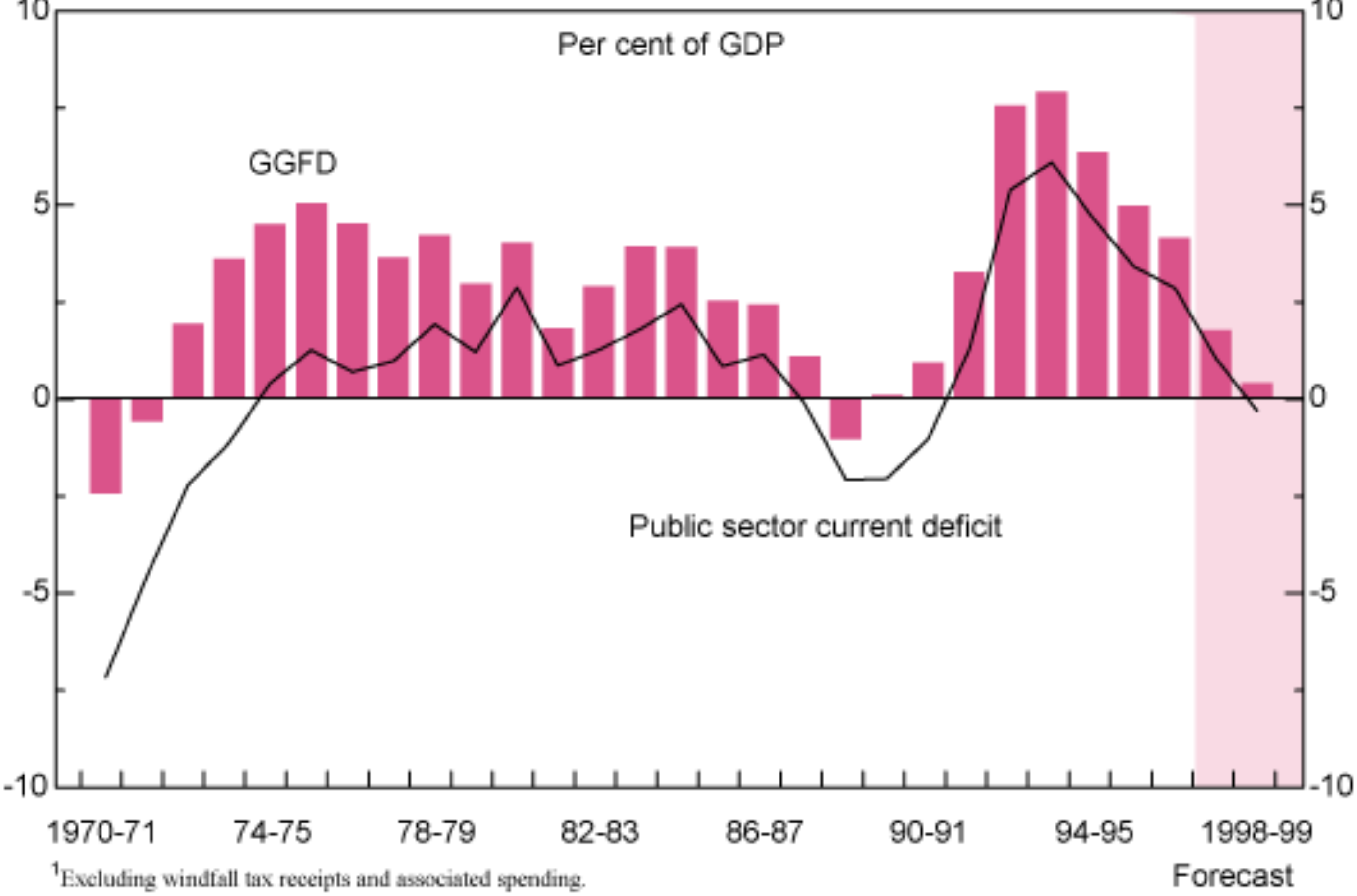
(2)*Although JSA was introduced in October 1996, it took until May 1997 for all claimants to have signed a Job Seeker's Agreement*. back

Chart 3A.1: G7 GDP and world trade



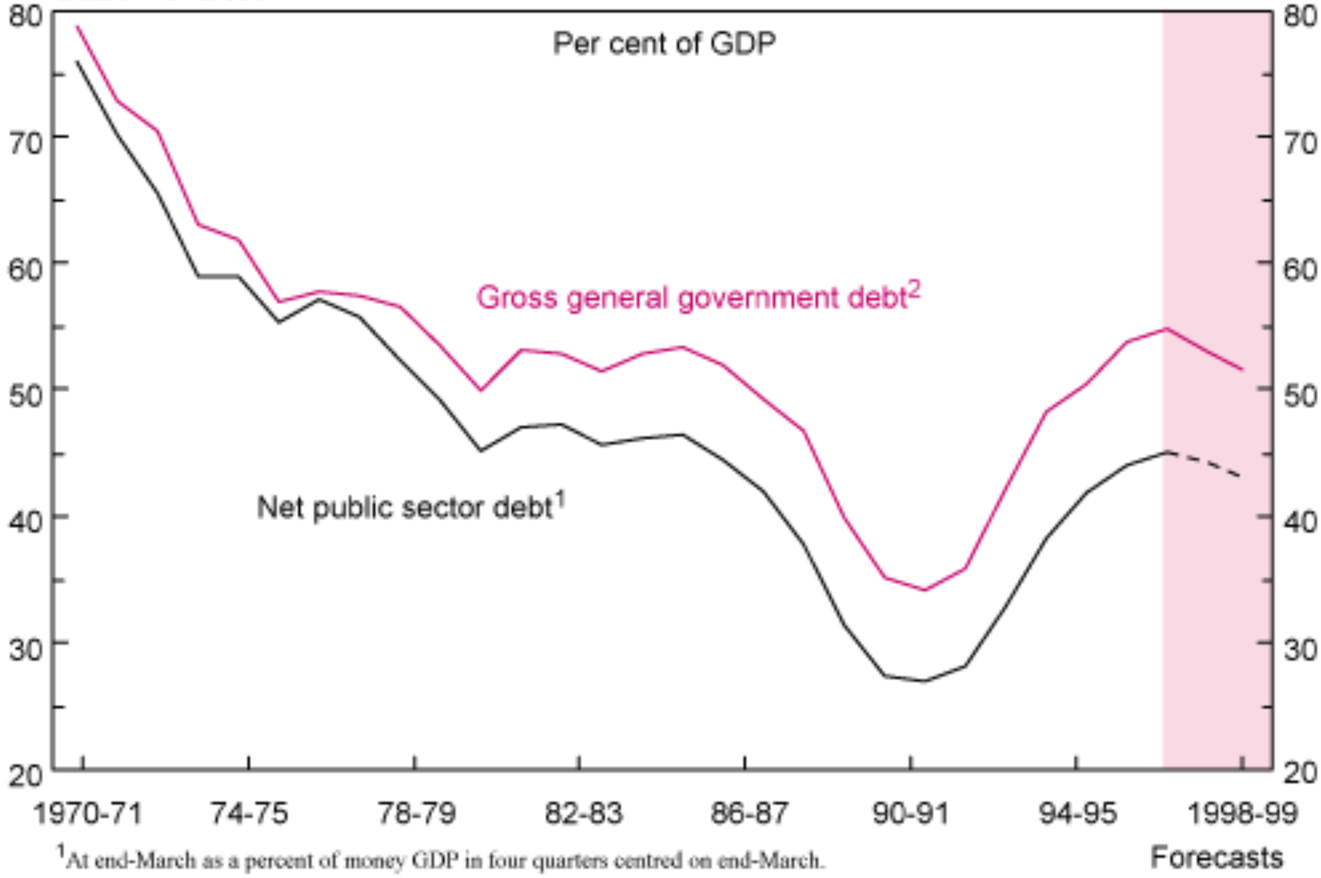
[1] Manufactures.

Chart 4.1: Public sector current deficit and GGFD[1]



[1]Excluding windfall tax receipts and associated spending.

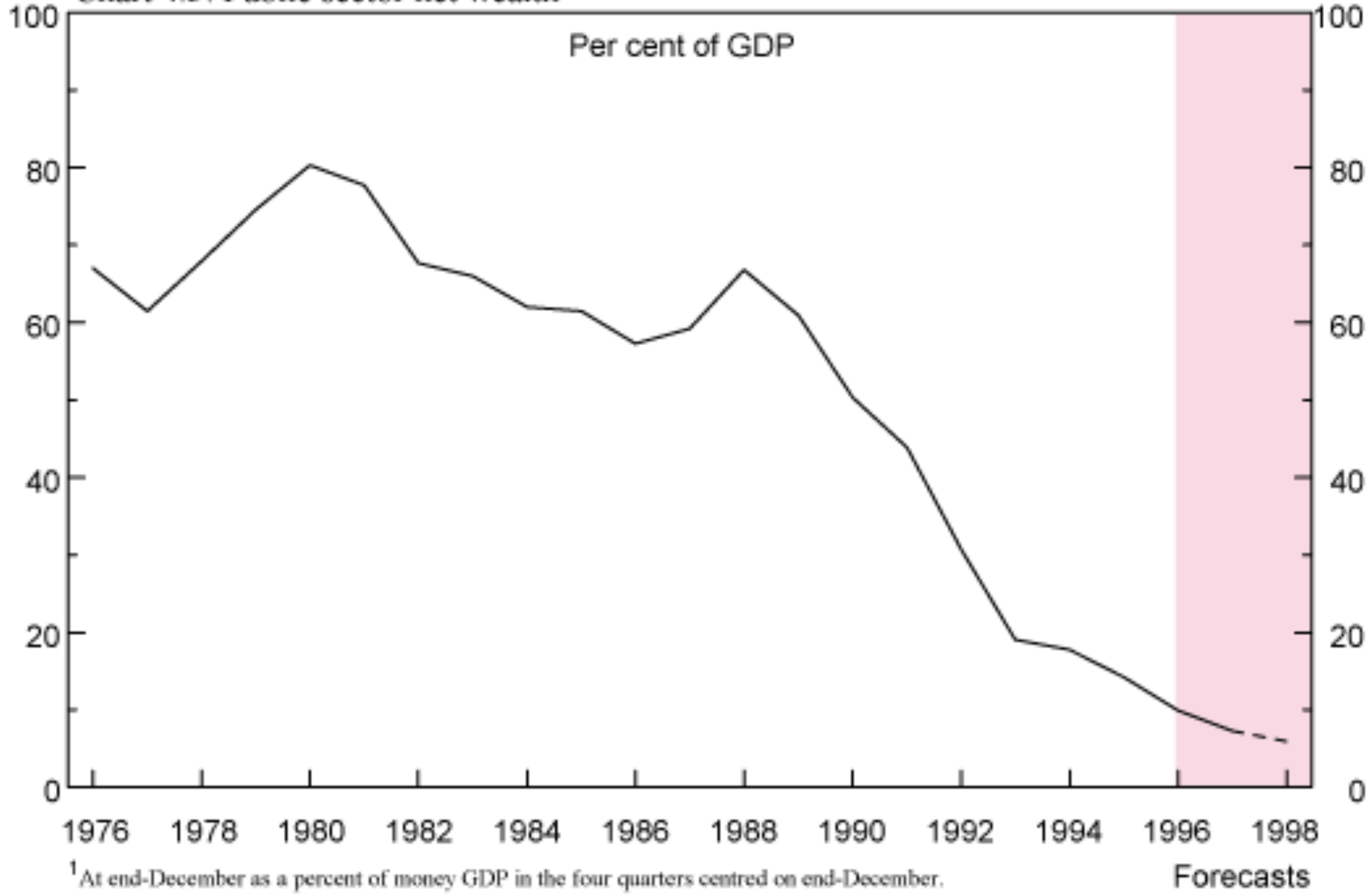
Chart 4.2: Debt



[1] At end-March as a percent of money GDP in four quarters centred on end-March.

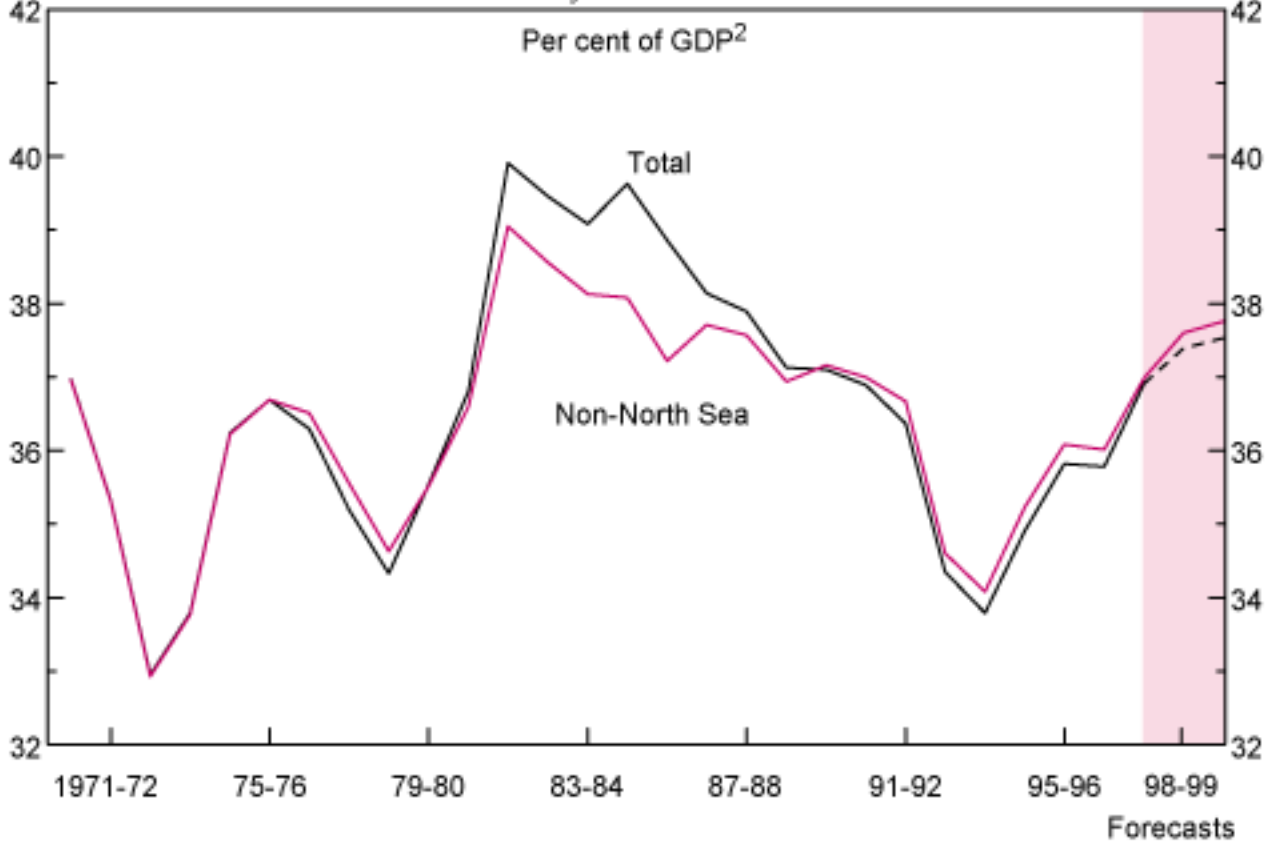
[2] GDP is on an ESA basis from 1991-92 onwards.

Chart 4.3: Public sector net wealth[1]



[1] At end-December as a percent of money GDP in the four quarters centred on end-December.

Chart 4.4: Total taxes and social security contributions[1]



[1]On a national accounts accruals basis.

[2]Non-North Sea taxes and social security contributions are expressed as a percent of non-North Sea money GDP.

General government expenditure

4.23 Table 4.6 shows the 1996-97 outturn and forecasts for 1997-98 and 1998--99 for general government expenditure (GGE) and its main components. The projections are consistent with the public expenditure plans set out in Chapter2. Specifically, it is assumed that the Control Total is unchanged in cash terms from the plans laid out in the last Budget. There is some additional expenditure associated with Welfare to Work and the local authority capital receipts initiative. The expenditure plans are explained more fully in Chapter 2.

The Control Total

4.24 The outturn for Control Total spending in 1996-97 is estimated at £260.4billion, £0.2billion lower than forecast at the time of the last Budget. This represents an overspend of £0.3billion on the original plans laid out in the 1995 Budget. Unanticipated expenditure on measures to eradicate BSE accounted for more than half of the public expenditure Reserve in 1996-97. Despite the modest overshoot in cash spending, the Control Total fell by 3/4 per cent in real terms on 1995-96.

Table 4.6 General government expenditure(1)

		£ billion	
	Outturn	Forecast	
	1996-97	1997-98	1998-99
Control Total	260.4	266.4	273.6
Welfare to Work spending		0.2	1.2
LA spending under the capital receipts initiative		0.2	0.7
Cyclical social security	14.3	13.7	14.0
Central government debt interest	22.3	24.6	24.4
Accounting adjustments	11.4	10.1	10.7
GGE(X)(2)	**308.4**	**315.3**	**324.7**
Privatisation proceeds	-4.4	-2.0	0.0
Other adjustments	5.1	6.2	6.6
GGE	**309.0**	**319.4**	**331.3**
GGE(X)(2)/GDP ratio - per cent	41	39 1/2	38 3/4

1 See Annex B for conventions and definitions.

2 Excluding privatisation proceeds and lottery financed spending and net of interest and dividend receipts.

4.25 The plans allow Control Total expenditure to rise at an average of just over 2 1/2 per cent in cash terms over the next two years, little changed from the last Budget. In real terms, Control Total expenditure is lower than projected at the time of the last Budget, due to the higher forecast for the GDP deflator.

Budget spending measures

4.26 Spending financed by the windfall tax amounts to £0.2billion in 1997-98 and £1.2billion in 1998-99. Local authority spending under the capital receipts initiative is £0.2billion in 1997-98 and £0.7billion in 1998-99.

Debt interest

4.27 Central government net debt interest was £22.3billion in 1996-97 and has risen by almost 1per cent of GDP over the past five years, reflecting high public sector borrowing. Debt interest is projected to increase further, peaking at over £24 1/2 billion in 1997-98 before stabilising the following year.

Cyclical social security

4.28 The outturn for cyclical social security in 1996-97 of £14.3billion represented a further real year-on-year fall in expenditure, as in the two preceding years. Declining unemployment has largely accounted for this recent trend. But underlying real spending - adjusted for unemployment and policy measures - has continued to grow. The forecast is based on a planning assumption that the level of UK unemployment will be flat at its recent level of 1.65million. The lower average level of unemployment in 1997-98 largely accounts for the projected fall in expenditure to £13.7billion. With unemployment assumed flat thereafter, expenditure is projected to rise the following year due to upratings of benefits and continuing growth in the numbers of non-unemployed claimants.

Privatisation proceeds

4.29 Privatisation proceeds are assumed to be £2billion in 1997-98, unchanged from the last Budget. This largely represents further proceeds from the earlier sales of British Energy and Railtrack. The Government has not announced any specific sales for 1998-99.

Expenditure as share of GDP

4.30 The GGE(X) ratio fell by almost 1 1/4 percentage point of GDP in 1996-97 to 41per cent. This is a little lower than expected at the time of the last Budget due to higher money GDP. The GGE(X) ratio is projected to fall by a further 2 1/4 percentage points over the next two years. Most of this fall stems from very low real growth in the Control Total. The cyclical social security ratio also declines in 1997-98 due to lower recent outturns for unemployment. The decline in the PSBR is sufficient to keep the debt interest ratio broadly stable between 1996-97 and 1998-99.

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Medium-term projections

4.31 The Government has kept to the Control Total cash spending plans announced in the last Budget both for 1997-98 and 1998-99. There are two special and one-off elements of expenditure: spending on Welfare to Work financed by the windfall tax and on housing under the capital receipts initiative. Spending plans for later years will be set only after the comprehensive spending review, which will make strategic decisions about spending from 1999-2000 onwards. It is impossible therefore to make any central assumption for the public finances in later years. However, Table4.7 sets out stylised projections for the public finances based on three illustrative assumptions for spending growth. These illustrative assumptions are:

- **A** real growth in the Control Total of 3/4 per cent a year from 1999-2000 onwards (the real growth assumed from 2000-01 in the 1996Budget);
- **B** real growth in the Control Total of 1 1/2 per cent a year - roughly the average over the past 20years;
- **C** the Control Total constant as a ratio of GDP, i.e. growing at 2 1/4 per cent a year in real terms.

Table 4.7 Medium-term fiscal projections

		per cent of GDP	
	1999-00	2000-01	2001-02
General government receipts(1)	39.1	39.6	39.7
Tax burden(1)	37.5	38.1	38.4
Money GDP - £ billion	877.0	919.0	962.0
(A) 3/4 per cent real CT growth			
GGE(X)	38.2	37.5	36.7
GGFD(2)	-0.5	-1.6	-2.5
Current balance(3)	1.2	2.3	3.3
PSBR	-0.2	-1.3	-2.2

Net public sector debt	41.0	38.1	34.2
Gross general government debt(2)	49.3	46.1	42.0
(B) 1 1/2 per cent real CT growth			
GGE(X)	38.4	38.0	37.5
GGFD(2)	-0.2	-1.1	-1.7
Current balance(3)	0.9	1.9	2.6
PSBR	0.1	-0.8	-1.4
Net public sector debt	41.3	38.8	35.6
Gross general government debt(2)	49.6	46.9	43.5
(C) 2 1/4 per cent real CT growth			
GGE(X)	38.7	38.5	38.4
GGFD(2)	0.0	-0.6	-1.0
Current balance(3)	0.7	1.4	1.9
PSBR	0.3	-0.3	-0.6
Net public sector debt	41.5	39.5	37.1
Gross general government debt(2)	49.8	47.7	45.1

1 Case B. Taxes and other receipts directly linked to public expenditure vary slightly in the three cases.

2 On a Maastricht basis. GDP is on an ESA basis, year ending in March.

3 Public Sector.

4.32 The economic assumptions are the same in all three projections, and an almost identical path for revenues is projected. With constant (indexed) tax rates and allowances, receipts tend to grow slightly faster than GDP. This tendency is reinforced by real increases in road fuel and tobacco duties and the cumulative impact of the "Spend to Save" package in the last Budget. The variant projections are shown in Table4.7 and Chart4.6.

4.33 In case C, the PSBR moves slightly into surplus in 2000-01. The ratio of net debt to GDP continues its steady decline, while the ratio of net wealth to GDP starts gradually to recover. In cases A and B, where spending grows more slowly, the PSBR moves more quickly into surplus, and the improvement in the net debt and net wealth ratios is slightly greater (see Chart4.6). However, in all cases the fall in the debt burden is insufficient to reverse fully the rise that occurred over the first half of the 1990s, and the improvement in the public sector's balance sheet is only very modest compared with the deterioration over the past ten years.

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4.34 These medium-term projections are subject to large error margins. One major uncertainty concerns the current cyclical position of the economy. The projections are based on the view that, at present, output in the economy is close to its trend level. But if that assumption was proved wrong, the outlook for the public finances could be very different (see box on page 14). Chart 4.7 illustrates this point further by showing alternative paths for the cyclically-adjusted GGFD and current balance on the cautious assumption that the output gap is currently 1 1/2 per cent higher than the central view. Under this assumption, the improvement in the public finances is significantly less marked.

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Changes since last Budget

4.35 The PSBR is forecast to be lower than in the last Budget by over £8billion both in 1997-98 and 1998-99. This partly reflects the Budget tax and spending measures, which have the net effect of reducing the PSBR by £5 1/2 billion in 1997-98 and £4 3/4 billion in 1998-99. It partly also reflects higher profits estimates for 1996, which feed through to higher corporation tax receipts in future years, and higher projected levels of money GDP, which raise the forecast of revenues from other taxes. These changes to the forecast are summarised in Table 4.8.

Table 4.8 Summary changes to the PSBR forecast since 1996 Budget

	£ billion	
	1997-98	1998-99
1996 Budget forecast	19.2	12.2
plus Changes to audited assumptions	0.6	3.2
plus LA spending under the capital receipts initiative	0.2	0.7
minus Tax measures (excluding windfall tax)	3.4	4.1
minus Estimated corporation tax yield from higher profits	2.1	3.3
minus Estimated yield from other taxes due to higher money GDP	1.8	3.0
plus Other changes	0.6	-0.4
equals 1997 Budget underlying PSBR(1)	13.3	5.4
minus Windfall tax	2.6	2.6
plus Welfare to Work spending	0.2	1.2
equals 1997 Budget PSBR forecast	**10.9**	**4.0**

1 Excluding windfall tax and associated spending.

Table 4.9 Effects on the PSBR of changing the assumptions for privatisation proceeds, Spend to Save, GDP growth and unemployment

			£ billion		
	1997-98	1998-99	1999-2000	2000-01	2001-02
Privatisation proceeds	0	1 1/2	1	1	1
Spend to Save	1/4	3/4	3/4	1	1
2 1/4 per cent GDP growth(1)			3/4	1 3/4	2 3/4
Flat unemployment(2)	1/2	3/4	1	1	1
Additional debt interest(3)	0	1/4	1/2	3/4	1 1/4
Total	**1/2**	**3 1/4**	**4**	**5 1/2**	**7**

A positive figure indicates an increase in the PSBR of changing the relevant assumption. The figures are rounded to the nearest £ 1/4 billion.

1 The effect of changing from 2 1/2 per cent to a 2 1/4 per cent GDP growth rate from 1999-2000 onwards.

2 The effect of assuming UK unemployment flat at its October 1996 level (2.0million) rather than declining as assumed in the November Budget.

3 The effect on public sector debt interest of higher borrowing resulting from changes in the four assumptions.

Changes to key forecast assumptions

4.36 The changes shown in Table 4.8 incorporate the effects of changes in the key assumptions described in paragraph 4.05, and set out in Table 4.9. It is estimated that the net impact of changes to the assumptions on privatisation, the effects of the "Spend to Save" package, unemployment and growth is to add around £ 1/2 billion to the projected level of the PSBR in 1997-98 and £3 1/4 billion in 1998-99.

4.37 Table4.10 gives more detail on changes in the fiscal projections since the last Budget.

Table 4.10 Changes to the PSBR forecast since 1996 Budget

	£ billion		
	1996-97	1997-98(1)	1998-99(1)
PSBR path in 1996 Budget	**26.4**	**19.2**	**12.2**
contribution from:			
General government receipts			
Windfall tax		2.6	2.6
Other Budget measures to tax/NICs(1)		3.4	4.1
Other changes to tax/NICs	4.5	3.2	5.3
Changes to other receipts	1.0	-0.3	0.5
Total change in GGR	**&b;5.5**	**8.9**	**12.4**
General government expenditure			
Control Total	-0.2	0.0	0.0
Welfare to Work		0.2	1.2
LA spending under the capital receipts initiative		0.2	0.7
Cyclical social security	0.0	-0.5	-0.3
Central government debt interest	0.1	-0.2	0.0
Accounting adjustments	1.1	0.9	0.8
Total change in GGE(X)(2)	**0.9**	**0.6**	**2.5**
Privatisation proceeds(3)	0.1	0.0	1.5
Other adjustments(4)	-0.5	-0.2	0.1
Total change in GGE	**0.5**	**0.4**	**4.1**
Total change in PSBR	-3.6	-8.3	-8.2
PSBR path in 1997 Budget	**&b;22.7**	**&b;10.9**	**&b;4.0**

1 Changes from an indexed base. See Table 2.2.

2 General government expenditure excluding privatisation proceeds and lottery-financed spending, and net of interest and dividend receipts.

3 A plus sign indicates lower privatisation proceeds.

4 Lottery financed spending and interest and dividend receipts.

1996-97 outturn

4.38 General government receipts in 1996-97 were some £5 1/2 billion higher than forecast in the 1996 Budget. Both income tax and corporation tax receipts were higher than forecast although this was partly offset by lower Customs and Excise taxes. Spending - GGE(X) - was nearly £1billion higher than forecast despite a small downward revision to the Control Total. Higher expenditure was concentrated within the accounting adjustments. Specifically, there has been a major upward revision to ONS data for general government VAT refunds.

General government receipts

4.39 The forecast of general government receipts for 1997-98 has been revised upwards by £9billion. This mostly reflects the Budget measures, but partly also the effect on tax receipts of higher money GDP. There is some offset from lower "other receipts", principally higher government pension payments. Receipts in 1998-99 are some £12 1/2 billion higher than in the last Budget. The Budget measures and higher money GDP growth are again the main explanations for the higher revenues.

General government expenditure

4.40 Expenditure - GGE(X) - is up by £0.6billion in 1997-98 from the last Budget, although Control Total spending is unchanged. Cyclical social security is down by £0.5billion; although unemployment is now projected flat rather than falling as in the last Budget, its level is lower because unemployment has fallen more sharply than expected since November. Debt interest is £0.2billion lower, mainly reflecting lower borrowing. The accounting adjustments are nearly £1billion higher, as the data revision to VAT refunds carries through. The upward revision of GGE(X) in 1998-99 is much larger at £2.5billion. This mainly reflects the additional spending associated with the windfall tax and LA spending under the capital receipts initiative.

Financing policy

4.41 Table4.11 updates the financing arithmetic to allow for the new CGBR forecast, and the latest information on gilts sales and assumptions for other funding. It is now expected that £16.5billion of gilts sales will be required in the months July 1997 to March 1998 to finance the CGBR. Financing policy will be carried out on the basis set out in the remit to the Bank of England (published in the 1997-98 Debt Management Report), subject to changes to the auction programme announced on 2 July, to accommodate the revised gilts sales figure.

Table 4.11 Financing requirement forecast for 1997-98

	£ billion
CGBR	**12.4**
Gilts maturing	19.6
Plus gilts sales residual from 1996-97	-3.9
Financing requirement	**28.1**
Less net National Savings inflow	3.0
Less other funding	0.0
Gilts sales required	**25.1**
Less gilts sales (April-June 1997)	8.6
Further gilts sales required (July 1997-March 1998)	**16.5**

Forecast errors

4.42 The budget deficit is the difference between two large aggregates of spending and receipts and forecasts of it are inevitably subject to a wide margin of error. Over the past five years the average absolute errors on spring and summer forecasts of the PSBR and the GGFD for the financial year ahead have been around 1per cent of GDP, or plus or minus £8billion in today's prices.

Table 4A.5 Public sector transactions by sub-sector and economic category

		£ billion				
		1996-97 estimated outturn				
		General government				
	Line	Central government	Local authorities	Total	Public corporations	Public sector
Current receipts(2)						
Taxes on income and royalties	*1*	99.1	0.0	99.1	-0.2	98.9
Taxes on expenditure	2	110.0	0.2	110.2	0.0	110.2
Taxes on capital	3	3.1	0.0	3.1	0.0	3.1
Social Security contributions	4	46.7	0.0	46.7	0.0	46.7
Council tax	5	0.0	10.1	10.1	0.0	10.1
Gross trading surplus	6	0.5	0.3	0.8	3.3	4.0
Rent and miscellaneous current transfers	7	0.8	4.6	5.4	0.7	6.0
Interest and dividends from private sector and abroad	8	2.0	0.6	2.5	0.2	2.7
Interest and dividends within public sector	9	6.0	-3.8	2.2	-2.2	0.0
Imputed charge for non-trading capital consumption	10	1.5	2.2	3.7	0.0	3.7
Total current receipts	***11***	**269.6**	**14.1**	**283.7**	**1.7**	**285.4**
Current expenditure(2)						
Current expenditure on goods and services	*12*	101.8	55.1	156.8	0.0	156.8
Depreciation	13	1.5	4.8	6.4	3.0	9.4
Subsidies	14	8.8	0.7	9.5	0.0	9.5
Current grants to personal sector	15	86.3	13.1	99.5	0.0	99.5
Current grants abroad	16	4.7	0.0	4.7	0.0	4.7
Current grants within public sector	17	59.2	-59.2	0.0	0.0	0.0
Debt interest	18	26.4	0.5(3)	26.9(3)	-0.3(3)	26.6(3)
Apportionment of Reserve	*19*					
Total current expenditure	***20***	**288.8**	**15.1**	**303.8**	**2.9**	**306.6**
Current balance(1)	*21*	**-19.2**	**-1.0**	**-20.1**	**-1.0**	**-21.2**
Capital transfers	***22***	**0.0**	**0.3**	**0.3**	**-0.1**	**0.2**
Capital expenditure(2)						
Gross domestic fixed capital expenditure	*23*	3.7	5.5	9.2	4.2	13.4
Less Depreciation	*24*	-1.5	-4.8	-6.4	-3.0	-9.4
Increase in stocks	25	0.2	0.0	0.2	-0.1	0.1
Capital grants to private sector	26	3.0	0.8	3.9	0.4	4.3
Capital grants to public sector	27	6.4	-2.8	3.6	-3.6	0.0
Apportionment of Reserve	28					
Total capital expenditure	***29***	**11.7**	**-1.1**	**10.5**	**-2.2**	**8.3**
Financial deficit	***30***	**30.9**	**-0.5**	**30.4**	**-1.1**	**29.2**
Financial transactions						
Net lending to private sector and abroad	31	0.4	0.0	0.4	0.0	0.4

Cash expenditure on company securities (including privatisation proceeds)	32	-4.3	0.0	-4.3	0.0	-4.3
Transactions concerning certain public sector pension schemes	33	0.9	0.0	0.9	0.0	0.9
Accruals adjustments on receipts	34	-2.2	-0.3	-2.5	0.0	-2.5
Other accruals adjustments	35	0.1	0.0	0.1	0.0	0.1
Miscellaneous financial transactions	36	-0.8	0.0	-0.8	-0.2	-1.0
Borrowing requirement	*37*	**24.9**(4)	**-0.9**	**24.1**(4)	**-1.3**	**22.7**

(1) Current balance (line 21) = current receipts (line 11) - current expenditure (line 20).
Financial deficit (line 30) = capital expenditure (line 29) - capital receipts (line 22) - current balance (line 21).

(2) *On an accruals basis.*

(3) *Excluding local authorities' payments to central government and public corporations' payments to general government, which are in line 9.*

(4) *Own account borrowing.*

Table 4A.5 Public sector transactions by sub-sector and economic category ***- continued***

£ billion

1997-98

	General government					
Line	Central government	Local authorities	Total	Public corporations	Public sector	
						Current receipts(2)
1	110.1	0.0	110.1	-0.3	109.9	Taxes on income and royalties
2	119.5	0.2	119.7	0.0	119.7	Taxes on expenditure
3	4.3	0.0	4.3	0.0	4.3	Taxes on capital
4	49.7	0.0	49.7	0.0	49.7	Social Security contributions
5	0.0	10.6	10.6	0.0	10.6	Council tax
6	0.4	0.8	1.1	3.6	4.7	Gross trading surplus
7	0.8	4.0	4.8	0.7	5.5	Rent and miscellaneous current transfers
8	1.9	0.8	2.7	0.2	2.9	Interest and dividends from private sector and abroad
9	6.3	-4.0	2.3	-2.3	0.0	Interest and dividends within public sector
10	1.5	2.2	3.7	0.0	3.7	Imputed charge for non-trading capital consumption
11	**294.5**	**14.5**	**309.0**	**1.9**	**310.9**	**Total current receipts**
						Current expenditure(2)
12	102.4	55.5	157.8	0.0	157.8	Current expenditure on goods and services
13	1.5	4.9	6.4	3.0	9.4	Depreciation
14	7.3	0.7	8.0	0.0	8.0	Subsidies
15	91.1	13.4	104.5	0.0	104.5	Current grants to personal sector
16	5.7	0.0	5.7	0.0	5.7	Current grants abroad
17	58.8	-58.8	0.0	0.0	0.0	Current grants within public sector
18	28.7	0.4(3)	29.1(3)	-0.3(3)	28.8(3)'	Debt interest
19	2.2	0.0	2.2	0.0	2.2	Apportionment of Reserve
20	**297.7**	**16.0**	**313.7**	**2.6**	**316.4**	**Total current expenditure**
21	**-3.2**	**-1.6**	**-4.7**	**-0.7**	**-5.4**	**Current balance**(1)

22	**0.0**	**0.3**	**0.3**	**-0.1**	**0.2**	**Capital transfers**
						Capital expenditure(2)
23	3.1	5.9	9.0	3.7	12.7	Gross domestic fixed capital expenditure
24	-1.5	-4.9	-6.4	-3.0	-9.4	Less Depreciation
25	0.1	0.0	0.1	0.0	0.1	Increase in stocks
26	2.8	0.8	3.6	0.4	4.0	Capital grants to private sector
27	5.2	-3.3	1.9	-1.9	0.0	Capital grants to public sector
28	0.2	0.0	0.2	0.0	0.2	Apportionment of Reserve
29	**9.9**	**-1.5**	**8.4**	**-0.8**	**7.6**	**Total capital expenditure**
30	**13.1**	**-0.2**	**12.9**	**0.0**	**12.9**	**Financial deficit**
						Financial transactions
31	-0.9	-0.1	-1.0	0.0	-1.0	Net lending to private sector and abroad
32	-2.0	0.0	-2.0	0.0	-2.0	Cash expenditure on company securities (including privatisation proceeds)
33	1.3	0.0	1.3	0.0	1.3	Transactions concerning certain public sector pension schemes
34	1.4	0.0	1.4	0.0	1.4	Accruals adjustments on receipts
35	-1.8	0.0	-1.8	0.0	-1.8	Other accruals adjustments
36	0.0	0.0	0.0	0.0	0.0	Miscellaneous financial transactions
37	**11.2**(4)	**-0.3**	**10.9**(4)	**0.0**	**10.9**	**Borrowing requirement**

(1) Current balance (line 21) = current receipts (line 11) - current expenditure (line 20).
Financial deficit (line 30) = capital expenditure (line 29) - capital receipts (line 22) - current balance (line 21).

(2) *On an accruals basis.*

(3) *Excluding local authorities' payments to central government and public corporations' payments to general government, which are in line 9.*

(4) *Own account borrowing.*

Historical series

4A.8 *Table 4A.6 sets out historical series for the public sector current balance, financial deficit and borrowing requirement, and the general government financial deficit. Table 4A.7 shows series for government receipts and expenditure.*

Table 4A.6 The budget deficit

			Per cent of money GDP	
	Public sector current balance	Public sector financial deficit	Public sector borrowing requirement	General(1) government financial deficit
1966-67	3 1/2	2 3/4	3	1/4
1967-68	3 1/4	4 1/4	5	1 3/4
1968-69	6	3/4	3/4	- 1/2
1969-70	8 1/4	-1 3/4	-1 1/4	-3
1970-71	7	- 1/2	1 1/2	-2 1/2
1971-72	4 1/2	1 1/4	1 3/4	- 1/2
1972-73	2 1/4	3	3 3/4	2
1973-74	1 1/4	4 3/4	6	3 1/2
1974-75	- 1/2	6 3/4	9	4 1/2

1975-76	-1 1/4	7 1/2	9 1/2	5
1976-77	- 3/4	5 3/4	6 1/2	4 1/2
1977-78	-1	4 1/2	3 1/2	3 1/2
1978-79	-2	5	5 1/2	4 1/4
1979-80	-1 1/4	4	4 3/4	3
1980-81	-2 3/4	5	5 1/4	4
1981-82	- 3/4	2 1/4	3 1/4	1 3/4
1982-83	-1 1/4	3	3 1/4	2 3/4
1983-84	-1 3/4	3 3/4	3 1/4	3 3/4
1984-85	-2 1/2	4 1/4	3	3 3/4
1985-86	- 3/4	2 1/4	1 1/2	2 1/2
1986-87	-1	2	1	2 1/2
1987-88	1/4	3/4	- 3/4	1
1988-89	2	-1 1/2	-3	-1
1989-90	2	- 1/2	-1 1/2	0
1990-91	1	3/4	0	1
1991-92	-1 1/4	3 1/4	2 1/4	3 1/4
1992-93	-5 1/4	7 1/2	6	7 1/2
1993-94	-6	7 3/4	7	7 3/4
1994-95	-4 1/2	6 1/4	5 1/4	6 1/4
1995-96	-3 1/4	5	4 1/2	5
1996-97	-2 3/4	4	3	4
1997-98	- 3/4	1 1/2	1 1/4	1 1/2
1998-99	1/2	1/2	1/2	1/4

1 GGFD on UK national accounts definition prior to 1997-98 and a Maastricht basis thereafter. See annex B for definitions.

Table 4A.7 Historical series for government expenditure and receipts

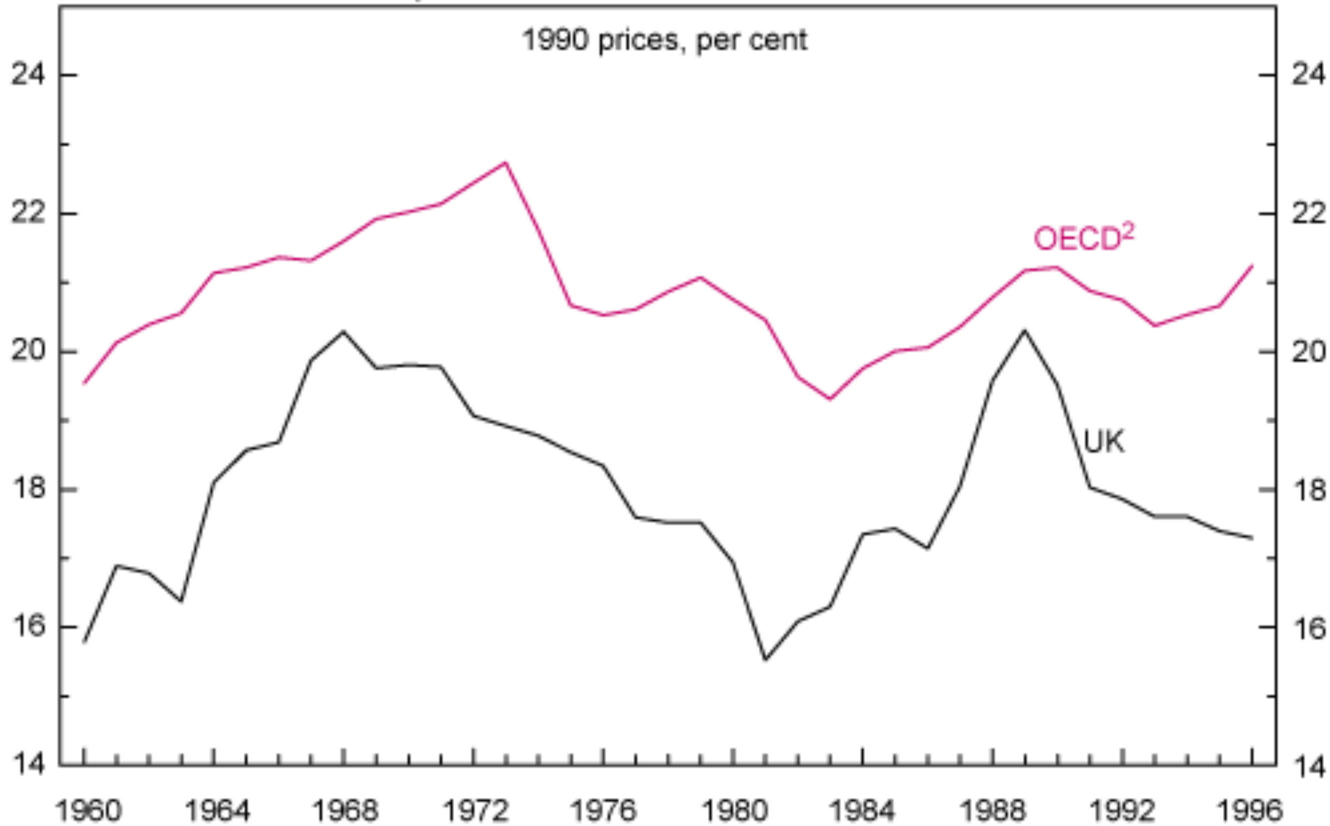
	Per cent of money GDP					
	Non-North Sea taxes and NICs(1)	Total taxes and NICs	General government receipts	Control Total(2)	GGE(X)	GGE
1966-67	32 1/2	32 1/2	36 1/4		38	39 1/2
1967-68	34	34	38		41 1/2	43 1/4
1968-69	35 3/4	35 3/4	40 3/4		40	41 1/2
1969-70	37 1/2	37 1/2	41 3/4		39 1/4	41
1970-71	37	37	40 1/4		39 1/2	41 1/4
1971-72	35 1/4	35 1/4	39 3/4		40	41 3/4
1972-73	33	33	38		39 3/4	41 1/2
1973-74	33 3/4	33 3/4	38 1/2		41 1/2	43 1/2
1974-75	36 1/4	36 1/4	40 1/2		46 3/4	48 3/4
1975-76	36 3/4	36 3/4	40 1/4		47 1/4	49 1/4
1976-77	36 1/2	36 1/4	41		44 3/4	46 3/4
1977-78	35 1/2	35 1/4	39 3/4		41 1/2	43
1978-79	34 3/4	34 1/4	38 3/4		42 1/4	44
1979-80	35 1/2	35 1/2	38 3/4		42 1/2	44
1980-81	36 1/2	36 3/4	40 3/4		44 3/4	46 1/2

1981-82	39	40	43 3/4		45 1/2	47
1982-83	38 1/2	39 1/2	43 3/4		45 1/2	47 1/4
1983-84	38 1/4	39	43		44 3/4	46 1/4
1984-85	38	39 3/4	43 1/2	38 3/4	45 1/4	46 1/4
1985-86	37 1/4	38 3/4	42 1/4	36 1/4	43 1/4	44 1/4
1986-87	37 3/4	38 1/4	41 1/2	35 1/4	42 1/4	42 3/4
1987-88	37 1/2	38	41	34 3/4	40 1/2	40 3/4
1988-89	37	37 1/4	40 1/4	32 3/4	38	37 3/4
1989-90	37 1/4	37	40 1/4	33 3/4	38 1/4	38 3/4
1990-91	37	37	39 1/4	34 3/4	39	39 1/4
1991-92	36 3/4	36 1/4	38 1/4	36 3/4	41	40 3/4
1992-93	34 1/2	34 1/4	36 3/4	38 1/4	43 1/2	43
1993-94	34	33 3/4	36	37 1/2	43 1/4	43 1/4
1994-95	35 1/4	35	37	36 1/2	42 3/4	42 1/2
1995-96	36	35 3/4	38	36	41 1/4	42 3/4
1996-97	36	35 3/4	38	34 3/4	41	41 1/4
1997-98	37	37	38 3/4	33 1/2	39 1/2	40
1998-99	37 1/2	37 1/2	39	32 3/4	38 3/4	39 1/2

1 As a percent of non-North Sea GDP

2 Figures for the Control Total are only available on a consistent basis since 1984-85.

Chart 3.9: Whole economy investment-GDP ratio[1]



[1]GDP at constant market prices.

[2]Source: OECD Quarterly National Accounts.

Chart 3.10: Business investment-GDP ratio[1,2]

[1]GDP at constant market prices.

[2]Business investment includes investment by public corporations (except National Health Service Trusts) and investment under the Private Finance Initiative.

Chart 3.11: Whole economy stock-output ratio

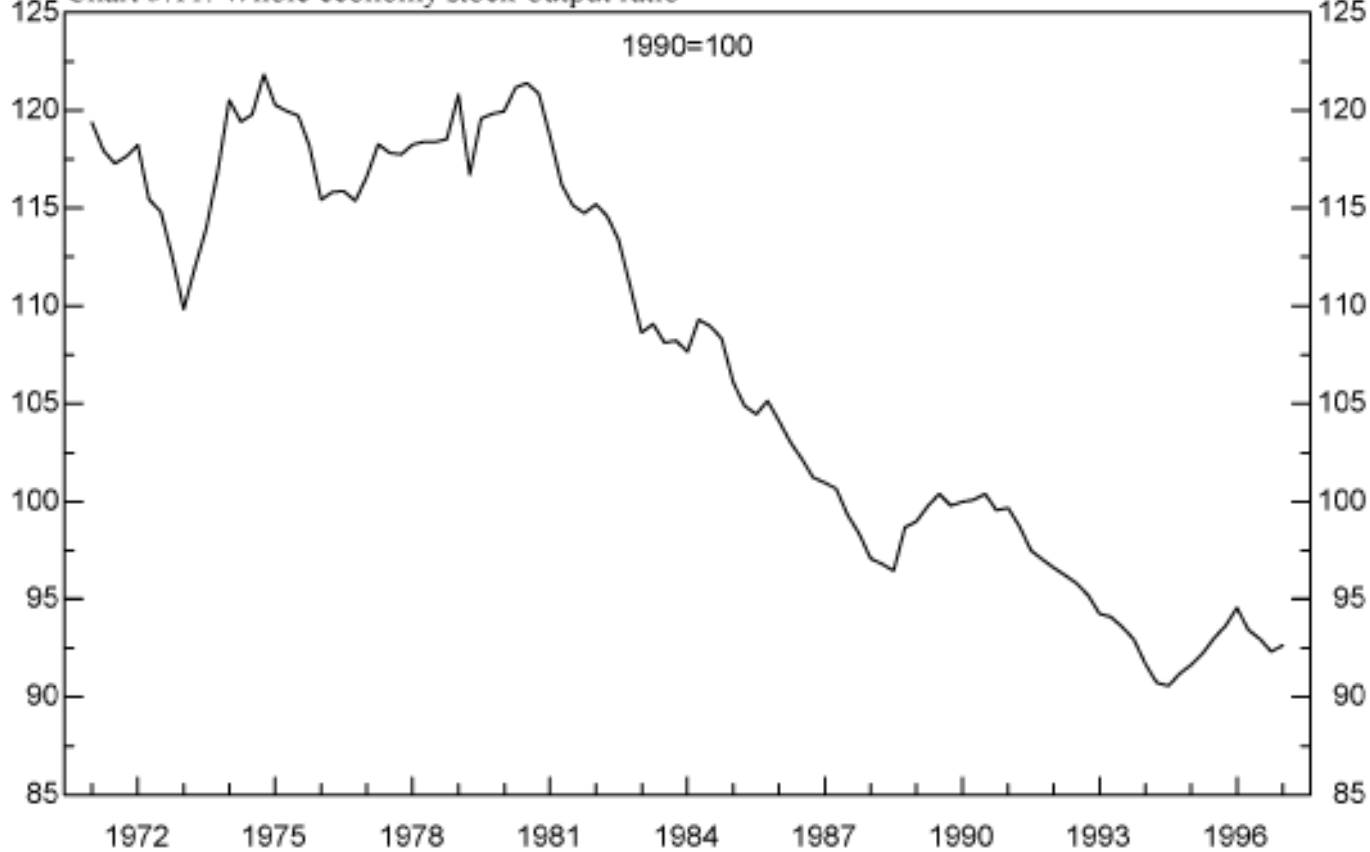


Chart 3.12: Stockbuilding and its contribution to GDP growth

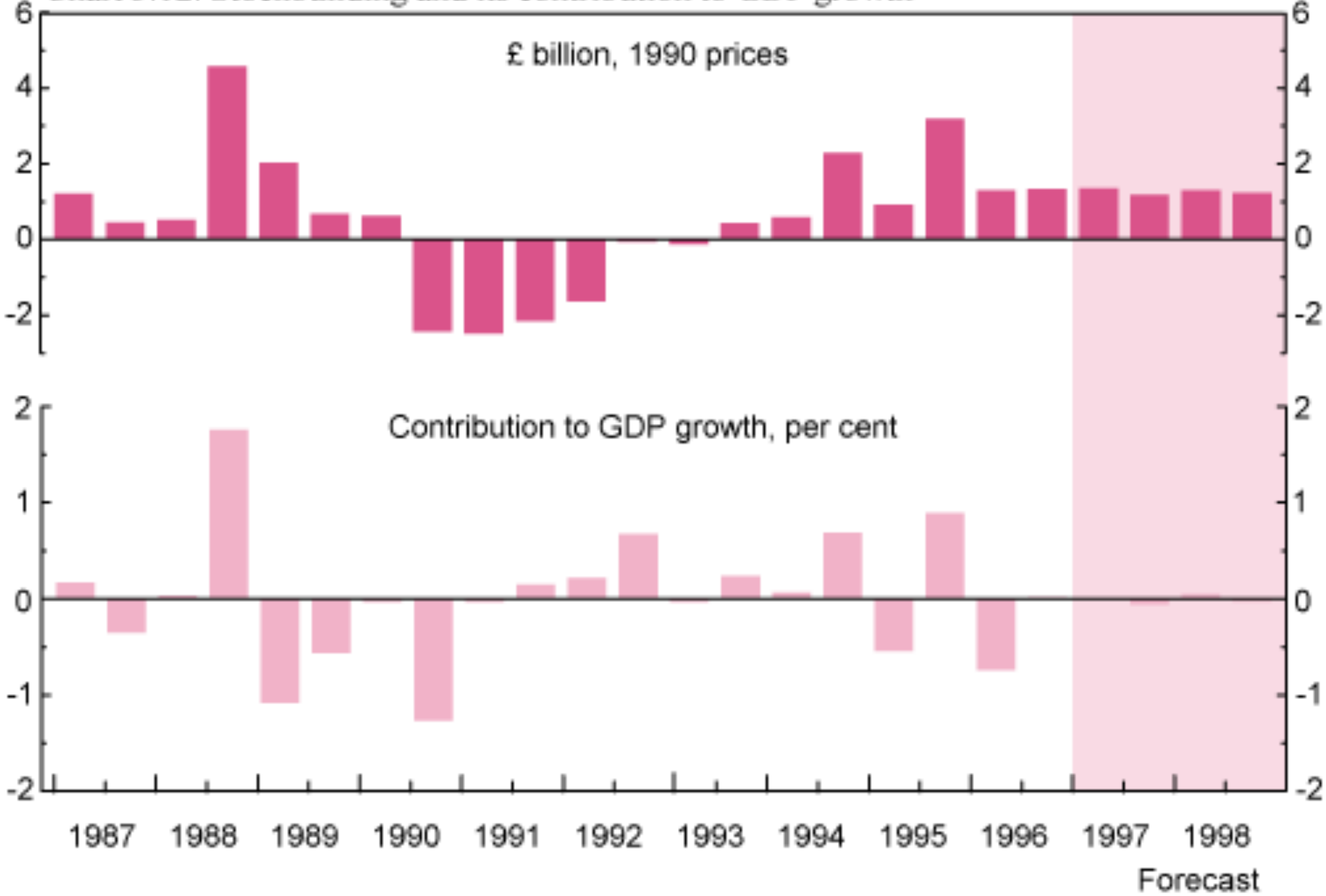
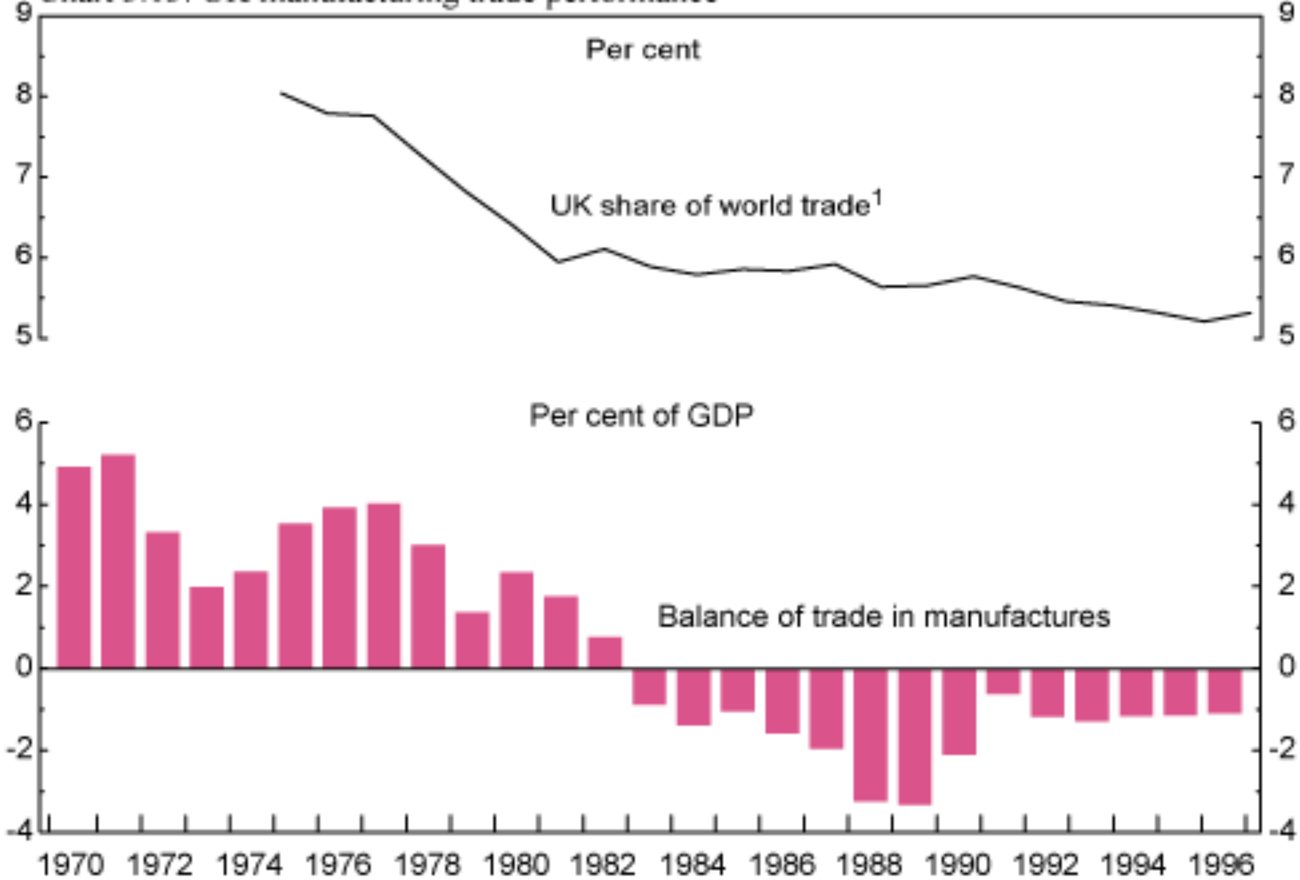


Chart 3.13: UK manufacturing trade performance



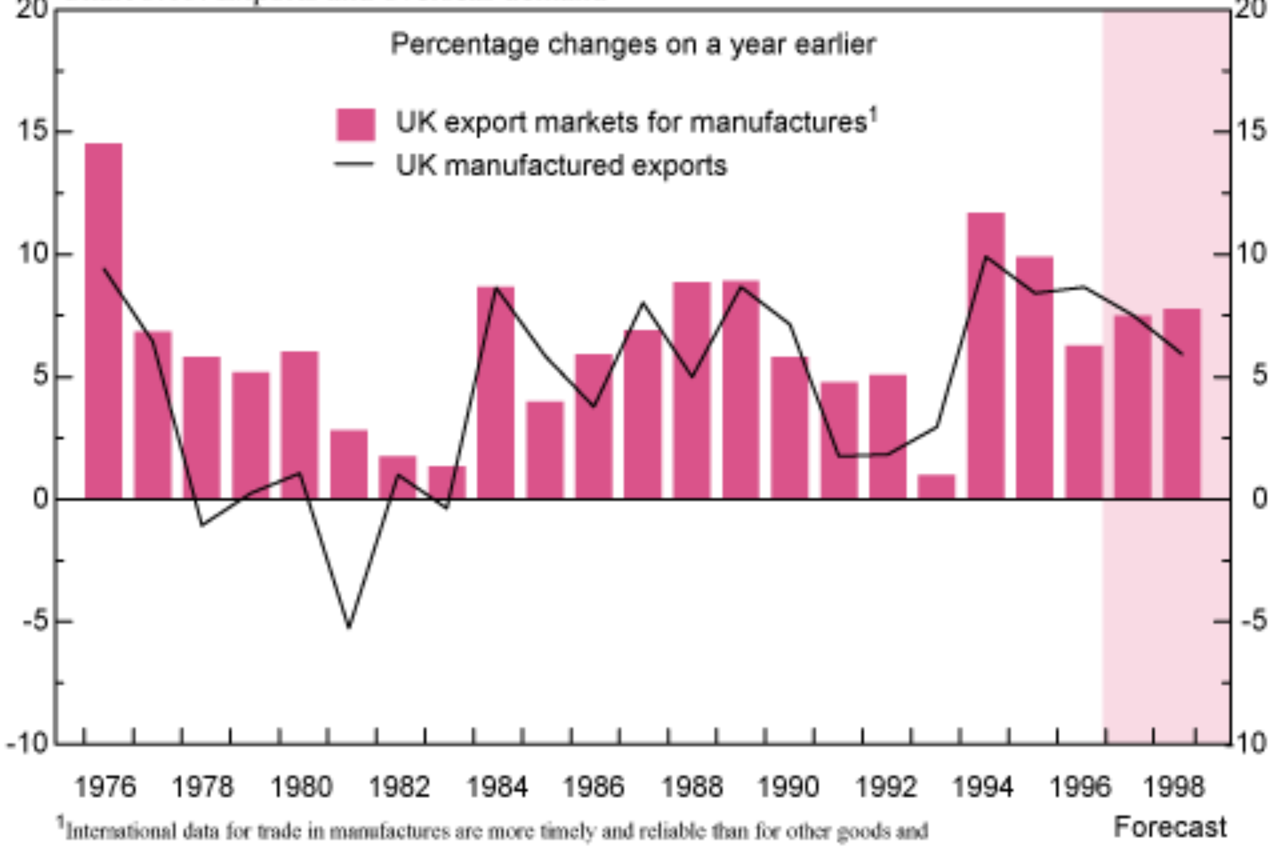
[1]UK manufactured export volumes as a percentage of world trade in manufactures. Series calculated from OECD data.

Chart 3.14: Relative cost and export price competitiveness[1]

[1]A fall means competitiveness has improved.

[2]Against major 15 industrial countries.

Chart 3.15: Exports and overseas demand



[1]International data for trade in manufactures are more timely and reliable than for other goods and services.

Chart 3.16: Imports and total final expenditure

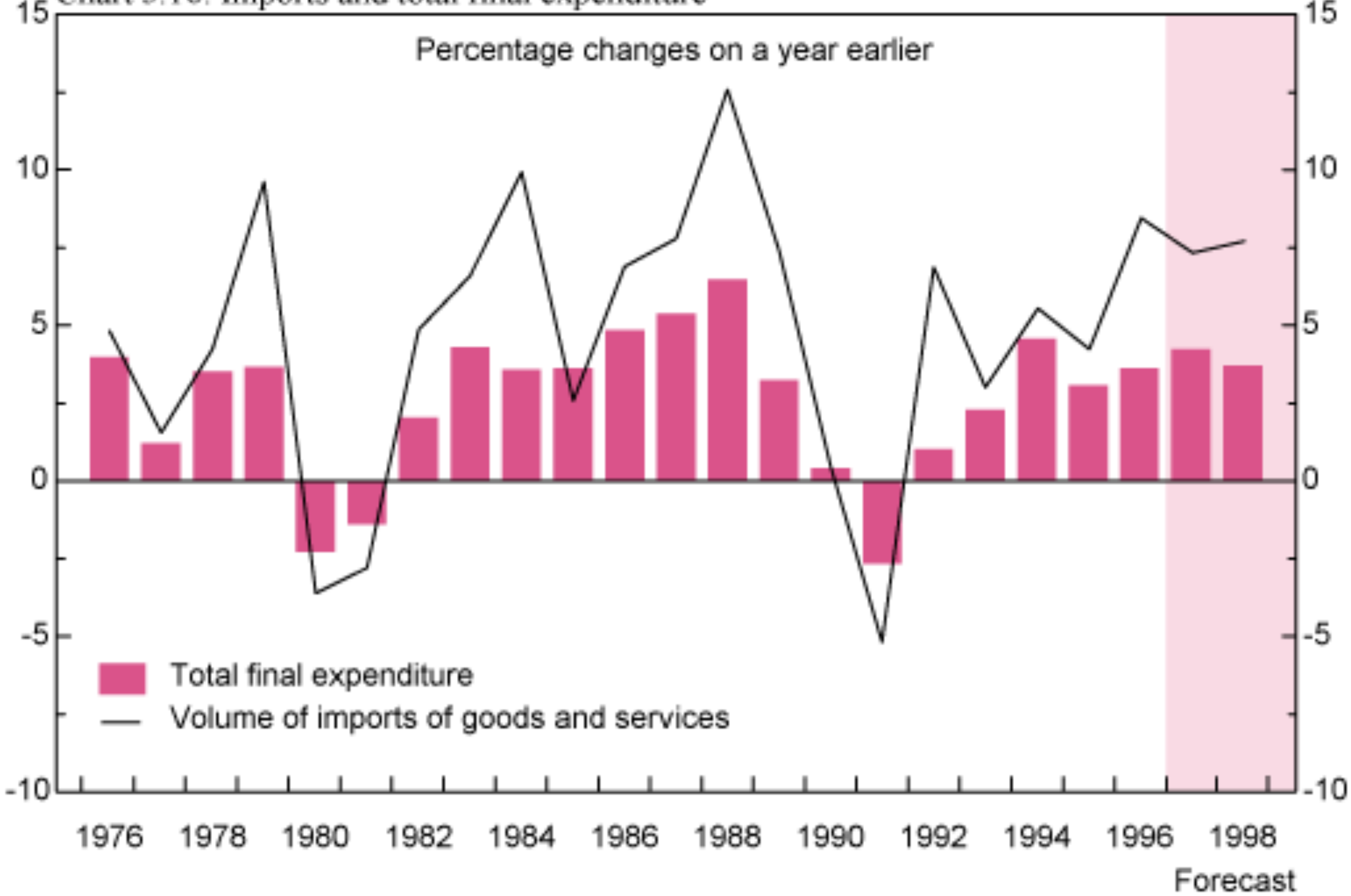


Chart 3.17: Current account

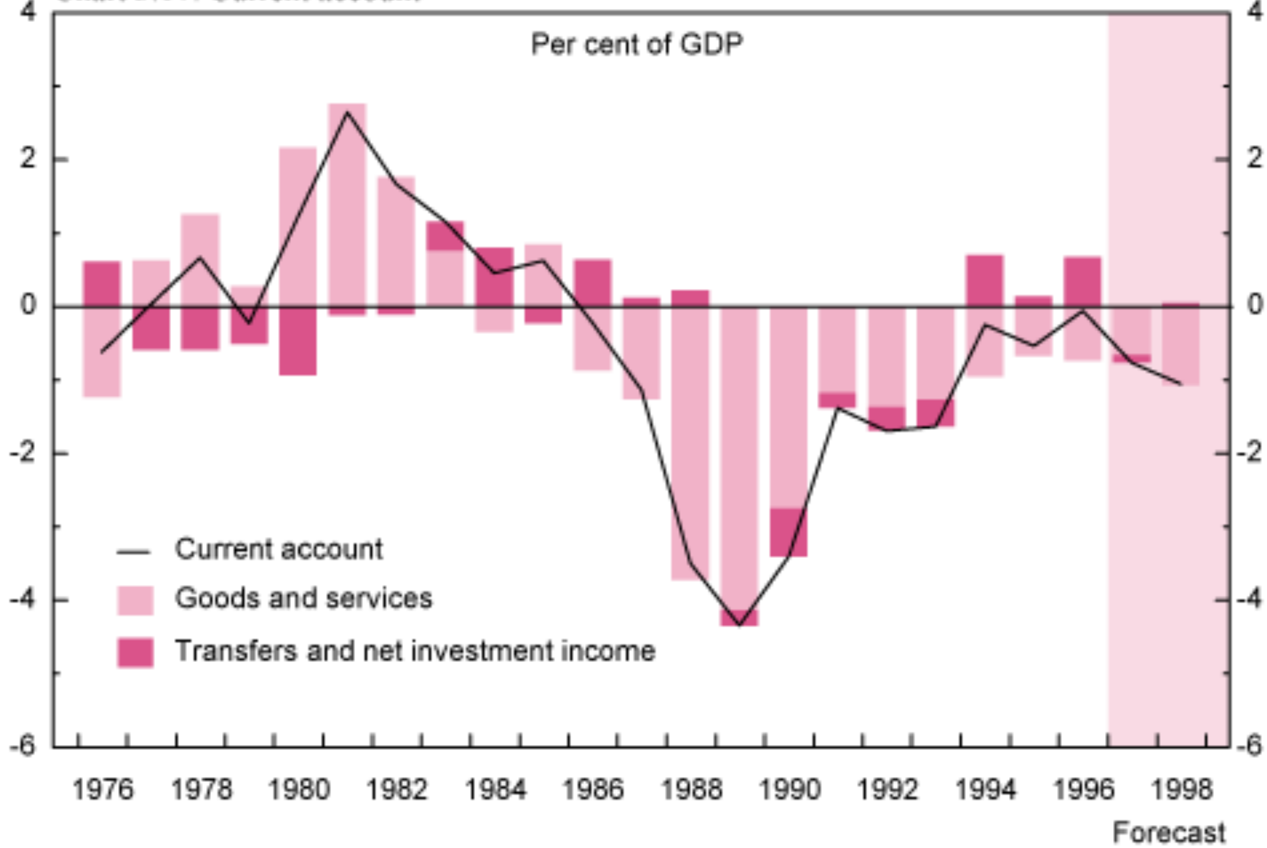


Chart 3.18: Financial balances and the current account

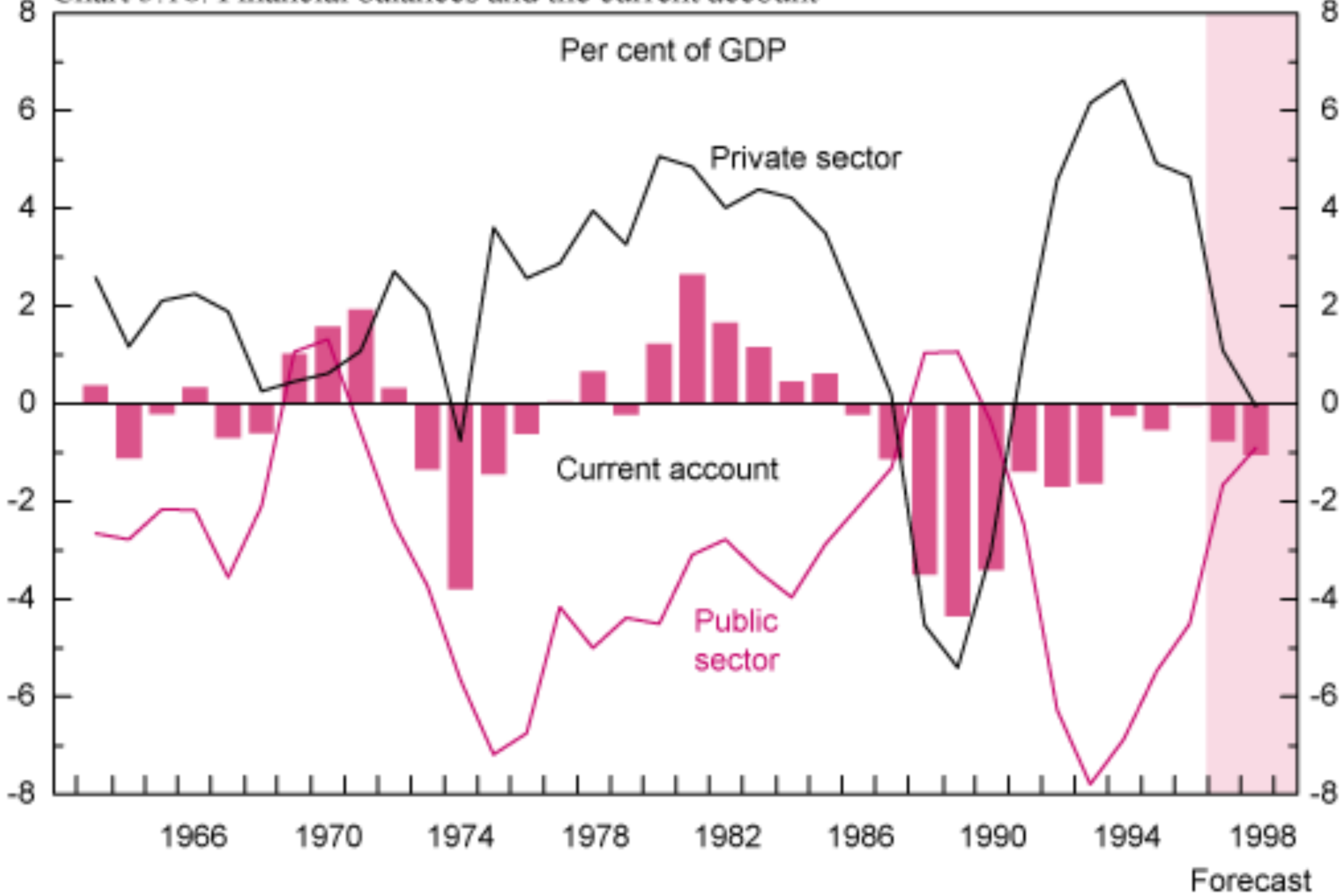
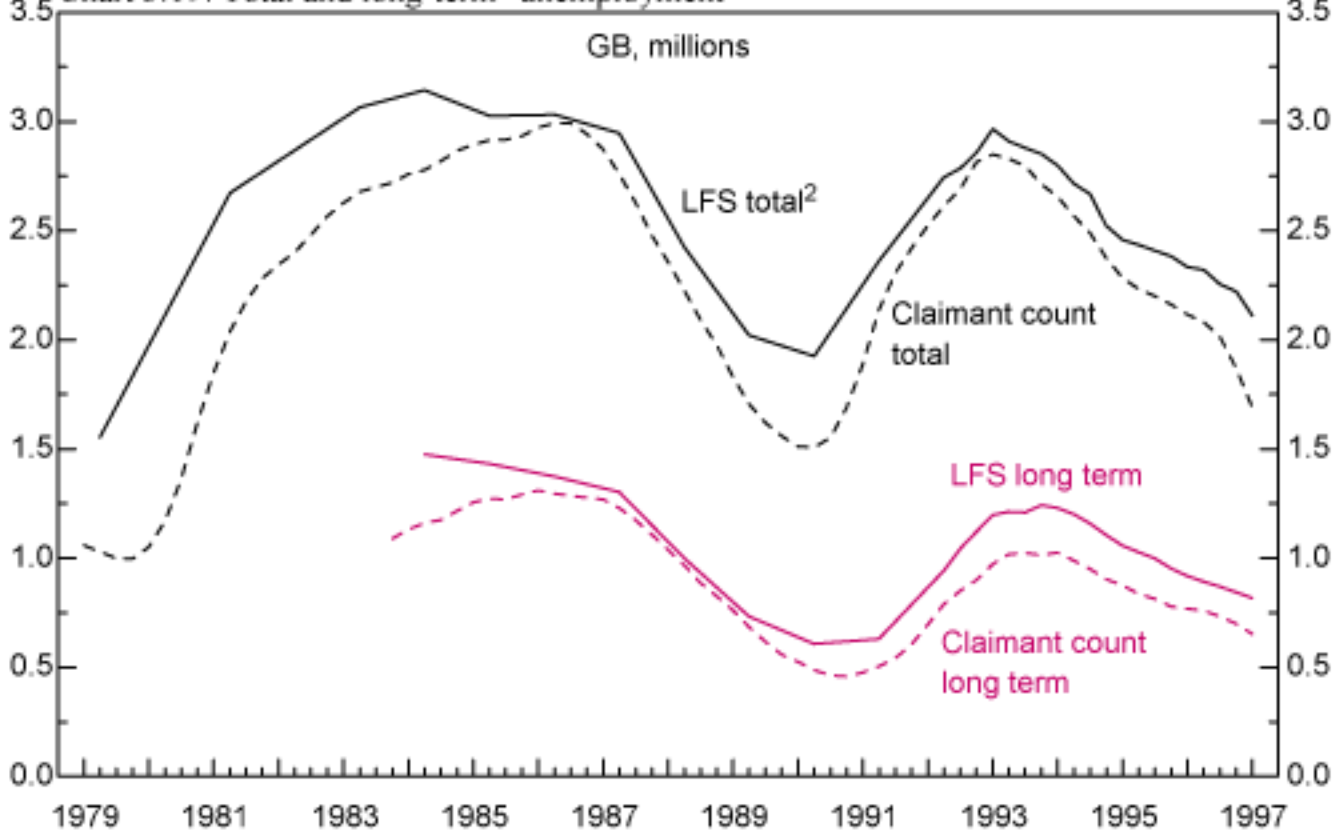


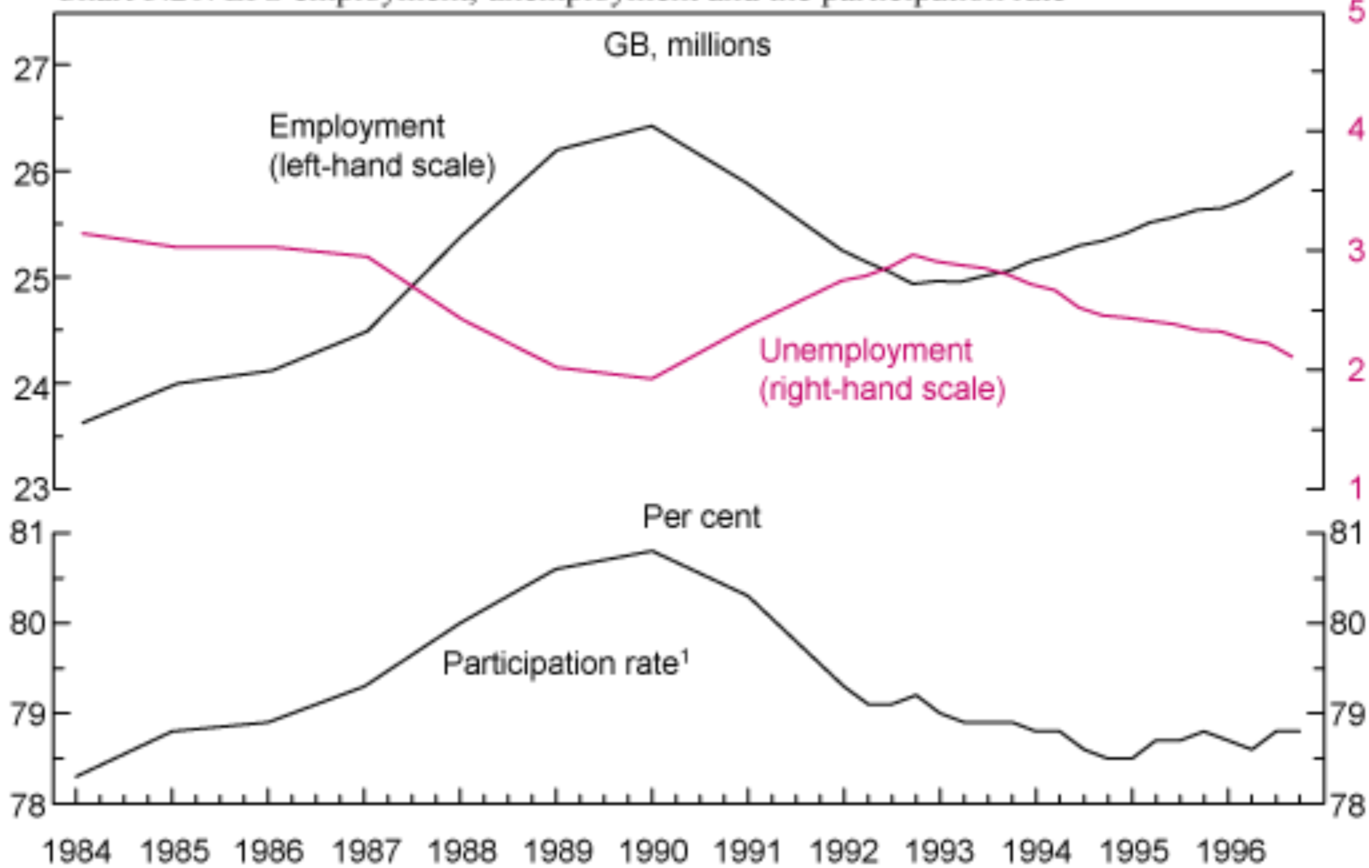
Chart 3.19: Total and long-term[1] unemployment



[1] 12 months or more.

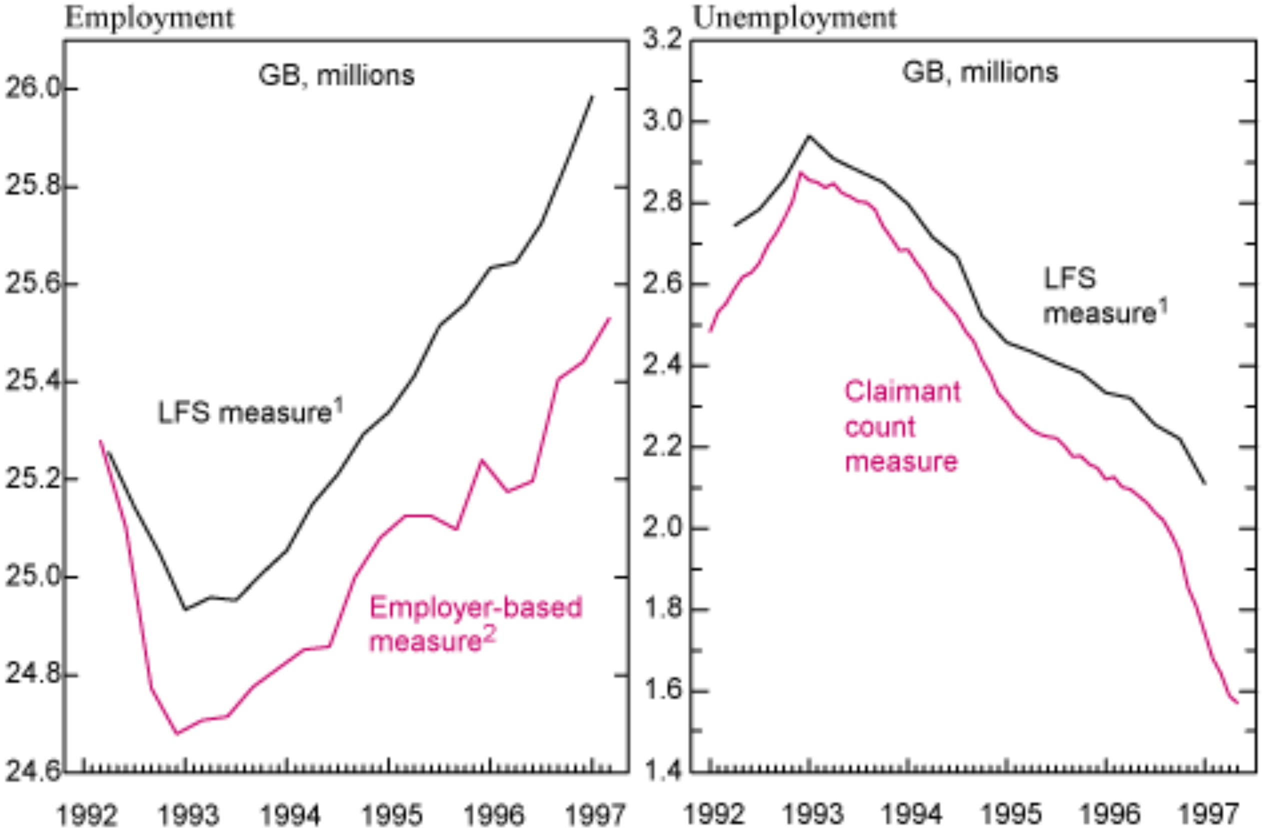
[2] LFS data for spring 1979, 1981 and 1983 adjusted for break in series in spring 1984.

Chart 3.20: LFS employment, unemployment and the participation rate



1Percentage of the population of working age who are economically active (i.e. employed or unemployed).

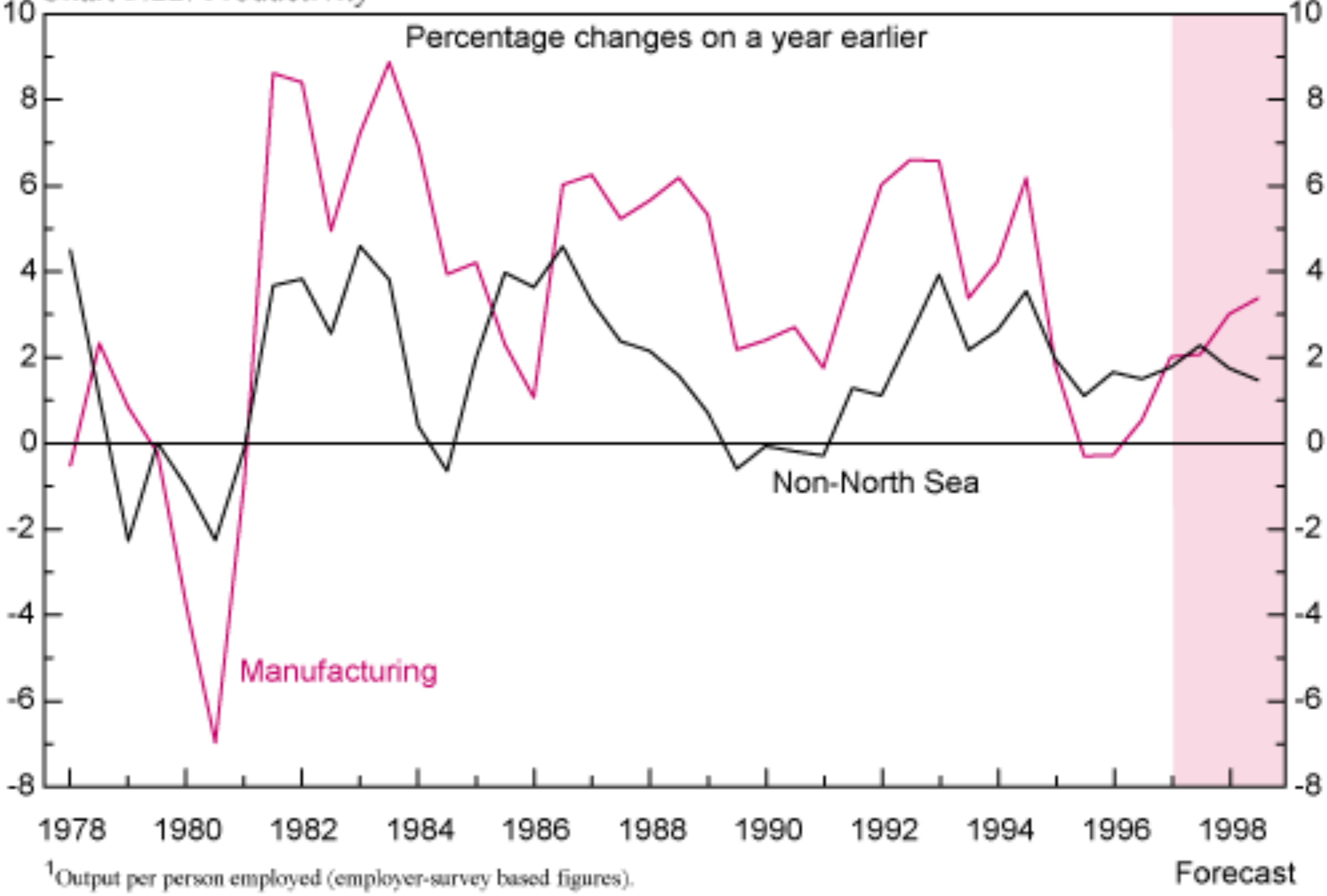
Chart 3.21: Employment and unemployment



[1] LFS data recorded against central month of each LFS quarter. LFS winter quarter refers to December to February, spring to March to May, etc.

[2] GB workforce in employment.

Chart 3.22: Productivity[1]



[1]Output per person employed (employer-survey based figures).

Chart 3.23: Sterling effective exchange rate index

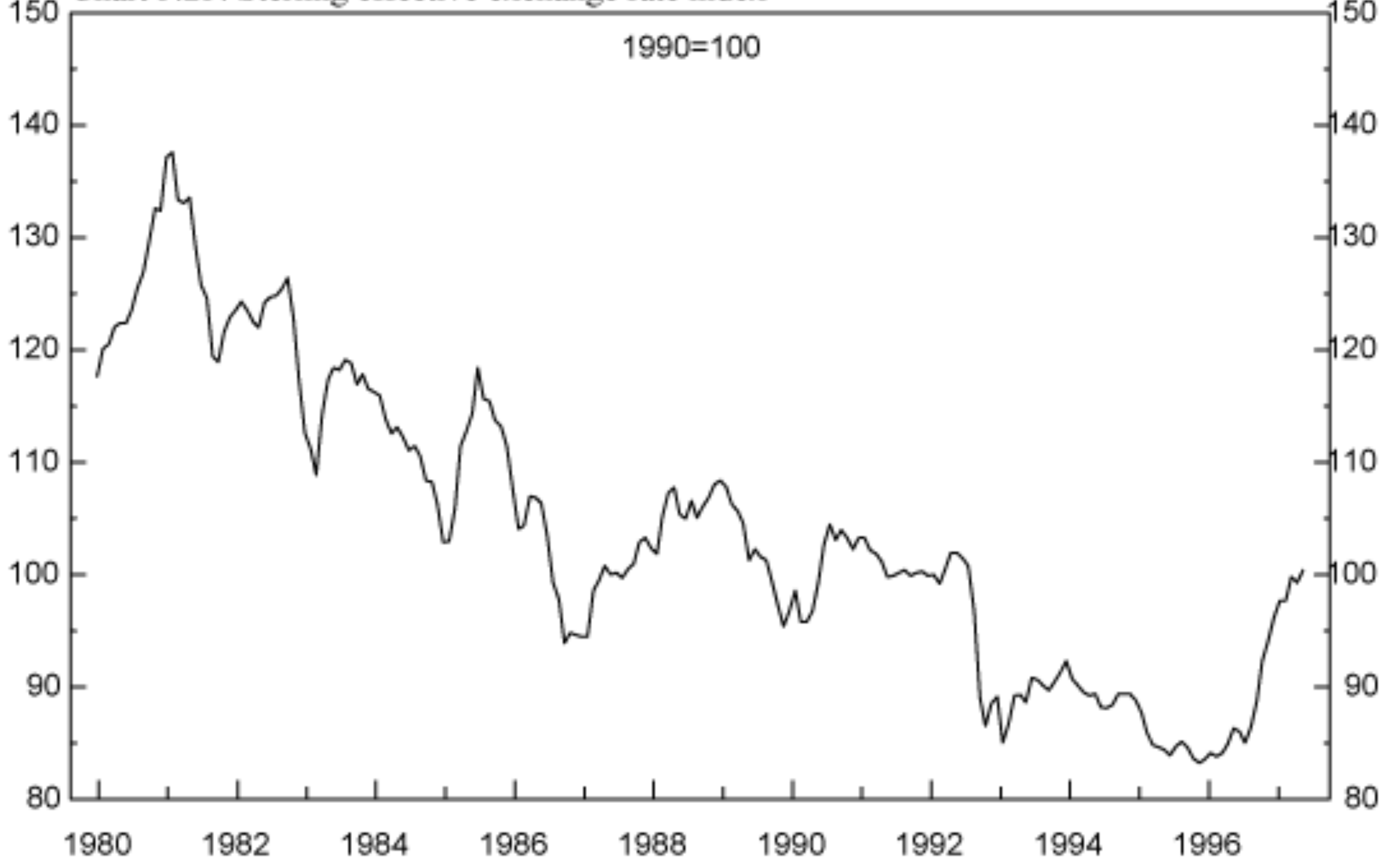


Chart 3.24: UK interest rates

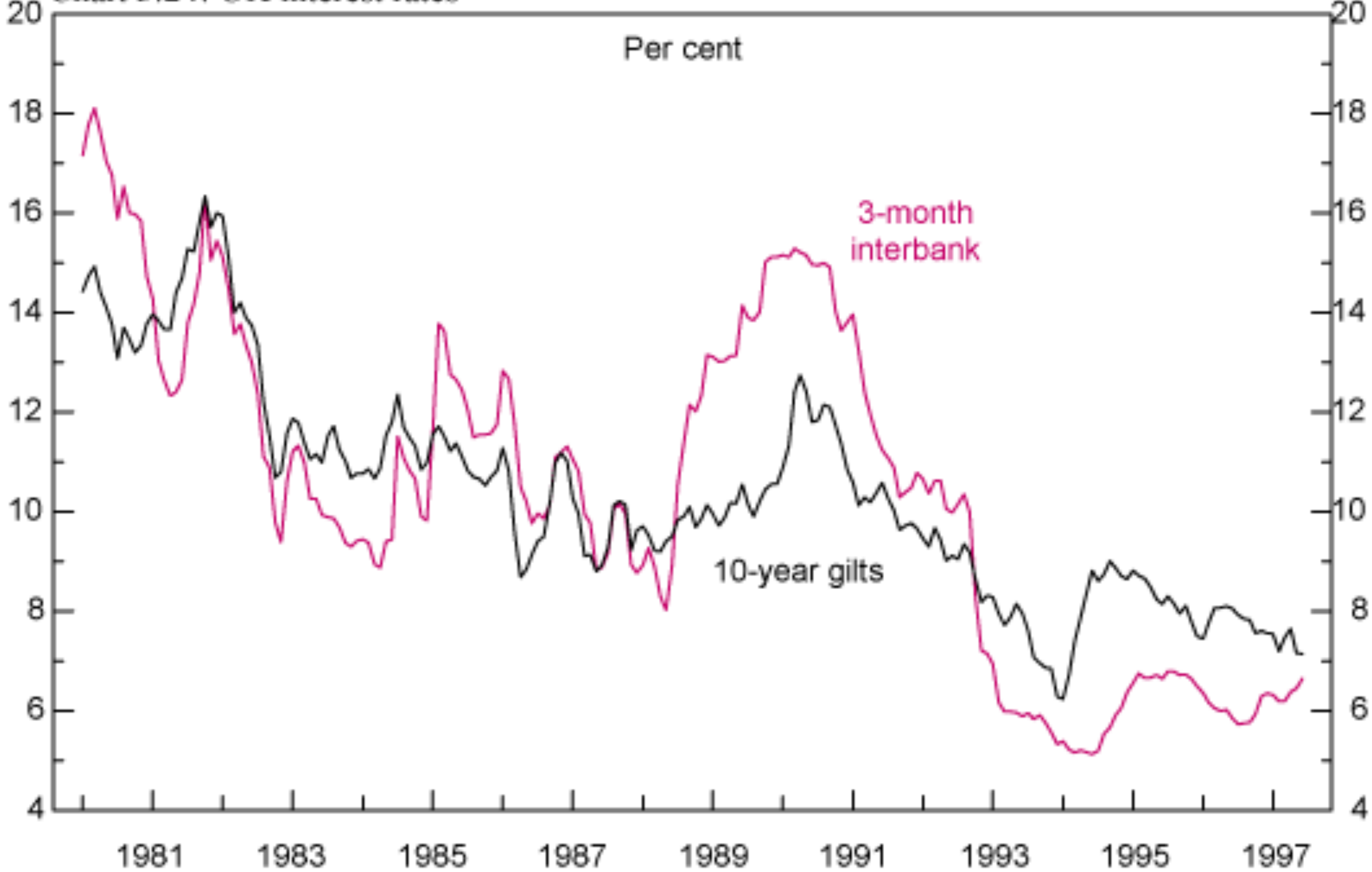


Chart 3.25: Monetary indicators

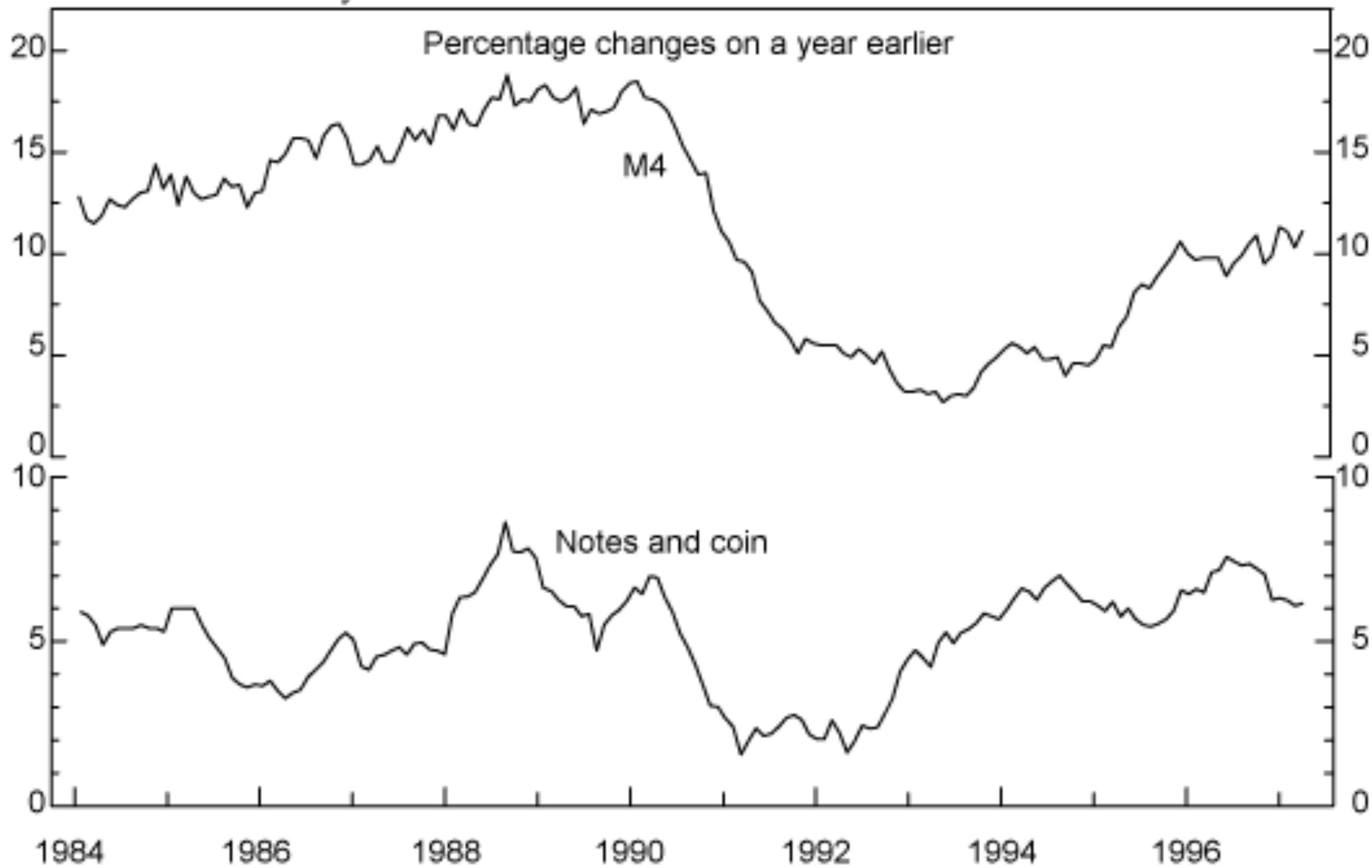
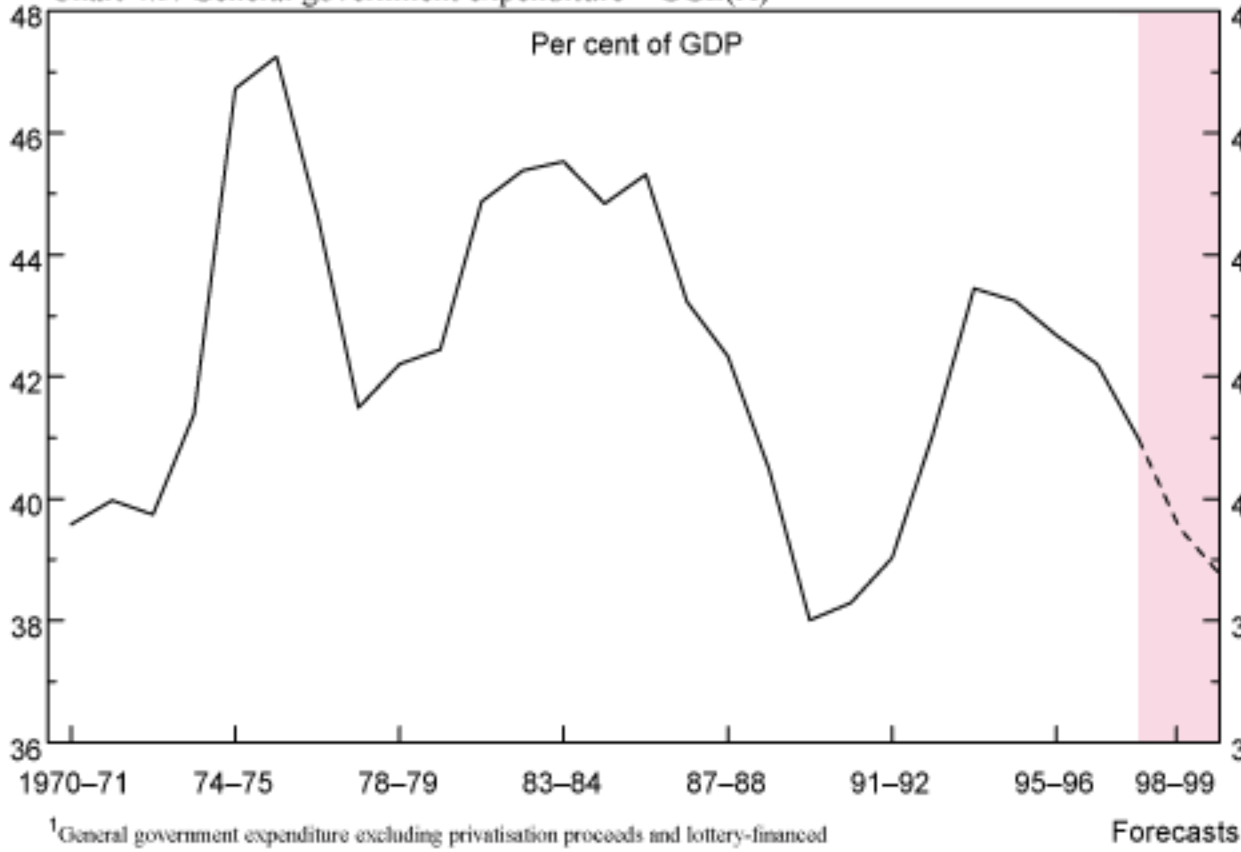
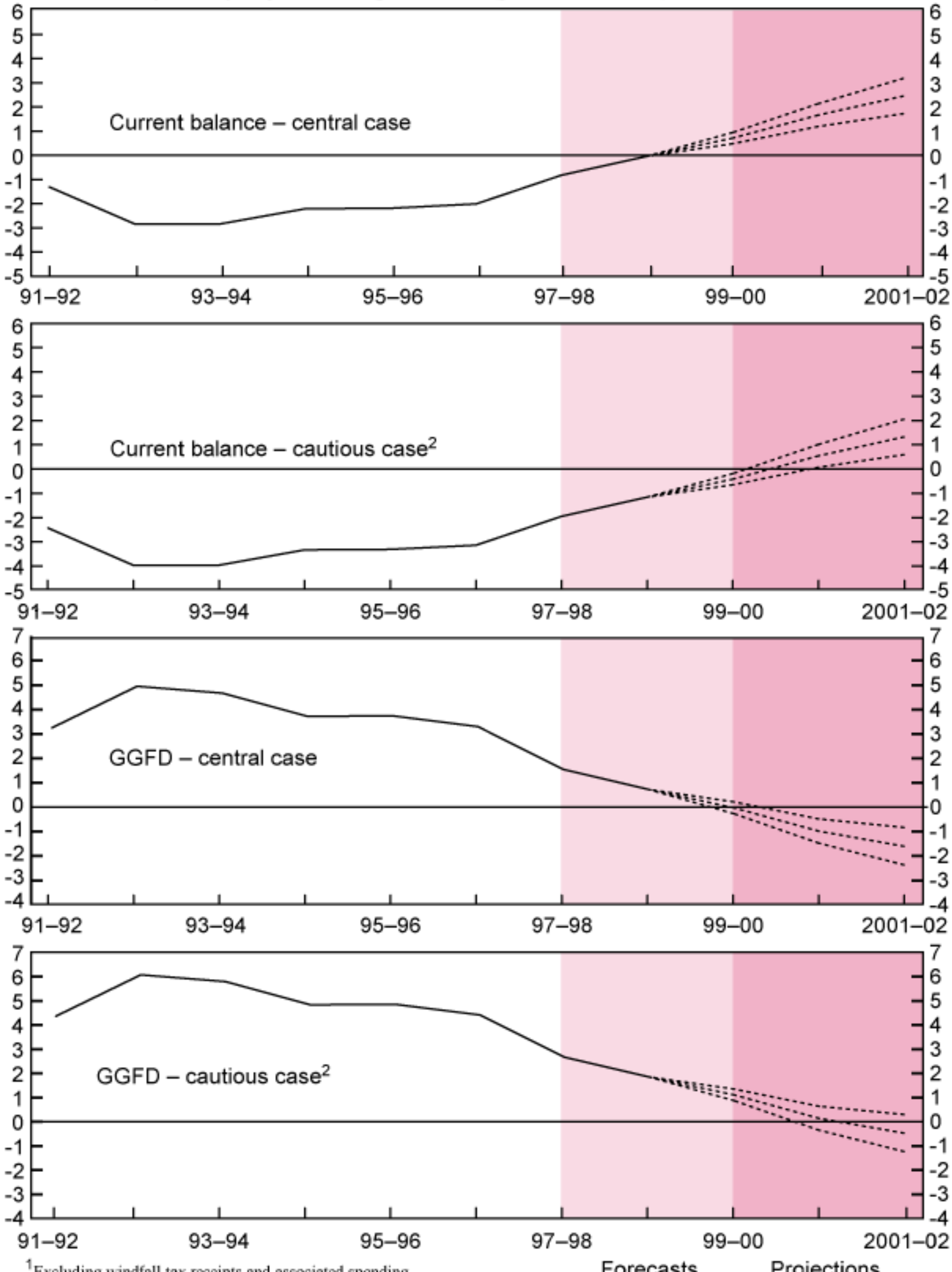


Chart 4.5: General government expenditure – GGE(X)[1]



[1]General government expenditure excluding privatisation proceeds and lottery-financed spending, and net of interest and dividend receipts.

Chart 4.7: Cyclically-adjusted budget deficit[1] (per cent of GDP)



[1]Excluding windfall tax receipts and associated spending.

[2]Assuming output gap is $1^1/_2$ per cent higher than the central case.