BUDGET 2001

Investing for the Long Term: Building Opportunity and Prosperity for All

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Economic and Fiscal Strategy Report and Financial Statement and Budget Report March 2001

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Overview

Budget 2001, *Investing for the Long Term: Building Opportunity and Prosperity for All*, comprises the Economic and Fiscal Strategy Report (EFSR) and the Financial Statement and Budget Report (FSBR).

The EFSR describes:

- **the comprehensive strategy which the Government is pursuing to meet its economic objectives;**
- **the progress that has been made so far; and**
- **how Budget 2001 takes further steps to meet the Government's objectives.**

The FSBR provides:

- **a summary of each of the main Budget measures; and**
- **updated forecasts for the economy and the public finances.**

INTRODUCTION

1.1 The Government's central economic objective is to raise the economy's sustainable rate of growth, and achieve rising prosperity, through creating economic and employment opportunities for all.

1.2 Over the past four years the Government has built a platform of economic stability, rejecting the short termism of the past which resulted in successive cycles of boom and bust. Instead it has locked in the stability that is the essential pre-condition to achieving high and stable levels of growth and rising prosperity. Through a prudent approach to policy making and taking tough decisions, the Government has been able to allocate more resources to the nation's priorities – families, children, pensioners, enterprise and public services.

1.3 By locking in the tough fiscal stance set out in Budget 2000 and the Pre-Budget Report, Budget 2001 maintains the right conditions for continued economic stability and underpins the planned expansion of key public services over the next three years, while taking further steps to meet the Government's long-term economic goals (see Box 1.1). The Budget includes targeted tax cuts to reward work and enterprise and to provide support for families, savers and pensioners. As a result of continued prudent management of the public finances, it is also able to allocate an additional £2$^{1}/_{3}$ billion over the next three years to health, education and tackling drugs and drug-related crime.

1.4 Full details of the Government's economic strategy are set out in the Pre-Budget Report. The EFSR follows the same structure as the Pre-Budget Report, describing the Government's strategy for:

- delivering macroeconomic stability;
- meeting the productivity challenge;
- increasing employment opportunity for all;
- ensuring fairness for families and communities; and
- protecting the environment.

Box 1.1: Meeting the Government's long-term economic goals

In working to deliver its central economic objective of high and stable levels of growth and employment, the

Government has set five key long-term economic goals:

- **raising productivity: that over the next decade, Britain will have a faster rise in productivity than its main competitors as it closes the productivity gap;**
- **increasing employment opportunity for all: that by the end of the decade, there will be a higher percentage of people in employment than ever before;**
- **providing educational opportunity for all: that by the end of the decade, and for the first time, the majority of the UK's young people can expect to go on from school or college into higher education;**
- **abolishing child poverty: that by the end of the decade, child poverty will be halved as the Government moves forward with its commitment to abolish child poverty within 20 years; and**
- **delivering strong and dependable public services: with sustainable increases in spending on the Government's priorities of education, health, transport and tackling crime.**

DELIVERING MACROECONOMIC STABILITY

1.5 Chapter 2 describes the Government's macroeconomic policy framework and shows how it is delivering economic stability. It summarises the prospects for the UK economy and the public finances, full details of which are set out in Chapters B and C of the FSBR.

The policy framework

1.6 The Government's first economic priority when coming into office in 1997 was to deliver stability for the long term. It therefore moved quickly to put in place a new macroeconomic policy framework, based on the principles of transparency, responsibility and accountability. The Bank of England's Monetary Policy Committee was given operational independence to set interest rates to deliver the Government's inflation target, while a new fiscal policy framework underpinned by two strict fiscal rules was introduced to deliver sound public finances. A new public spending framework, integrated into the fiscal framework, provides for better long-term planning and places a greater focus on the quality of public service provision and the outcomes achieved.

1.7 Under this new macroeconomic framework, the economy has experienced a period of stability and steady growth. Employment has risen to record levels and both inflation and interest rates have been lower and more stable than in the past. The large structural deficit the Government inherited has been tackled, returning the public finances to a sustainable position.

The economy

1.8 The UK economy grew by 3 per cent last year, in line with the Government's forecasts, while RPIX inflation averaged just over 2 per cent and unemployment fell to its lowest levels since the 1970s. The Budget 2001 forecast shows that:

- **GDP** is expected to increase by $2^1/_4$ to $2^3/_4$ per cent a year over the next three years, unchanged from the Pre-Budget Report forecast. Weaker than previously expected external demand will be offset by stronger momentum in domestic spending;
- **RPIX inflation** is forecast to rise gradually back to the $2^1/_2$ per cent target by spring 2002; and
- clear **risks** to US growth make the overall outlook more uncertain. But with sound public finances and low inflation, policy is well placed to respond to adverse news.

The public finances

1.9 Fiscal outturns have been better than expected over the past year. The surplus on current budget is now expected to be £23.1 billion in 2000–01, compared with a forecast of £14 billion at the time of Budget 2000. A similar improvement is expected for public sector net borrowing.

1.10 This improvement over the past year largely appears to have been structural, reflecting non-discretionary improvements in both tax receipts and spending which feed through into future years.

1.11 The upward revisions in the forecast include further improvements on top of those identified in the Pre-Budget Report interim forecast. Since November, the forecast for income tax receipts for 2000–01 has been revised upwards by over £3 billion, reflecting buoyant
Self-Assessment and PAYE receipts, which largely carry forward into future years. There have also been further non-

discretionary savings in Annually Managed Expenditure (AME) in addition to those identified in the Pre-Budget Report forecast. In particular, debt interest payments are forecast to be £1½ billion lower in 2001–02 than expected in November as a result of lower inflation and lower interest rate expectations, and £½ billion a year lower thereafter as a result of lower interest rate expectations.

1.12 These structural improvements in the public finances have enabled additional discretionary changes in Budget 2001, including:

- a £1.1 billion a year package of further support for families and children;
- a £½ billion a year package of measures on maternity and paternity pay;
- a cut in income tax through a widening of the 10 pence band by £300 over and above inflation, at a cost of around £1 billion a year benefiting around
  25 million taxpayers; and
- an additional £2⅓ billion of spending over the next three years, comprising an extra £1 billion for education, £1 billion for health and £⅓ billion for fighting drugs and drug-related crime.

1.13 In addition, the Government has drawn down the savings in AME that were allocated to the AME margin at the time of the Pre-Budget Report. This frees up resources for the implementation of Pre-Budget Report consultation measures.

1.14 Taking account of all these factors, the fiscal stance – as measured by cyclically-adjusted public sector net borrowing – is at least as tight as set out in Budget 2000 and the Pre-Budget Report throughout the next five years.

Meeting the fiscal rules

1.15 The surplus on current budget is projected to decline from 2.4 per cent of GDP in 2000– 01 to 0.8 per cent of GDP over the forecast period. On a cyclically-adjusted basis, the surplus on current budget remains positive throughout the forecast period leaving the Government on track to meet the golden rule, including in the cautious case.

1.16 Net debt is projected to decline from 31.8 per cent of GDP at the end of March 2001 to 30.3 per cent of GDP at the end of March 2002, thereafter remaining around 30 per cent of GDP.

1.17 As required by the *Code for Fiscal Stability*, Annex A of the EFSR presents illustrative long-term fiscal projections and examines the long-term sustainability of the public finances. The projections indicate that the UK has a broadly sustainable fiscal position in the long term.

Table 1.1: Fiscal balances comparison with Budget 2000 and PBR 2000[1]

	Outturn[2] 1999–00	Estimate 2000–01	2001–02	2002–03	Projections 2003–04	2004–05	2005–06
Surplus on current budget (£ billion)							
Budget 2000	17.1	14	16	13	8	8	–
PBR 2000	19.4	16.6	16	14	8	8	8
Budget 2001	**19.2**	**23.1**	**17**	**15**	**8**	**9**	**9**
Net borrowing (£ billion)							
Budget 2000	–11.9	–6	–5	3	11	13	-
PBR 2000	–16.4	–10.1	–6	1	10	12	13
Budget 2001	**–16.0**	**–16.4**	**–6**	**1**	**10**	**11**	**12**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2000	1.8	1.3	1.3	1.0	0.7	0.7	–
PBR 2000	1.9	1.5	1.4	1.1	0.6	0.7	0.7
Budget 2001	**1.9**	**2.1**	**1.4**	**1.1**	**0.6**	**0.7**	**0.7**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2000	–1.2	–0.5	–0.3	0.5	1.1	1.1	–

PBR 2000	–1.6	–0.8	–0.3	0.3	1.1	1.1	1.1
Budget 2001	**–1.6**	**–1.4**	**–0.3**	**0.3**	**1.1**	**1.1**	**1.1**
Public sector net debt[3] (per cent of GDP)							
Budget 2000	37.1	35.1	33.6	32.7	32.6	32.6	–
PBR 2000	36.8	32.3	30.9	30.1	30.2	30.3	30.4
Budget 2001	**36.8**	**31.8**	**30.3**	**29.6**	**29.7**	**29.9**	**30.0**

[1] *Excluding windfall tax receipts and associated spending.*

[2] *The 1999–2000 figures were estimates in Budget 2000.*

[3] *Including windfall tax receipts and associated spending.*

MEETING THE PRODUCTIVITY CHALLENGE

1.18 Raising the UK's productivity performance is a key route to higher prosperity and living standards. Chapter 3 describes the action which the Government has already taken and the further steps it is taking in Budget 2001 to meet its goal of achieving a faster rise in productivity than in the UK's major competitor countries over the next decade, to help close the productivity gap which currently exists with other major economies.

Measures so far

1.19 To develop its strategy on productivity, the Government has identified five priority areas for action – the five drivers of productivity growth – and has taken significant steps forward in each of these areas, including:

- **competition:**strengthened powers for the Office of Fair Trading under the new Competition Act which came into force last year and investigations into competition in particular markets, including a review of retail banking;
- **enterprise and innovation:** major reforms to capital gains tax, permanent 40 per cent first year capital allowances for small and medium-sized enterprises (SMEs), a new All-Employee Share Ownership Plan and an Enterprise Management Incentive for small firm employee share options, an R&D tax credit for SMEs and action to promote enterprise and innovation across every region of the country through the work of the Regional Development Agencies and the Small Business Service;
- **investment:** reducing corporation tax rates, the introduction of a new 10 pence rate for the smallest companies, launching a review of institutional investment in the UK, measures to stimulate more private investment in under-invested communities and a planned doubling of public sector net investment by 2003–04;
- **skills:** substantial extra resources for education to raise standards in primary and secondary schools, additional funding for places in higher education, a focus on lifelong learning through learndirect and Individual Learning Accounts and changes to work permit arrangements; and
- **public sector productivity:** a greater focus on outcomes for public service delivery through Public Service Agreements, Departmental Investment Strategies to improve public sector investment, the Public Services Productivity Panel to help the public sector to innovate and deliver change, and the creation of the Office of Government Commerce to deliver more efficient procurement across government.

Budget measures

1.20 Budget 2001 sets out additional measures to raise productivity, promote enterprise in every region of Britain and support the implementation of regional economic strategies:

- full financial flexibility for **Regional Development Agencies (RDAs)** from 2002–03, including full end-year flexibility to carry over their resources from one year to the next, matched by increased accountability through objectives and targets for meeting their strategic goals;
- a package of measures to **help small businesses**, including the implementation of the Pre-Budget Report proposals to reduce the impact of VAT on small businesses, and also consultation on proposals to simplify the way in which small businesses are required to calculate tax due on their profits;
- an expansion of **Enterprise Management Incentives (EMIs)**, going further than the option set out in the Pre-Budget Report by abolishing the 15 employee limit from April 2001 and replacing it by a £3 million per company limit on

the total value of shares under EMI option – double the current company limit;

- consultation on a new **tax credit for community investment**, to encourage private investment in enterprises in disadvantaged communities;
- consultation on proposals for a new **tax credit to boost R&D and innovation by large firms**, to complement the R&D tax credit for small firms;
- an independent study aimed at enhancing the supply of **highly-qualified scientists and engineers** in the UK;
- taking forward all the recommendations of the Myners **review of institutional investment;**
- replacement of the **Minimum Funding Requirement** with a long-term scheme-specific funding standard; and
- examining the need for further action – including from Government – to address the low level of **skills in the workforce**.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.21 The Government is committed to creating employment opportunity for all – the modern definition of full employment. It has set the goal that, by the end of the decade, there will be a greater proportion of people in work than ever before.

Measures so far

1.22 The Government's strategy to increase employment opportunity for all is described in detail in Chapter 4 and focuses on helping people to move from welfare to work, easing the transition to work, making work pay and then securing progression once in work. A wide range of measures has already been introduced in each of these areas:

- **welfare to work:** the New Deal programme now spans a large number of groups including young people, those aged 25+, the over 50s, lone parents, people with disabilities and partners of the unemployed. Action Teams and Employment Zones are targeting worklessness in the most disadvantaged areas and the Job Transition Service will provide help in areas where large-scale redundancies occur;
- **easing the transition to work:** with the new Job Grant, a four-week Income Support for Mortgage Interest run-on, simplified extended payments in Housing Benefit and increased childcare provision and support through the National Childcare Strategy and the childcare tax credit; and
- **making work pay:** through reforms to the tax and benefit system including reform of national insurance contributions (NICs), a 10 pence rate of income tax, a reduction in the basic rate of income tax to 22 pence and the introduction of the Working Families' Tax Credit and the Disabled Person's Tax Credit, underpinned by the National Minimum Wage.

Budget measures

1.23 The Budget takes further steps towards ensuring that every person in every region of Britain who is able to work has the opportunity to do so:

- within the **New Deal for lone parents** there will be further help with training, starting up in self employment and up-front childcare costs, and a new outreach service for lone parents and partners;
- from April 2002, to ensure that lone parents are aware of the help available to them through the New Deal, **all lone parents on Income Support will be required to attend work-focused interviews** and an additional interview will be introduced at the six-month stage in the Income Support claim;
- resources will be allocated to **enhance the New Deal and other programmes** over the coming three years, focusing on employer needs, the hardest to help and the most disadvantaged areas;
- as announced on 5 March, the **National Minimum Wage** for workers aged 22 and over will be increased from its current £3.70 an hour to £4.10 an hour from October 2001 and, subject to the economic conditions prevailing at the time, £4.20 an hour from October 2002;
- a widening of the **10 pence income tax band** by £300 over and above indexation from April 2001 to cover the first £1,880 of taxable income, benefiting 25 million taxpayers and increasing the number of those only paying tax at 10 pence to nearly 3 million;
- the **basic credit in the Working Families' Tax Credit (WFTC) will be increased by £5 a week** from June 2001, on top of increases in line with indexation from April 2001. These increases will be matched in the Disabled Person's Tax Credit (DPTC); and
- the WTFC and DPTC **childcare tax credit** limits will be increased from £100 to £135 a week for childcare costs for

one child and from £150 to £200 week for two or more children from June 2001. The Government will also consider how to help families who need to use formal childcare in their homes.

Taken together, the Government's making work pay measures by October 2001 will guarantee:

- a minimum income of £225 a week for a one earner family with someone in full time work; and
- a family with one part-time worker a minimum income of £166 a week.

FAIRNESS FOR FAMILIES AND COMMUNITIES

1.24 As described in Chapter 5, the Government is working to build a fairer and more inclusive society in which everyone can contribute to and benefit from rising economic prosperity. The Government places particular priority on supporting families, tackling child and pensioner poverty, rewarding saving and providing high quality public services funded by a modern and fair tax system.

Measures so far

1.25 Since 1997, the Government has taken action on many fronts to address these priorities:

- **support for families and children:** with increases in Child Benefit, the introduction of the WFTC and the new Children's Tax Credit, targeted support for low-income parents including a new Sure Start Maternity Grant and a new Children's Fund to provide improved support for children, young people and their families;
- **fairness for pensioners:** including the introduction of the Minimum Income Guarantee (MIG) uprated by earnings for the poorest pensioners, an annual winter fuel payment which was set in the Pre-Budget Report at £200 for December 2000 for every 60+ household and concessionary TV licences for those aged 75 and over. In addition, the Pre-Budget Report announced a major package of new measures to boost pensioner incomes in advance of the introduction of the Pension Credit in 2003:
    - **increasing the basic state pension** by £5 to £72.50 a week in April 2001, and by a further £3 to £75.50 a week in April 2002 for single pensioners. For couples, this will mean an increase of £8 to £115.90 a week in April 2001, and a further £4.80 to £120.70 a week in April 2002; and
    - **increasing the lower rates of the MIG** to equal its highest rate, raising this by earnings, and further, by the real increase in the basic state pension, so that from April 2001 the new, simplified MIG will be £92.15 a week for single pensioners and £140.55 a week for couples.
- **supporting saving:** introducing Individual Savings Accounts (ISAs) and retaining the £7,000 annual contribution limit (and the associated £3,000 cash limit) for a further five years until April 2006 and making cash ISAs available to 16 and 17 year olds from April 2001; and
- **high quality public services:** substantial additional resources allocated to key public services over the next three years in the 2000 Spending Review, including health, education and transport.

Budget measures

1.26 Budget 2001 takes further action to support families and children, help pensioners, improve public services and ensure a fair tax system.

Families and children

1.27 To provide further support for families with children and help tackle child poverty:

- the **Children's Tax Credit** will be introduced from April 2001 at £10 a week – more than the £8.50 previously announced - making it worth up to £520 a year for around 5 million taxpaying families;
- to recognise the additional costs of a new child in the first year, from April 2002 the **Children's Tax Credit** will be increased by a further £10 to £20 a week, making it worth up to £1,000 a year, for **families in the year of a child's birth;**
- in addition to increases in the WFTC and DPTC set out above, the child premia in **Income Support and the Jobseeker's Allowance** will be increased by £1.50 a week from October 2001; and
- a package of measures on **maternity pay and parental leave:**
    - an increase in the flat rate of **Statutory Maternity Pay (SMP) and Maternity Allowance** from its present £60.20 a week to £75 a week from April 2002 and £100 a week from April 2003;
    - an extension of the **period of maternity pay** at this enhanced rate from 18 to 26 weeks from April 2003;

- the right to two weeks **paid paternity leave** for working fathers from 2003, paid at the same flat rate as SMP;
- from 2003, **paid adoption leave** when a child is first placed with a family, to allow one of the adoptive parents to take paid leave for the same period and at the same flat rate as maternity pay;
- a doubling of the threshold for **Small Employer Relief** to £40,000 from April 2002, so that around 60 per cent of all firms paying SMP each year can reclaim their costs in full, plus compensation; and
- a further increase in the **Sure Start Maternity Grant** from £300 to £500 in April 2002.

Over the Parliament as a whole, following Budget 2001, the tax and benefit changes introduced will lift over 1.2 million children out of poverty.

Pensioners

1.28 In addition to the major package of support for pensioners announced in the Pre-Budget Report and summarised above, Budget 2001:

- raises the **age-related income tax personal allowances** by £240 over and above indexation from April 2003, following consultation announced in the Pre-Budget Report. The Government will then raise these allowances by reference to the rise in earnings rather than prices throughout the remainder of the Parliament.

From April 2001, the average pensioner household will be £600 a year better off than in 1997 as a result of the personal tax and benefit changes introduced during this Parliament.

Savings

1.29 The £300 widening of the **10 pence income tax band** over and above indexation from April 2001 will apply to savings income and benefit around 1 million savers, many of whom are pensioners.

High quality public services

1.30 Building on the substantial increase in resources allocated in the 2000 Spending Review and as a result of the prudent management of the public finances, Budget 2001 provides an **additional £2$^{1}/_{3}$ billion over the next three years for key public service priorities:**

- **an extra £1 billion for education.** In England, additions of £837 million over three years will go to schools. £600 million over three years will go direct to head teachers to modernise buildings and equipment, and improve pupil attainment. This will mean primary schools will receive additional direct payments of between £3,000 and £13,000 a year; and secondary schools will get additions of between £10,000 and £23,000 a year. A further £200 million fund over three years will help schools implement new recruitment and retention incentives for teachers;
- **an extra £1 billion for health.** In England, additions of £835 million over three years will go direct to the NHS. £450 million over three years will go to frontline hospital investment to help pay for new equipment such as scanners, and replace old Nightingale wards. Each of the acute hospital trusts will get between £$^{1}/_{2}$ million and £1 million a year. A further new fund for recruitment and retention will help to tackle shortages of key staff in the health service; and
- **an extra £$^{1}/_{3}$ billion to help tackle drugs.** In England and Wales, additions of £220 million over three years will go straight to Crime and Disorder Reduction Partnerships to help local communities drive out drugs and drug-related crime. Each of the 376 Partnerships should get up to £0.5 million over three years and those with larger areas and the worst problems to tackle, up to £1 million over three years. Further resources will also be provided to support voluntary action against drugs by leaders of the business and sporting worlds.

Further details of each of these packages will be announced shortly.

Tackling global poverty

1.31 Budget 2001 sets out proposals for a new **tax credit for research and development on drugs and vaccines** for the diseases of poverty affecting the world's poorest countries, and a new incentive to encourage the pharmaceutical industry to raise the level of **donations of drugs and vaccines** to developing countries.

A modern and fair tax system

1.32 Budget 2001 helps to promote a modern and fair tax system through measures including:

- a freeze in the **duties on alcohol** and an increase in **tobacco duties** in line with inflation;
- replacing general betting duty with a **gross profits tax** by 1 January 2002;
- a new scheme that will refund **national museums and galleries** the VAT they incur on their purchases when they allow the public free admission;
- **reforms to VAT** to modernise the system and make it fairer; and
- a continued commitment to **tackle tax avoidance and protect the revenue base**, with measures to ensure that both individuals and businesses pay their fair share of taxes.

PROTECTING THE ENVIRONMENT

1.33 Chapter 6 describes the Government's strategy towards protecting and, where possible, improving the environment and the measures that it is taking to tackle climate change, improve air quality, regenerate towns and cities and protect the countryside.

Measures so far

1.34 The Government has already taken significant steps to deliver its environmental objectives:

- **tackling climate change and improving air quality:** the climate change levy which will be introduced on 1 April 2001 to encourage more efficient business use of energy, consultation on an Emissions Trading Scheme, reforms to car and lorry vehicle excise duty (VED) and company car tax, tax incentives for ultra-low sulphur fuels and substantial extra resources for transport in the 2000 Spending Review as part of the new Ten Year Transport Plan; and
- **regenerating towns and cities and protecting the countryside:** a major package of tax measures over five years to regenerate Britain's towns and cities announced in the Pre-Budget Report, continued annual increases in the standard rate of landfill tax and a new aggregates levy from April 2002 to reflect the environmental costs of quarrying.

Budget measures

1.35 Following the various consultations announced in the Pre-Budget Report, the Budget sets out an affordable and carefully targeted series of measures which will help modernise road transport, increase access to cheaper motoring for people who need to use their cars and continue to protect the environment. In addition to the **cash freeze in all road fuel and other oil duties** announced in the Pre-Budget Report, the Budget includes:

- a 2 pence per litre reduction in the duty on **ultra-low sulphur petrol (ULSP)** with an accompanying and time-limited 2 pence per litre reduction in the duty on **unleaded petrol** until 14 June 2001 when ULSP should be available from all retailers;
- a 3 pence per litre reduction in the duty on **ultra-low sulphur diesel (ULSD)**;
- abolition of the duty premium on **lead-replacement and 'super-unleaded' petrol;**
- as part of the **Government's Green Fuels Challenge,** a cut in the duty on road fuel gases by the equivalent of 3 pence per litre and then a freeze in real terms until at least 2004, and Budget 2002 will introduce a new duty rate for biodiesel set at 20 pence per litre below the rate of duty on ULSD;
- a cash **freeze in VED** on cars, motorcycles and buses until Budget 2002;
- an **extension of the small car VED threshold from 1,200cc to 1,549cc** from July 2001, backdated to 1 November 2000;
- a **major reform of lorry VED** to be introduced from December 2001, reducing the total burden that lorry VED imposes on the haulage industry. In the meantime, the transitional arrangements announced in the Pre-Budget Report remain in place, with rebates of up to 50 per cent for licences in force on 30 November 2000 and lorry VED rates reduced by up to 50 per cent from 1 December 2000;
- initial allocations from the **£100 million Haulage Modernisation Fund** announced in the Pre-Budget Report; and
- abolition of **VED on tractors,** similar agricultural vehicles and other vehicles which currently qualify for the special concessionary rate from April 2001.

1.36 Budget 2001 takes additional steps to protect and improve the environment:

- full implementation of the package of measures set out in the Pre-Budget Report to help **regenerate Britain's towns and cities**, including abolition of stamp duty on all property transactions in the most disadvantaged parts of the UK;

- building on the Pre-Budget Report measures, the Budget extends the 5 per cent reduced rate of VAT to the **renovation of homes** empty for three years or longer. It also extends the 5 per cent reduced rate of VAT to cover a range of **conversions of residential property;**
- announcement of plans to consult on a **Green Technology Challenge** to offer enhanced capital allowances to encourage the development of environmentally-friendly technologies;
- a grant scheme to help congregations pay for repairs to **listed places of worship**; and
- the Government welcomes the latest proposals from industry stakeholders to reduce the environmental impact of **pesticides** and would like to see the package implemented on a UK-wide basis as soon as possible.

1.37 Table 6.1 of the EFSR shows how environmental tax measures fit into the overall framework of the Government's environmental policy. An environmental assessment of these measures is detailed in Table 6.2.

THE BUDGET MEASURES AND THEIR IMPACT ON HOUSEHOLDS

1.38 The measures in this and previous Budgets support the Government's objectives of promoting and rewarding work, while giving extra support to pensioners and families with children.

1.39 By October 2001, as a result of personal tax and benefit measures, UK households will be, on average:

- £150 a year better off from this Budget, compared to indexation;
- £240 a year better off from all measures taking effect this year, compared to indexation; and
- £590 a year better off from measures introduced over the Parliament as a whole[1]

Families with children

1.40 By October 2001, as a result of personal tax and benefit measures, UK families with children will be, on average:

- £180 a year better off from this Budget, compared to indexation;
- £420 a year better off from all measures taking effect this year, compared to indexation; and
- £1,000 a year better off from measures introduced over the Parliament as a whole.[1]

Supporting working families

1.41 The personal tax and benefit measures introduced over the Parliament mean that by October 2001:

- a single-earner family on average earnings (£25,400 a year) and with two children will be £520 a year better off in real terms;
- a single-earner family on half average earnings (£12,700 a year) and with two young children will be £3,000 a year better off in real terms;
- the direct tax burden on a single-earner family on average earnings with two children will be the lowest since 1972; and
- families with someone in full-time work will have a guaranteed minimum income of at least £225 a week, £11,700 a year.

Living standards

- for a single-earner family on average earnings and with two young children, real living standards will have risen by 10 per cent over this Parliament;
- for a single-earner family on half average earnings and with two young children, real living standards will have risen by 28 per cent over the Parliament; and
- for a single person on average earnings, real living standards will have risen by 9 per cent over the Parliament.

Tackling poverty

By October 2001, as a result of the personal tax and benefit measures:

- families with children in the poorest fifth of the population will on average be £1,700 a year better off;[1]
- over 1.2 million children will be lifted out of poverty; and

- around 2 million of the poorest pensioners will be at least £800 a year better off – a real terms rise in living standards of at least 17 per cent.[1]

1.42 Table 1.2 lists the key Budget policy decisions and their impact on government spending and revenues. Further details are provided in Chapter A of the FSBR.

Table 1.2: Budget 2001 policy decisions

	(+ve is an Exchequer yield)			£ million
	2001–02 indexed	**2002–03 indexed**	**2003–04 indexed**	**2001–02 non-indexed**
PBR CONSULTATION MEASURES				
1 Enterprise Management Incentives: expansion	–10	–15	–20	–10
2 Abolition of withholding tax on intra-UK corporate interest	–250	–25	*	–250
3 General betting duty: reform by January 2002	–45	–145	–100	–45
4 Over index aged income allowances by £240 from April 2003	0	0	–120	0
5 Authorised mileage rates	0	–5	–5	0
Fuel duty				
6 Ultra-low sulphur petrol: cut duty by 2p	–445	–470	–465	–445
7 Ultra-low sulphur diesel: cut duty by 3p	–610	–620	–625	–610
8 Abolition of higher rate on higher octane unleaded petrol (including lead replacement petrol)	–85	–80	–65	–85
9 Road fuel gases: cut duty by 6p per kg	*	–5	–5	*
10 Biodiesel: cut duty by 20p from Royal Assent 2002	0	–10	–15	0
Vehicle Excise Duty				
11 Increase threshold for reduced VED rates for private and light goods vehicles tax class to 1549cc from November 2000	–430	–270	–250	–430
12 Introduction of reformed VED system for lorries	–105	–310	–310	–105
13 Abolition of VED for tractors	–15	–15	–15	–15
Total: PBR consultation measures (tax and AME)	**–1,995**	**–1,970**	**–1,995**	**–1,995**
NEW BUDGET MEASURES				
MEETING THE PRODUCTIVITY CHALLENGE				
14 All-employee share ownership plan: stamp duty exemption on purchase of shares from trust	*	*	–5	*
15 EIS/VCTs/CVS: enhancement	–5	–5	–5	–5
16 Films: extension of 100 per cent write-off for production costs	0	*	–50	0
17 Improved flexibility of close company foreign capital gains rules	*	–10	–10	*
INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
18 Income Tax: over-indexation of starting rate band by £300 from £1,520	–750	–950	–950	–900

	to £1,880				
19	Income Tax: indexation of basic rate limit	0	0	0	–400
FAIRNESS FOR FAMILIES AND COMMUNITIES					
Supporting families with children					
20	Increase Children's Tax Credit by £1.50 to £10 from April 2001	–230	–310	–310	–230
21	Increase Children's Tax Credit by a further £10 for families in the year of a child's birth from April 2002	0	–170	–250	0
22	Increase Working Families' Tax Credit (WFTC) basic credit by £5 from June 2001	–165	–300	–315	–165
23	Increase WFTC childcare tax credit limit from June 2001 to £135 for child care costs for one child and £200 for two or more	–5	–15	–15	–5
24	Increase Income Support and Jobseeker's Allowance child premia by £1.50 from October 2001	–120	–245	–250	–120
Maternity package					
25	Raise flat rate Statutory Maternity Pay and Maternity Allowance to £75 from April 2002 and £100 from April 2003	0	–45	–205	0
26	Extend Statutory Maternity Pay and Maternity Allowance from 18 to 26 weeks from April 2003	0	0	–160	0
27	Small Employer Relief: expand eligibility from April 2002	0	–30	–30	0
28	Increase Sure Start Maternity Grant by £200 from April 2002	0	–40	–40	0
29	Introduce two weeks paid paternity leave from April 2003	0	0	–50	0
30	Introduce paid adoption leave for one parent from April 2003	0	0	–5	0
Duties and other tax changes					
31	Alcohol: freeze duties	–90	–90	–90	0
32	Tobacco: revalorise duties	0	0	0	+125
33	Inheritance tax: index threshold	0	0	0	–40
34	VAT: modernising relief on vehicles adapted for people with disabilities	–10	–10	–10	–10
35	VAT: reduced rate on children's car seats	–5	–5	–5	–5
36	VAT: modernising relief for young children's clothing and footwear	–20	–20	–20	–20
37	VAT: refund scheme for national museums and galleries	–10	–15	–15	–10
38	Increase in de minimis limit for business gifts for business taxes and VAT	–15	–15	–15	–15
39	Life insurance policies: policyholder information	*	*	+10	*
40	Controlled foreign companies	0	+20	+20	0
PROTECTING THE ENVIRONMENT					
41	VAT: revalorisation of fuel scale charges	0	0	0	–15
42	Unleaded petrol: cut duty by 2p from 7 March 2001 to 14 June 2001	–15	0	0	–15
Vehicle Excise Duty					

43	Freeze car VED for one year	–85	–85	–85	0
Urban regeneration					
44	VAT: extend scope of reduced rate on conversion of residential dwellings	–25	–35	–35	–25
45	VAT: reduced rate on renovations of homes empty for 3 or more years	–5	–5	–5	–5
46	Enhanced tax relief for cleaning contaminated sites	–15	–35	–40	–15
Total: new Budget measures (tax and AME)		**–1,570**	**–2,415**	**–2,940**	**–1,875**
Total: Budget measures (tax and AME)		**–3,565**	**–4,385**	**–4,935**	**–3,870**
ADDITIONAL BUDGET POLICY DECISIONS					
	Additions to DEL				
	Education	–290	–330	–380	
	Health	–360	–355	–290	
	Fighting crime and drugs	–70	–110	–155	
	Carrying forward of DEL underspend	–1,000	0	0	
	Additions to Capital Modernisation Fund	–60	0	0	
	Change to AME margin	+1,730	+1,580	+1,610	
TOTAL: BUDGET POLICY DECISIONS		**–3,615**	**–3,600**	**–4,150**	

* *Negligible*

GOVERNMENT SPENDING AND REVENUE

1.43 Chart 1.1 presents public spending by main function. Total public spending – Total Managed Expenditure (TME) – is expected to be around £394 billion in the coming financial year, 2001–02. TME comprises Departmental Expenditure Limits (DEL), shown in Table C13 of the FSBR, and Annually Managed Expenditure (AME), shown in Table C11 of the FSBR. A number of DELs, in particular those of the devolved administrations, contribute to spending on more than one function. Chart 1.1 includes spending by local authorities, rather than the grants they receive from central government, which are included in Tables C11 and C13.

Chart 1.1: Government spending by function

1.44 Chart 1.2 shows the sources of government revenue. In total, public sector current receipts are expected to be around £398 billion in 2001–02. Table C7 of the FSBR provides a more detailed breakdown of receipts consistent with the chart below.

Chart 1.2: Government receipts

[1]Compared to an indexed 1997-98 base.

2
Delivering macroeconomic stability

The Government's forward looking macroeconomic framework is continuing to deliver economic stability:

- **the monetary policy framework is delivering low and stable inflation which has meant that long-term interest rates are around their lowest level for 35 years;**
- **the fiscal policy framework has restored the public finances to a healthy and sustainable position: a surplus on public sector net borrowing of £16.4 billion is now estimated for 2000-01.**

Budget 2001 locks in economic stability for the future. This chapter shows that:

- **Budget 2001 locks in the tough fiscal stance set out in Budget 2000 and the Pre-Budget Report;**
- **fiscal outturns have been better than expected, largely reflecting non-discretionary, structural improvements to the public finances which feed through into future years, enabling:**
    - **new resources to be released to priority areas, while maintaining a long-term sustainable fiscal position even when world economic prospects are less certain;**
- **Budget 2001 measures include:**
    - **targeted tax cuts for productivity, work, savings and families;**
    - **an additional £21/3 billion over the next three years for education and health, and to tackle drugs and crime;**
- **the fiscal stance including Budget measures is at least as tight as set out in Budget 2000 and the Pre-Budget Report throughout the next five years;**
- **the Government is on track to meet its firm fiscal rules, including in the cautious case.**

By continuing to deliver economic stability, Budget 2001 underpins the 2000 Spending Review settlement while allocating more resources to improve public services, growth, standards of living and prosperity for all.

THE MACROECONOMIC FRAMEWORK

2.1 The Government's central economic objective is to raise the economy's trend rate of growth, and achieve rising prosperity, through creating economic and employment opportunities for all.

2.2 Large fluctuations in output, employment, inflation and interest rates create uncertainty for businesses and consumers alike. They impose significant costs on the economy and society and can hold back the economy's long-term growth potential. The Government has been determined to avoid the sort of volatility which characterised the cycles of boom and bust of the past. That is why it has put in place a new macroeconomic framework to deliver economic stability - to help businesses and people, as well as Government, plan for the long term.

2.3 The framework is built on a set of clear principles based on transparency, accountability and responsibility and sets down a platform of economic stability for the long term. The monetary policy framework based on an operationally independent Bank of England seeks to secure low and stable inflation, while the fiscal policy framework is underpinned by two fiscal rules that are designed to deliver sound public finances. A long-term public spending framework provides for better planning of government spending and places a greater focus on the quality of public service provision and the outcomes achieved.

The monetary policy framework

2.4 Since its creation at the start of this Government's period of office, the monetary policy framework has helped to keep inflation close to the Government's target and has enjoyed a high degree of credibility. This has been for a number of reasons:

- objectives are clear and precise. The primary objective of monetary policy is price stability, while the symmetry in the Government's inflation target ensures that outcomes below target are treated as seriously as outcomes above target. In this way monetary policy helps to support the Government's wider economic policy objective of high and stable levels of growth and employment;
- the Bank of England's Monetary Policy Committee (MPC) has full operational independence and is responsible for setting interest rates to meet the Government's inflation target. The Government has reaffirmed in this Budget the target of $2^1/_2$ per cent for the 12-month increase in the Retail Prices Index excluding mortgage interest payments (RPIX) which applies at all times;
- the framework promotes openness, transparency and accountability through the publication of MPC members' voting records, prompt reporting of minutes of the monthly MPC meetings and the Bank of England's quarterly *Inflation Report;* and
- the 'Open Letter' system, whereby if inflation deviates by more than one percentage point above or below target the Governor of the Bank of England must set out in an open letter why inflation has deviated from target, what action the MPC intends to take to get it back to target, how long it will be before inflation returns to target and how this meets the MPC's remit as set out by the Chancellor.

2.5 The new arrangements have removed the suspicion of short-term political influence over monetary policy and ensure that interest rates are set in a forward-looking manner to meet the Government's symmetric inflation target.

The fiscal policy framework

2.6 The reforms to the monetary policy framework have been accompanied by a parallel set of reforms to fiscal policy, ensuring that the highest standards of transparency, responsibility and accountability apply to fiscal policy decisions. The two arms of policy work in a coordinated way to deliver economic stability.

2.7 The *Code for Fiscal Stability* sets out the five key principles of fiscal management which are at the heart of the framework - transparency, stability, responsibility, fairness and efficiency. The Code also requires the Government to state its objectives and fiscal rules through which it operates fiscal policy based on these principles. The Government's key objectives are:

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

2.8 These objectives are implemented through the Government's two fiscal rules, against which the performance of fiscal policy can be judged:

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

2.9 The fiscal rules promote economic stability by ensuring sound public finances, while allowing flexibility in two key respects. First, the rules are set over the economic cycle, allowing fiscal balances to vary between years in keeping with the cyclical position of the economy. This allows the automatic stabilisers to operate freely to dampen the effects of the economic cycle, boosting aggregate demand when the economy is below trend, and reducing aggregate demand when it is above trend.

2.10 Second, the interaction of the two rules promotes capital investment while ensuring the sustainability of the public finances in the longer term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only for capital spending. The sustainable investment rule limits government borrowing to a stable and prudent level: other things equal, lower than 40 per cent of GDP.

2.11 The fiscal framework has enhanced the credibility of the Government's fiscal policy and has promoted a constituency of support for stability-orientated policies, enabling and encouraging people and businesses to plan for the long term.

2.12 As set out in the 2000 EFSR, the Government is committed to ensuring that households are fully informed about tax and spending decisions and in due course intends to amend the *Code for Fiscal Stability* to guarantee this. It is considering the most effective way to take this forward, including the distribution to households of a leaflet.

The public spending framework

2.13 Across the public sector, planning for the long term and increasing capital investment have been supported by the new public spending framework. The key elements are:

- three-year spending allocations for departments (Departmental Expenditure Limits - DELs) providing departments with greater certainty and flexibility over their budgets and thereby enabling improved planning and management of resources over the medium term;
- Annually Managed Expenditure (AME) which covers those elements of spending which cannot reasonably be subject to firm multi-year limits and are instead subject to tough annual scrutiny as part of the Budget process. DEL and AME sum to Total Managed Expenditure (TME);
- separate resource (current) and capital budgets for each department, consistent with the distinction in the fiscal rules. Departments are required to manage their resource and capital budgets separately, removing the bias against investment which was present in the previous planning regime. These are reinforced by Departmental Investment Strategies, published in November 2000, which show departments' plans for investment over the next three years;
- new Public Service Agreements (PSAs) through which each department is committed to deliver challenging outcome-focused targets; and
- Resource Accounting and Budgeting, which measures the full economic costs of government activity and provides better information and incentives for public sector managers.

2.14 The 2000 Spending Review set DEL allocations for the three years to 2003-04. The next Spending Review will take place in 2002.

Box 2.1: Promoting international stability

The crises in emerging markets in the 1990s brought to light fundamental weaknesses in the architecture of the international financial system and highlighted the need for new measures to promote stability at the international level in parallel to the reforms to the UK's macroeconomic framework. These crises demonstrated the need for governments to pursue transparent, consistent and credible macroeconomic policies. At the international level, these crises underlined the need for enhanced international surveillance, greater international cooperation in financial regulation and a new framework for managing crises.

To address these challenges, the G7 Finance Ministers pledged in October 1998 to create a new international financial architecture for an integrated global economy. The UK Government has played a leading role in taking forward this ambitious reform agenda, building on the structural changes introduced domestically. In the past three years, there has been substantial progress in a number of important areas, including:

- a new framework of codes and standards to act as benchmarks against which countries can assess their performance and improve their economic and financial policy frameworks;
- a new model of cooperation in global financial regulation - the Financial Stability Forum - was established in 1999 to bring together the IMF, World Bank and key regulatory authorities with the objective of tackling areas of vulnerability in the international financial system;
- a new framework of partnership for crisis prevention and resolution between the private and public sectors which will help ensure that all parties which benefit from the international financial system play their part in maintaining its stability. The private sector has been involved in the handling of a number of recent crises, including those in Ukraine, Pakistan, Ecuador, Turkey, and Argentina; and
- a new mechanism for informal dialogue between systemically important economies - the G20 - was also established in 1999 to provide a forum for broader discussion and co-operation on key economic and financial issues.

Taken together, these changes have laid the foundation of a new international financial system fit for the 21st century which will enable all countries to participate in the new global economy and share in rising prosperity.

PERFORMANCE OF THE FRAMEWORK

Monetary strategy

2.15 The monetary framework has helped to enhance the credibility of economic policymaking and is delivering tangible results:

- RPIX inflation has averaged 2.4 per cent since May 1997 almost exactly in line with the Government's target and has fluctuated in the narrow range of 1.8 to 3.2 per cent;
- long-term inflation expectations in financial markets remain in line with the Government's target (see Chart 2.1) having fallen from over 4 per cent between 1994 and early 1997 to $2^1/_2$ per cent by mid-1998;
- official interest rates have been much less volatile since 1997, remaining in a narrow band of between 5 and 7.5 per cent; and
- low and stable inflation has meant that long-term interest rates are around their lowest levels for over 35 years and this is helping to reduce the Government's debt interest payments.

2.16 The monetary framework is designed to be able to cope with unforeseen shocks and to leave room for pre-emptive policy responses. For example, the MPC reacted to events in East Asia in 1998 by reducing interest rates by $1^1/_4$ percentage points between October and December 1998. This helped to cushion the UK economy against potential adverse consequences with growth moderating slightly from 2.6 per cent in 1998 to 2.3 per cent in 1999. When activity recovered strongly and inflationary pressures became more evident the MPC also reacted pre-emptively, raising interest rates by 1 percentage point between Autumn 1999 and early 2000.

2.17 More recently interest rates have been cut, by 25 basis points on 8 February 2001 to $5^3/_4$ per cent. The MPC's decision reflected concerns, as expressed in the February Inflation Report, that: "In the Committee's judgment, the risks to growth and inflation are presently clearly on the downside, stemming in particular from the risk of a deeper or more prolonged slowdown in the United States."

Fiscal strategy

Chart 2.1: RPIX inflation and inflation expectations 10 years

2.18 Since 1997, the public finances have been transformed and returned to a sustainable position. The Government took tough and immediate action to reduce the £28 billion deficit it inherited. It worked within the previous Government's spending plans for its first two years and made a number of difficult tax decisions, including continuing, until the November 1999 Pre-Budget Report announcement, to raise fuel duties by more than inflation under the escalator introduced by the previous Government.

2.19 By adopting a prudent and responsible approach to fiscal policy, a cumulative structural fiscal tightening of $4^1/_2$ percentage points of GDP between 1996-97 and 2000-01 restored the public finances to a sustainable position. Fiscal policy was also supporting monetary policy when the economy was above trend.

2.20 Budget 2000 locked in the fiscal tightening of Budget 99 and set a firm spending envelope for the three years covered by the 2000 Spending Review, ensuring that the Government remained on track to meet its fiscal rules while releasing new resources for key public services. This enabled significant increases in real current spending and a more than doubling of net investment by 2003-04. Net investment is projected to rise to 1.8 per cent of GDP by the end of the projection period. Thereafter, it will be set within this ceiling as a share of GDP, consistent with the net debt to GDP ratio remaining below 40 per cent in the medium term.

2.21 The 2000 Spending Review settlement provided a detailed breakdown of spending plans for the next three years, consistent with the spending limits announced in Budget 2000. Within that envelope, the Government was able to release additional resources to priority public services as a result of prudent management of the economy and public finances. Savings have been made in a number of areas, including:

- lower growth in spending on social security, through cutting the cost of worklessness; and
- reduced debt interest payments resulting from lower interest rate expectations and the debt repayment following the auction of radio spectrum licences.

2.22 As a result, changes in social security benefits and debt interest payments are expected to account for only 16 per cent of the change in TME in the period 2000-01 to 2003-04. This compares to 42 per cent in the period 1978-79 to 1996-97. Table 2.1 illustrates this and includes the impact of Budget policy decisions. A greater share of resources are available for priority public services.

Table 2.1: Changes in Total Managed Expenditure accounted for by social security benefits and debt interest payments

	1978-79 to 1996-97	1996-97 to 2003-04	2000-01 to 2003-04
Social security benefits[1]	33%	23%	19%
Central government debt interest payments	9%	–3%	–3%

[1]*For the purpose of comparison, social security includes Working Families' Tax Credit and Disabled Person's Tax Credit.*

2.23 The additional resources released by the Spending Review settlement will have an important impact on the productivity and sustainable growth of the economy. The Government is redressing historically low levels of public investment through a strategic programme of renewal and modernisation of the country's capital stock, including:

- a Ten Year Plan for transport, doubling investment in transport infrastructure in the Spending Review period with a balanced package of investment in high quality public transport and targeted improvements to the road network;
- an increase in capital expenditure on health by over £1.2 billion between 2000-01 and 2003-04, a 39 per cent rise in real terms;
- increased capital investment in schools amounting to £7.8 billion over 2000-01 to 2003-04.

Box 2.2: EMU and EMU preparations

The Government's policy on membership of the single currency remains as set out by the Chancellor of the Exchequer in his statement to the House of Commons in October 1997, and restated by the Prime Minister in February 1999. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous.

The Government has set out five economic tests which must be met before any decision to join can be made. In 1997, the Government's statement made clear that it would not start another assessment of the five tests until early in the next Parliament. The Government has said that the assesment will be produced within two years of the start of the next Parliament. The assessment will be comprehensive and rigorous. On the basis of the assessment, the Government will take a decision on whether the five tests have been met. The Government believes that, if a decision to recommend joining is taken by the Government, it should be put to a vote in Parliament and then to a referendum of the British people. The referendum would only occur if the five tests were met and the Government had made a decision to recommend joining.

The Government is committed to ensuring that the UK retains a genuine option to join a successful single currency. Over the past three years, the Government has worked intensively with the business community, wider public sector and voluntary groups both to ensure that the necessary preparations were in place to deal with the euro from 1 January 1999, and to take forward detailed planning work for possible UK entry, if that is what Government, Parliament and the people decide.

The Government has produced a range of resources to help firms understand the impact which the single currency may have on their business. These resources include a website, business-to-business case studies and factsheets covering core business euro information. The Government has also carried out surveys and works with 12 Regional Euro Forums to provide help at the local level. It also prepares regular progress reports on euro preparations.

The Treasury published the second Outline National Changeover Plan in March 2000. The plan, which was drawn up in consultation with business, the voluntary sector and the public sector, sets out the planning assumptions for a possible changeover to the euro. The public sector has given a clear signal of its commitment to prepare, undertaking targeted investment as part of the ongoing modernisation of public sector systems.

2.24 The Pre-Budget Report in November took further steps towards achieving the Government's goals of raising productivity performance to deliver stronger sustainable growth, while ensuring that all can share in rising prosperity. It also contained an affordable and carefully targeted package of announcements and proposals to help motorists and improve the competitiveness of the UK's transport sector. The interim fiscal forecast in the Pre-Budget Report showed that the fiscal stance, including measures, was at least as tight as set out in Budget 2000.

2.25 The challenge for Budget 2001 is not only to continue to deliver macroeconomic stability by ensuring that the Government locks in the tough fiscal stance set out in Budget 2000 and the Pre-Budget Report, but that it also puts in place policies to boost productivity and employment, while tackling child and pensioner poverty.

RECENT ECONOMIC DEVELOPMENTS AND

PROSPECTS

Recent economic developments

2.26 GDP increased by 3 per cent in 2000, as forecast in the Pre-Budget Report. Preliminary estimates showed a rise of just 0.3 per cent in the fourth quarter though, excluding erratic falls in oil and gas output, growth remained much closer to trend. Domestic demand remained buoyant in 2000, reflecting strong growth in household consumption, while lower growth of business investment was partly offset by the pick-up in general government investment. Healthy export volume growth contributed to a stronger net trade performance than in previous years, but import volume growth remained strong. Manufacturing output growth was the fastest for six years, but continued to lag behind the expansion in services.

2.27 The labour market has continued to perform well. Labour Force Survey (LFS) employment increased by a further 225 thousand during 2000 and unemployment reached its lowest level since the 1970s, ending the year at 5.3 per cent on the International Labour Organisation measure. While official data suggest that the employment rate may be stabilising at an historically high level, still buoyant survey indicators and vacancies suggest that labour demand is robust. Despite evidence of skills shortages, wage growth and unit wage costs remain largely in check. Underlying earnings growth (excluding bonuses) remains very close to the $4^1/_2$ per cent rate that would be consistent with the inflation target with trend medium-term productivity growth of 2 per cent a year.

2.28 Price and cost pressures remain subdued. A fall in oil prices from their autumn peak, combined with moderating domestic price pressures, helped RPIX inflation edge to a low of 1.8 per cent in January. The rise in productivity growth, to $2^1/_4$ per cent for the year as a whole, contributed to benign domestic cost pressures, as did a further compression of producer and retail margins.

Economic prospects

2.29 Overall UK growth prospects are unchanged since the Pre-Budget report, with GDP forecast to rise by $2^1/_4$ to $2^3/_4$ per cent in 2001 and later years. However, recent global developments signal a changed composition of demand in the short term. Table 2.2 summarises the outlook for growth and inflation.

Table 2.2: Summary of forecast

	Outturn	Forecast		
	2000	**2001**	**2002**	**2003**
GDP growth (per cent)	3	$2^1/_4$ to $2^3/_4$	$2^1/_4$ to $2^3/_4$	$2^1/_4$ to $2^3/_4$
RPIX inflation (per cent, Q4)	2	2	$2^1/_2$	$2^1/_2$

2.30 Global economic growth moderated considerably in the second half of 2000, driven by a sharper than anticipated slowdown in the US. Combined with renewed weakness in Japan, G7 growth is expected to fall to 2 per cent in 2001, much weaker than in the Pre-Budget Report. Despite marked improvements in survey indicators, export volume growth is forecast to slow much more markedly during the course of 2001 than expected at the time of the Pre-Budget Report, reflecting weaker growth in UK markets overall. Net trade is now expected to reduce GDP growth by 1 percentage point in 2001 and 2002.

2.31 The deterioration in the global outlook does not yet appear to have impacted adversely on business optimism. Consumer confidence also remains at very high levels, which is expected to drive a $3^1/_4$ to $3^1/_2$ per cent increase in household consumption in 2001, with a gradual moderation thereafter. Government spending will make a strong contribution to growth, with public consumption forecast to rise by $4^1/_4$ per cent. Domestic demand overall is expected to rise by $3^1/_4$ to $3^1/_2$ per cent in 2001, easing to more sustainable rates in later years, but with greater short-term momentum offsetting the weaker trade outlook.

2.32 RPIX inflation is expected to rise back gradually to its $2^1/_2$ per cent target by spring 2002 reflecting upward pressure from non-oil import prices and a declining negative contribution from changes in margins. Earnings growth has edged up in recent months, and domestic costs may exert further upward pressure before the output gap closes. The more prolonged undershoot of target mainly reflects the lower starting point for the projection and a smaller contribution from indirect taxes.

2.33 Downside risks to the outlook have sharpened since November, mainly reflecting risks to US growth. A harder than expected landing for the US economy, would imply a stronger direct trade impact, though possibly partly offset by adjustments in world exchange rates. Falling equity prices, or a more general loss of confidence, could lead to a more rapid, and possibly deeper, adjustment in UK private demand. But despite the recent deterioration, private sector financial imbalances remain modest compared to the past, and also current US experience. Overall balance sheet health provides a cushion against adverse external events, and policy is well placed to respond proactively given sound public finances and low inflation.

TREND GROWTH

2.34 The trend growth rate of the economy provides a measure of the growth in the supply capacity of the economy, or the rate at which output can increase over the medium term without placing upward or downward pressure on inflation. Over the short term, the actual level of output tends to cycle around the trend level of output. The estimate of the difference between actual and trend output, or output gap, is an indicator of the risk of inflation. In addition, the public finances appear stronger when the economy is operating above trend, and weaker when the economy is below trend. Therefore, accurately measuring trend growth is important in order to judge inflationary pressures in the economy and to enable policy makers to take the cycle into account when making fiscal policy decisions.

2.35 Based on business survey indicators of capacity and labour utilisation, the economy was judged to be at or close to trend in the first half of 1997 and again around mid-1999. Since then, most survey measures of capacity and labour utilisation have moved slightly above their long run averages suggesting that the economy was slightly above trend at the end of 2000. Trend output growth is estimated to be just over $2^1/_2$ per cent per year. This assessment of the probable shape of the UK economic cycle since 1997 - moving above trend in 1997 and 1998 followed by a small deviation below trend in early 1999 - is broadly unchanged from the Pre-Budget Report and Budget 2000.

Economic cycle

2.36 Given the closeness of output to trend throughout 1997 to 1999, possible measurement errors and the prospect of further data revisions, it remains difficult to conclude for certain that the UK economy has completed a full, albeit short and shallow, economic cycle between the first half of 1997 and mid-1999. For the purposes of the Budget and the assessment of performance against the fiscal rules, the provisional judgement remains that a cycle may have been completed by mid-1999 when the current cycle is assumed to begin.

Prospects for trend growth

2.37 Looking ahead, the mid-points of the Budget 2001 forecast ranges are again anchored on the neutral assumption of trend output growth rising by $2^1/_2$ per cent a year. This is based on productivity growth around its long-run historical average of 2 per cent. In comparison a number of independent organisations explicitly take a more favourable central view of trend growth in the near future, with estimates between $2^3/_4$ and 3 per cent. These are, in part, based on the view that the UK is well placed to achieve a significantly stronger productivity performance than the neutral $2^1/_2$ per cent assumption underlying the Budget 2001 forecast.

2.38 There is a clear upside potential for trend growth to be higher in the future due to higher productivity growth. The more favourable views of trend growth and productivity partly reflect a period of 'catch up', with businesses striving to secure further productivity improvements in order to restore profitability and also to avoid wage pressures in a tight labour market. Moreover, 'capital deepening' through Information and Communication Technology (ICT) investment and related diffusion of know-how may contribute to an increase in UK productivity, as it has in the US since the mid-1990s. But while the evidence shows UK firms are well placed to emulate US productivity performance, Budget 2001 makes only a small allowance for upside productivity potential within the upper limits of the forecast ranges.

Caution and the public finance projections

2.39 Looking forward over the projection period, while the economic forecast is based on a neutral estimate of $2^1/_2$ per cent a year trend growth, the public finance projections in this Budget continue to be based on the deliberately prudent and cautious trend growth assumption of $2^1/_4$ per cent a year, as audited by the NAO. This is because the Government is determined not to repeat the mistakes of the past by assuming a potential improvement in trend growth before this has demonstrably been achieved and audited.

2.40 The prudent and cautious view about trend growth is one of several assumptions audited by the NAO under the three year rolling review established in Budget 2000, which ensures they remain reasonable and cautious. A full list is set out in Chapter C of the FSBR. For Budget 2001, the Comptroller and Auditor General has audited the assumptions relating to the composition of GDP and debt funding. He has concluded in both cases that it is reasonable to continue to use the assumption as a basis for the fiscal projections.[1]

FISCAL DEVELOPMENTS AND OUTLOOK

2.41 Budget 2001 is the first definitive forecast since Budget 2000, which set the envelope for spending allocations to 2003-04. The forecast reflects the significant structural improvement in the health of the public finances over the past year which has enabled new resources to be released to the Government's priorities while ensuring fiscal discipline is maintained.

2.42 A surplus on current budget of £23.1 billion is now estimated for 2000-01 compared with a forecast of £14 billion at the time of Budget 2000. A similar improvement is expected for public sector net borrowing (PSNB). A net repayment of £16.4 billion is estimated for 2000-01, compared with a projected net repayment of £6 billion at the time of Budget 2000. These surpluses are also higher than expected at the time of the Pre-Budget Report.

2.43 It is important to distinguish between cyclical and structural components of a fiscal improvement. Based on the Treasury's methodology for cyclical adjustment, it is clear that the improvement over the past year largely appears to have been structural.[2] The stronger than expected fiscal tightening for 2000-01 will continue to impact on activity and inflation in the coming year.

2.44 Since 1996-97, the cumulative changes to structural public sector net borrowing add up to a fiscal tightening of $4^1/_2$ percentage points of GDP. Over the same period, net debt has declined by over 12 percentage points. Fiscal policy has supported monetary policy by reducing inflationary pressures when the economy has been above trend.

2.45 In making its fiscal projections, the Government distinguishes between non-discretionary factors which affect the public finances, such as changing consumption patterns affecting tax receipts and changes to the economic forecast, for example to GDP growth, and discretionary Budget measures. Further detail on this distinction is set out in *Analysing UK fiscal policy*.[3] This chapter first outlines the non-discretionary changes which, together with the 2000 Spending Review and the Pre-Budget Report, form the fiscal context for Budget decisions.

Non-discretionary changes - receipts

2.46 Receipts are now expected to be stronger in 2000-01 than expected at the time of Budget 2000. Full details of all tax and spending changes are included in Chapter C of the FSBR. Higher than expected receipts arise from:

- higher outturns for 1999-2000 than expected at the time of Budget 2000. This has raised the forecast base, affecting the profile in future years;
- increased receipts in 2000-01, notably higher income tax receipts from higher wages and employment; and
- greater than expected proceeds from the auction of radio spectrum licences.

2.47 The upward revisions in this forecast include further improvements on top of those identified in the Pre-Budget Report interim forecast. Since November, the forecast for income tax receipts for 2000-01 has been revised upwards by over £3 billion, reflecting buoyant Self-Assessment and PAYE receipts, which largely carry forward into future years. The structural improvement in income tax receipts stemming from higher wages and employment is analysed further in Chapter C.

Non-discretionary changes - spending

2.48 The estimated outturn for AME for 2000-01 is significantly lower than forecast in Budget 2000. Before taking into account discretionary changes since Budget 2000, there are also significant savings through the forecast period. Expenditure on social security benefits and debt interest payments is expected to be over £2 billion lower in 2000-01 than forecast in Budget 2000 and nearly £6 billion lower in 2001-02. Table 2.3 decomposes the savings into those arising from lower social security expenditure and those arising from lower debt interest payments. It shows that the benefits of economic stability, lower unemployment and sound public finances are leading to a structural improvement in government spending, which is freeing up resources in the future for the Government's priorities.

Table 2.3: Savings in Annually Managed Expenditure (AME) since Budget 2000 due to social security and debt interest

before policy decisions

	£ billion			
	2000-01	2001-02	2002-03	2003-04
Change from Budget 2000				
Social security benefits[1]	–0.9	–1.9	–2.3	–2.9
Central Government debt interest	–1.2	–4.0	–2.5	–2.2
Of which, changes since PBR2000:				
Social security benefits[1]	*0.1*	*–0.2*	*–0.4*	*0.0*
Central Government debt interest	*–0.4*	*–1.5*	*–0.6*	*–0.4*

[1]*Excluding PBR measures and Budget policy decisions.*

2.49 Table 2.3 shows that these savings include further non-discretionary improvements in addition to those identified in the Pre-Budget Report forecast. In particular, debt interest payments are forecast to be £1$^{1}/_{2}$ billion lower in 2001-02 than expected at the time of the Pre-Budget Report as a result of lower inflation and lower interest rate expectations, and £$^{1}/_{2}$ billion lower thereafter as a result of lower interest rate expectations.

2.50 The Government will make a final judgement about the underspend on DEL for 2000-01 once more information on the outturn is available. Its preliminary judgement is that there is a £1 billion underspend in 2000-01.

Summary of changes since Pre-Budget Report

2.51 New information since the Pre-Budget Report on the DEL underspend and other non-discretionary improvements to receipts and spending have substantially improved the estimated fiscal balances for 2000-01 since November. Receipts are now estimated to be around £3 billion higher and current spending about £1 billion lower. The Government has also decided to use the £2$^{1}/_{2}$ billion savings in 2000-01 allocated to the AME margin in the Pre-Budget Report to pay down net debt. The total effect on the current budget is to increase the surplus by about £6$^{1}/_{2}$ billion, a significant proportion of which feeds through into future years (see Table 2.4).

BUDGET DECISIONS

2.52 The Budget is the definitive statement of the Government's desired fiscal policy settings. In making its Budget decisions, based on the structural position of the public finances, the Government has considered:

- the need to ensure that, over the economic cycle, the Government will meet its tough fiscal rules;
- its broader medium term fiscal objectives, including the need to ensure sound public finances and that spending and taxation impact fairly both within and across generations; and
- the path that best ensures that fiscal policy supports monetary policy over the cycle.

2.53 Within this disciplined framework, which is designed to continue to deliver economic stability, the better than expected performance of the public finances in 2000-01, which is expected to persist into the future, has enabled additional discretionary changes to promote growth and opportunity for all, including:

- targeted tax cuts for productivity, work, savings and families. A full explanation of Budget measures is given in the FSBR; and
- an additional £2$^{1}/_{3}$ billion over the next three years to boost education and health, and to tackle drugs and crime.

2.54 In addition, in light of the improved forecast, the Government has drawn down the savings in AME beginning in 2001-02 that were allocated to the AME margin at the time of the Pre-Budget Report. This frees up resources for the implementation of the Pre-Budget Report consultation measures. As in previous Budgets, the AME margin is being reset to £1, £2 and £3 billion for the next three years (from 2001-02).

2.55 Also in accordance with previous practice, the Government has decided to carry forward from 2000-01 to 2001-02 the underspend on DEL of £1 billion to the Reserve to cover departments' End Year Flexibility.

MEDIUM TERM FISCAL PROJECTIONS

2.56 Table 2.4 compares the projections for the surplus on current budget and public sector net borrowing with those in Budget 2000 and last November's Pre-Budget Report. Changes are divided into those resulting from discretionary policy measures and those resulting from revisions and forecasting changes. It includes the impact of all Budget decisions in accordance with the *Code for Fiscal Stability*. A more detailed breakdown is given in Table C6.

2.57 The table distinguishes between the headline figures and the underlying structural position, which includes adjustments for the economic cycle. This is necessary because the Government takes care not to treat cyclical improvements to the public finances as structural improvements.

2.58 The cyclically-adjusted current surplus for 2000-01 is projected to equal 2.1 per cent of GDP, up on the Budget forecast of 1.3 per cent. Looking at PSNB on a cyclically-adjusted basis, a surplus of 1.4 per cent is now estimated for 2000-01, up on the Budget 2000 forecast of 0.5 per cent. In each year of the forecast period, the fiscal stance - defined as cyclically-adjusted PSNB - is projected to be at least as tight as set out in Budget 2000 and the Pre-Budget Report. Fiscal policy is supporting monetary policy in controlling inflation. Budget 2001 locks in the tough fiscal stance set out in Budget 2000 and the Pre-Budget Report.

Table 2.4: Fiscal balances comparison with Budget 2000 and PBR 20001

	Outturn	**Estimate**			**Projections**		
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
Fiscal balances (£ billion)							
Surplus on current budget							
Budget 2000	**17.1**	**14**	**16**	**13**	**8**	**8**	**–**
PBR/SR 2000 revision/forecasting changes	2.3	2.7	4	5	4	5	–
PBR/SR 2000 policy measures	–	–0.3	–3	–4	–4	–4	–
PBR 2000	**19.4**	**16.6**	**16**	**14**	**8**	**8**	**8**
Revision/forecasting changes	–0.1	6.5	3	4	4	5	5
Budget policy decisions	–	–	–3	–3	–4	–4	–4
Of which: Change to AME margin	–	–	*2*	*2*	*2*	*2*	*2*
PBR consultation measures	–	–	*–2*	*–2*	*–2*	*–2*	*–2*
New measures	–	–	*–2*	*–3*	*–3*	*–4*	*–4*
Budget 2001	**19.2**	**23.1**	**17**	**15**	**8**	**9**	**9**
Net borrowing							
Budget 2000	**–11.9**	**–6**	**–5**	**3**	**11**	**13**	**–**
PBR/SR 2000 revision/forecasting changes	–4.5	–4.4	–4	–6	–5	–5	–
PBR/SR 2000 policy measures	–	0.8	3	4	4	4	–
PBR 2000	**–16.4**	**–10.1**	**–6**	**1**	**10**	**12**	**13**
Revision/forecasting changes	0.4	–6.3	–4	–4	–4	–5	–5
Budget policy decisions	–	–	4	4	4	4	4
Of which: Change to AME margin	–	–	*–2*	*–2*	*–2*	*–2*	*–2*
PBR consultation measures	–	–	*2*	*2*	*2*	*2*	*2*
New measures	–	–	*3*	*3*	*4*	*4*	*4*
Budget 2001	**–16.0**	**–16.4**	**–6**	**1**	**10**	**11**	**12**
Cyclically–adjusted budget balances (per cent of GDP)							
Cyclically–adjusted surplus on current budget							

Budget 2000	1.8	1.3	1.3	1.0	0.7	0.7	–
PBR 2000	1.9	1.5	1.4	1.1	0.6	0.7	0.7
Budget 2001	**1.9**	**2.1**	**1.4**	**1.1**	**0.6**	**0.7**	**0.7**
Cyclically–adjusted net borrowing							
Budget 2000	–1.2	–0.5	–0.3	0.5	1.1	1.1	–
PBR 2000	–1.6	–0.8	–0.3	0.3	1.1	1.1	1.1
Budget 2001	**–1.6**	**–1.4**	**–0.3**	**0.3**	**1.1**	**1.1**	**1.1**

[1] *Excluding windfall tax receipts and associated spending.*

[2] *The 1999–2000 figures were estimates in Budget 2000.*

NB. Figures may not sum due to rounding.

ADHERING TO PRINCIPLES

2.59 Table 2.5 presents a summary of the key fiscal aggregates focused around five themes: fairness and prudence, sustainability, economic impact, financing and European commitments.

Table 2.5: Summary of public sector finances[1]

Outturn Estimate Projections

	Per cent of GDP						
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
Fairness and prudence							
Surplus on current budget	2.1	2.4	1.7	1.4	0.8	0.8	0.8
Average surplus since 1999-2000	2.1	2.3	2.1	1.9	1.7	1.5	1.4
Cyclically-adjusted surplus on current budget	1.9	2.1	1.4	1.1	0.6	0.7	0.7
Long-term sustainability							
Public sector net debt[2]	36.8	31.8	30.3	29.6	29.7	29.9	30.0
Net worth[2]	17.4	18.8	21.3	21.6	21.4	21.0	20.4
Primary balance	4.2	4.0	2.5	1.7	0.8	0.7	0.6
Economic impact							
Net investment[2]	0.4	0.8	1.1	1.5	1.7	1.8	1.8
Public sector net borrowing (PSNB)	–1.8	–1.7	–0.6	0.1	0.9	1.0	1.0
Cyclically–adjusted PSNB	–1.6	–1.4	–0.3	0.3	1.1	1.1	1.1
Financing							
Central government net cash requirement[2]	–1.0	–3.5	0.0	0.5	1.5	1.4	1.4
European commitments							
Treaty deficit[3]	–1.7	–1.7	–0.5	0.1	0.9	0.9	1.0
Treaty debt ratio[4]	43.7	40.6	37.6	36.1	35.7	35.6	35.6
Memo: Output gap	0.2	0.6	0.5	0.3	0.2	0.1	0.0

[1] *Excluding windfall tax receipts and associated spending.*

[2] *Including windfall tax receipts and associated spending.*

[3] *General government net borrowing on an ESA95 basis. The Treaty definition includes the windfall tax and associated spending.*

[4] *General government gross debt.*

Golden rule

2.60 Table 2.5 indicates that, after allowing for non-discretionary changes to receipts and spending and after releasing additional resources, the Government remains on track to meet both fiscal rules. The surplus on current budget represents the difference between current receipts and current expenditure, including depreciation. The surplus on current budget is estimated to equal 2.4 per cent of GDP in 2000-01. It is then projected to decline to 0.8 per cent over the forecast period, largely because of the increased current spending provided by the 2000 Spending Review, as well as measures announced in Budget 2001 and the Pre-Budget Report.

2.61 On a cyclically-adjusted basis, the surplus on current budget remains positive throughout the forecast period. The average surplus since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, also stays positive, remaining above 1 per cent over the next five years. On this basis, the Government is on track to meet the golden rule.

Chart 2.2: Meeting the fiscal rules - cyclically-adjusted surplus on current budget and public sector net debt

Sustainable investment rule

2.62 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This depends on maintaining public debt at a low and sustainable level. The Budget 2001 forecast shows that net debt continues to fall more sharply than predicted. With the benefits of sound public finances, lower interest rate expectations, lower inflation and the proceeds from the radio spectrum licence auction, the public sector net debt ratio is estimated to fall to below 32 per cent of GDP in 2000-01, and thereafter to fall further to 30 per cent or lower.

2.63 In every year of the forecast period net debt is also lower than the PBR forecast, reflecting lower than expected net borrowing in the current year. The Government is therefore firmly on track to meet the sustainable investment rule with net debt held at a stable and prudent level, well below 40 per cent.

2.64 Chart 2.2 illustrates the falling net debt ratio, as well the cyclically-adjusted current budget remaining in surplus. It shows that the Government met its fiscal rules over the economic cycle that was probably completed between mid-1997 and mid-1999, and that it is on track to meet them in every year up to 2005-06.

2.65 Another measure of the sustainability of the government's fiscal position is net worth, the difference between the total assets and liabilities of the Government. Net worth is projected to rise to over 21 per cent by 2001-02, thereafter remaining broadly stable.

Economic impact

2.66 While the key objective for fiscal policy is to ensure sound public finances, fiscal policy also impacts on the economy and plays a role in supporting monetary policy over the cycle. The key indicator for assessing the overall fiscal impact is the change in PSNB. The forecast for net borrowing is set out in Chart 2.3 which shows the actual and cyclically-adjusted figures as a percentage of GDP. The chart shows the projected move from surplus into deficit over the medium term. This is because the Government is planning to borrow modestly to fund its increased investment in the country's capital stock. This is fully consistent with the Government's long-term approach and with the fiscal rules, since net debt is being held at a stable and prudent level.

Chart 2.3: Public sector net borrowing - actual and cyclically-adjusted

2.67 The overall fiscal impact on the economy is made up of changes in:

- the fiscal stance - that part of PSNB resulting from changes in cyclically-adjusted PSNB; and
- the automatic stabilisers - that part of PSNB resulting from cyclical movements in the economy.

2.68 Between Budgets, the fiscal stance can change as a result of a discretionary measure to:

- achieve a desired change in the fiscal stance; or

- accommodate or offset the impact of non-discretionary factors (non-cyclical or structural changes to tax receipts or public spending).

2.69 Table 2.6 explains how these concepts relate to the projections in the Budget. It shows the change in both the fiscal stance and the overall fiscal impact relative to the projections in Budget 2000, which set the envelope for the 2000 Spending Review allocations of departmental spending until 2003-04.

Table 2.6: The overall fiscal impact - change from Budget 2000

	Percentage points of GDP				
	Estimate	**Projections**			
	2000-01	**2001-02**	**2002-03**	**2003-04**	**2004-05**
Budget policy decisions	0.0	0.4	0.3	0.4	0.3
+					
PBR/SR 2000 measures	0.2	0.3	0.4	0.4	0.4
+					
non-discretionary factors	–1.1	–0.7	–0.8	–0.7	–0.8
=					
CHANGE IN FISCAL STANCE	**–0.9**	**0.0**	**–0.1**	**0.0**	**–0.1**
+					
automatic stabilisers	–0.1	–0.1	–0.1	–0.1	–0.1
=					
OVERALL FISCAL IMPACT	–1.0	–0.1	–0.2	–0.1	–0.2

2.70 In 2000-01 there was a significant tightening of the fiscal stance relative to that anticipated at the time of Budget 2000. This occurred as a result of buoyant tax receipts and lower than expected spending. As a result of higher growth than expected, the automatic stabilisers have also operated to a slightly greater extent than forecast. In total, the overall fiscal impact was greater than expected a year ago by an amount equivalent to 1.0 per cent of GDP.

2.71 The non-discretionary improvement persists through the forecast period (reflecting in part the structural improvement to the tax base discussed in Chapter C). Discretionary measures announced in the Budget, combined with decisions taken in the 2000 Spending Review and in the Pre-Budget Report offset this. The fiscal stance in Budget 2001 is therefore at least as tight as set out in last year's Budget. In addition, the automatic stabilisers are projected to operate to a greater extent throughout the forecast period than projected at the time of the last Budget. Overall therefore, fiscal policy will continue to support monetary policy as the economy remains above trend.

Financing

2.72 A revised Gilts Remit was published on 12 June 2000 in the light of the better than expected outcome from the auction of radio spectrum licences. Gross gilts issuance was fixed at £10 billion for the remainder of the financial year. This represented a reduction of £2.2 billion from the original remit issued in March 2000. Additionally, the contingencies outlined in the Debt Management Report 2000-01 were exercised. It was decided that the surplus should be used to reduce net debt. In the Pre-Budget Report, the forecast for the Central Government Net Cash Requirement (CGNCR) was revised from –£4.9 billion to –£28.2 billion. Additionally, further decisions were made regarding the composition of the reduction in net debt. It was also announced that the Debt Management Office would be holding a net short term cash surplus which they would unwind over the next three financial years.

2.73 The forecast for the CGNCR in 2001-02 is £0.3 billion. In order to add to the financing requirement and maintain the level of gross issuance, the Government has decided to pre-finance foreign currency debt due in 2003. In addition, the Government forecasts that it will purchase £1 billion of gilts through secondary market buy-backs. Both of these measures help increase the financing requirement and this will help to address the current liquidity problems in the gilts market. Gross gilt sales are planned to be £13.5 billion in 2001-02. Details of the debt management plans for 2001-02, including the remits for the Debt Management Office and National Savings are published today in the Debt and Reserves Management Report 2001-02.

European commitments

2.74 The Treaty provides reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP). The Budget 2001 projections are consistent with these Treaty requirements and are in line with the Stability and Growth Pact. Gross debt is projected to fall to 37.6 per cent in 2001-02 and then to nearly 35 per cent by the end of the forecast period, well below the relevant value. Consistent with the Government's fiscal rules, the general government financial balance moves into a small deficit in the medium term reflecting the impact of increased investment in priority public services announced in the 2000 Spending Review. It remains well within the 3 per cent reference value.

Dealing with uncertainty

2.75 Projections of public finances necessarily involve a considerable degree of uncertainty. In particular, public revenue and spending projections depend heavily on forecasts of economic growth and, in particular, on assumptions about where the economy is in relation to trend at a given point in time. The health of public finances can quickly deteriorate if most of the strength turns out to be cyclical and if the economy slows to below trend over the forecast horizon. This could result in the need for significant and costly changes in the direction of fiscal policy.

2.76 To counter this risk and avoid potential disruptions to policy arising from other economic or fiscal shocks, the Government stress tests its projections against a cautious case in which the level of trend output is assumed to be 1 percentage point lower than in the central case. This is illustrated in Chart 2.4. Even on this basis, the Government is on track to meet the golden rule over the economic cycle.

Chart 2.4: Cyclically-adjusted surplus on current budget

2.77 This increases the probability of meeting the fiscal rules and also creates a buffer against fiscal risks. By creating a safety margin, it minimises the need for unexpected changes of direction and so allows a smoother path for public spending.

LONG TERM FISCAL PROJECTIONS

2.78 It is important that the Government ensures that its short term fiscal policy decisions are consistent with long-term fiscal sustainability. Failure to do so could have detrimental effects on long-term economic growth. Illustrative long term projections are presented in Annex A of the EFSR. They show that the fiscal position is sustainable in the long term, with net debt to GDP projected to remain below 40 per cent.

2.79 The projections, which are based on prudent and cautious assumptions, show that current public consumption can grow faster than real GDP, while public net investment can be sustained at around $1^3/_4$ per cent of GDP without jeopardising the fiscal rules. The high degree of uncertainty surrounding the projections indicates that there is no scope for complacency.

CONCLUSION

2.80 The impact of introducing a new and comprehensive macroeconomic framework since 1997 is helping to sustain macroeconomic stability and enhanced economic performance. The sound fiscal position, sustainable into the medium and long term, coupled with a credible and effective framework for monetary policy, are creating an environment where the private sector can take decisions with more confidence and where the necessary improvements in public services can be afforded.

2.81 The challenge remains, however, to move to a significantly higher level of sustainable growth, the benefits of which are widely spread through the domestic economy, and which allow the UK to play a full part in maintaining a healthy world economy. Improving productivity is central to achieving this aim. The next chapter outlines measures the Government is taking to close the productivity gap.

[1]See *Audit of Assumptions for the March 2001 Budget,* March 2001 (HC304).

[2]See *Fiscal Policy: Public Finances and the Cycle*, HM Treasury, March 1999.

[3]HM Treasury, November 1999.

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3
Meeting the Productivity Challenge

The Government's long-term ambition is to close the productivity gap between the UK and its main competitors. The Government's strategy focuses on the five drivers of productivity growth: competition, enterprise and innovation, skills, investment and public sector productivity.

To achieve its aims, the Government is committed to a regional economic policy that exploits the indigenous strengths of each city and region, and which gives flexibility to locally and regionally based initiatives. This Budget gives Regional Development Agencies further flexibility to take responsibility for their own finances and to implement regional strategies for the delivery of economic development and regeneration.

In this Budget the Government is also:

Strengthening competition by:

- continuing to ensure that the UK competition regime does all it can to promote competition in the economy.

Encouraging enterprise and innovation by:

- introducing a package of measures to reduce the administrative burden of tax on small businesses;
- consulting on a new tax credit for community investment;
- expanding the scope of Enterprise Management Incentives;
- consulting on proposals for a new research and development tax credit for large firms; and
- launching an independent study aimed at enhancing the supply of highly qualified scientists and engineers in the UK.

Strengthening investment by:

- taking forward all the recommendations of the Myners review of institutional investment.

Working to raise the skills base by:

- examining the need for further action - including from Government - to address the low level of skills in the workforce.

THE PRODUCTIVITY CHALLENGE

3.1 The Government's objective is to deliver high and stable levels of growth and employment by raising the trend rate of growth. The nation's output depends on the number of people in work, and how productive those people are. Raising the rate of productivity growth is, consequently, a key route to raising living standards.

3.2 The UK has a poor track record on productivity. Historically, the UK economy has suffered from macroeconomic instability and microeconomic failures which have inhibited productivity growth and created a substantial productivity gap between the UK and many other advanced industrial economies.

3.3 To address these problems, the Government has developed a comprehensive strategy for increasing productivity growth and meeting the joint Public Service Agreement (PSA) target held by the DTI and the Treasury to narrow the productivity gap.

Box 3.1: Productivity ambition

In the 1999 Pre-Budget Report, the Government set the ambition that UK productivity would, over the next decade, rise faster than that of its major competitors.

The UK's output per worker performance has long lagged behind that of its competitors. By this measure, US productivity is 45 per cent higher, and productivity in France and Germany 19 and 7[1] per cent higher, respectively, than in the UK.

Chart 3.1: The productivity gap

Increasing the employment rate may have a short-term dampening effect on recorded productivity - as new entrants are generally less productive than existing workers - and recent years have seen strong employment growth, with well over 1 million more people now in work. However, this need only be a short-term effect - as the US experience shows, high employment levels and strong productivity growth can be delivered side by side.

On the latest figures, year-on-year productivity growth is 2.6 per cent, with encouraging signs related to the drivers of productivity growth. For instance:

- business investment was above 14 per cent of GDP in 2000, compared with around 10 per cent in 1994;
- the number of small businesses in the economy increased by 170,000 between 1997 and 1999;
- civil R&D investment by business increased by 8 per cent in nominal terms between 1998 and 1999; and
- literacy levels at age 11 have increased by nearly a third over the last four years.

3.4 This is outlined in *Productivity in the UK: The Evidence and the Government's Approach*, which was published alongside the Pre-Budget Report. Alongside this Budget, the Government is publishing a further paper, which examines progress in improving UK productivity: *Productivity in the UK: Progress towards a Productive Economy*.

3.5 The Government's strategy tackles problems at regional, national and international levels. The Government's approach to European economic reform is set out in box 3.2.

Box 3.2: European economic reform

At the Lisbon European Council last year, Europe's leaders committed themselves to an ambitious ten-year strategy for economic reform. The vision agreed at Lisbon is of a dynamic job-creating Europe that delivers on both economic and social objectives to become the leading knowledge-based economy in the world.

Making this vision a reality is a substantial challenge: to raise the EU's employment and productivity performance beyond that of the US by 2010. Matching US performance on both measures would raise Europe's output by 40 per cent - equivalent to around £5,000 per person per year.

The Lisbon summit marked a major change in economic policy making in Europe. It was the result of three years' work to establish a new economic policy framework that will deliver the higher levels of growth, productivity and employment needed in the EU. Recognising the UK's interdependence with other EU economies, and in close cooperation with its European partners, the Government has been at the forefront of developing this new policy framework.

The next step is the Stockholm European Council on 23-24 March 2001. At Stockholm, Europe's leaders will need to continue along the path agreed at Lisbon. This will require:

- further reforms mainly at national level to deliver a full employment Europe and to close the R&D gap. Shared European social objectives need a modernised approach to social policy, focused on helping people find jobs, equal opportunities, lifelong learning and combating social exclusion;
- further reforms at EU level to strengthen the single market - fulfilling commitments in telecoms and financial services, setting new targets in areas such as energy and opening up cross border employment opportunities; and
- the EU to show global leadership by calling for a new trade round.

The Government will shortly publish a paper setting out its priorities for the Stockholm European Council. The Government will follow this up by publishing a White Paper on economic reform in Europe for the Spanish presidency.

3.6 The two pillars of the Government's approach are delivering macroeconomic stability, to allow firms and individuals to invest for the future, and implementing microeconomic reforms to remove the barriers which prevent markets from functioning efficiently. These reforms address historic weaknesses in five areas that can drive productivity growth:

- strengthening **competition**, encouraging firms to innovate and reduce slack, putting downward pressure on costs;
- promoting **enterprise and innovation** in an environment where people are enabled and encouraged to start up new companies, generate new ideas and introduce new technology and working practices;
- improving the **skills** base to maximise the contribution of human capital to growth;
- encouraging **investment** in physical capital by promoting well-functioning capital markets; and
- alongside these measures, working directly to improve **public sector productivity**.

The regional dimension

3.7 Raising productivity provides a sustainable basis for rising living standards. The Government aims to raise living standards across the whole of the UK. Regional imbalances - within or between regions - hold back national economic performance. Regionally balanced growth, led by the regions themselves, is not only desirable in its own right but also an essential element of the Government's approach to raising productivity. The Government wants to maximise the potential of all areas - towns, cities and rural areas - and has set out its strategies for doing so in the Urban and Rural White Papers, published in November 2000. These strategies tie together the need to tackle economic, social and physical regeneration (also covered in Chapters 5 and 6).

3.8 The Government's regional economic policy is based on two principles. First, exploiting indigenous strengths in each area and region is likely to be the most effective way of strengthening the essential building blocks of growth - innovation, skills and the development of enterprise. Second, the best mechanisms for achieving this are likely to be based in the regions themselves, and so national government must enable regional and local initiatives to work by providing the necessary flexibility and resources within a national framework.

3.9 Regional Development Agencies (RDAs) have a key role as the strategic leaders in regional and local economic development. They work with Government Offices, Learning and Skills Councils, the Small Business Service, Local Strategic Partnerships and locally-focused partnerships such as New Deal and Employment Zones. Taken together, these institutions form a powerful and influential set of levers, working with each other and central government to drive up productivity in all regions.

3.10 The RDAs have developed regional strategies whose primary purpose is to enhance each region's competitiveness through sustainable economic development, regeneration and business growth. These have been agreed with regional partners and set out a shared understanding of the challenges their regions face and a strategic vision for meeting them. They provide an essential overall context for the work of other regional, sub-regional and local partners on economic development and regeneration.

3.11 This has two clear advantages. First, it provides a framework within which regional and local partnerships can develop in a coherent way, and so maximise their effectiveness. Second, it provides an inclusive focal point for strengthening regional accountability. The Deputy Prime Minister will shortly be setting out proposals for increasing the opportunities for the RDAs to demonstrate their achievements to their regions

Flexibility for the RDAs

3.12 The Government has strengthened the RDAs' role with a substantial increase in resources and significantly increased flexibility over how they use those resources. The 2000 Spending Review increased RDA budgets from £1.2 billion in 2000-01 to £1.45 billion in 2001-02 and over £1.7 billion in 2003-04, with separate budgets from DETR, DfEE and DTI brought together in a cross-departmental Single Budget from April 2002.

3.13 In order to deliver a smooth transition to this Single Budget, the November Pre-Budget Report announced that from April 2001 flexibility would be enhanced within the existing framework and that a Strategy Fund would be created for innovative schemes.

3.14 RDAs will now be given further additional flexibility to manage their finances within the Single Budget framework, boosting their effectiveness and efficiency. RDAs will be given full financial flexibility within their capital and current budgets. They will also be allowed full "end-year flexibility" - freedom to carry their resources forward from one year into the next. This increased flexibility is to be matched with increased accountability. RDA Objectives and Targets for meeting strategic goals under the Single Budget have been agreed and will be announced by the Deputy Prime Minister shortly.

Box 3.3: The CBI/TUC productivity campaign

Recognising that closing the productivity gap cannot be achieved without a wider drive across the economy, in October 2000 the Chancellor invited the TUC and the CBI to work together on an agenda to raise productivity.

In a joint response, the TUC and CBI endorsed the Chancellor's request. As a result, working groups have now been set up in the four areas identified as being most urgently in need of attention:

- training, with a focus on developing intermediate skills in the workplace. The group will be chaired by John Monks (General Secretary, TUC) with John Roberts (Chief Executive, Post Office) his deputy;
- investment, to consider the barriers to investment in the UK economy. The work will be chaired by Digby Jones (Director General, CBI), with Bill Morris (General Secretary, TGWU) his deputy;
- technology and innovation. This group will be chaired by Sir Ken Jackson (General Secretary, AEEU) with John Robinson (Chairman, Wimpey) his deputy; and
- dissemination and application of best practice, building on existing Government initiatives. The work will be chaired by Paul Barron (President, Alstom UK) with John Edmonds (General Secretary, GMB) his deputy.

Each working group will include additional members from the two organisations, academics, and regional representatives. In advance of the 2001 Pre-Budget Report, the groups will come forward with proposals oriented towards action, concentrating on what employers, unions and the Government can do to raise productivity.

COMPETITION

3.15 Competition has long been recognised as essential to an efficient economy. Research[2] shows that competition is strongly correlated with productivity performance. Competition creates pressure to innovate, keep costs down and improve the quality and choice of products available, and it ensures that resources are allocated to the most efficient firms. Competition is also the most effective way of ensuring that consumers receive a fair deal. The Government has taken a number of measures during this Parliament to improve the competition regime in the UK. These include:

- introducing the Competition Act, which has strengthened the powers of the Office of Fair Trading (OFT) to take action against anti-competitive agreements and the abuse of market power; and announcing an intention to reform mergers control so that decisions are taken by the competition authorities against a competition-focused test;
- conferring a new role on the OFT (and other regulators) to assess when laws and regulations create barriers to entry and competition;
- increasing resources for the OFT;
- introducing the Utilities Act, to strengthen competition in the electricity sector through reforms to the wholesale electricity market and the separation of electricity supply from the monopoly activity of electricity distribution; and
- investigating competition in particular markets, including the Cruickshank review of retail banking. The Government will shortly announce its decision on how to increase competition in the water industry, following the Deputy Prime Minister's review.

3.16 But the Government remains anxious to ensure that all sectors of the economy are exposed to competition. The OFT has today published its report to the Government on competition in the market for professional services. The Government warmly welcomes the report and appreciates the effort that has gone into preparing it. While some of the issues raised are for the OFT to take forward using its Competition Act powers the report also contains a number of wide ranging recommendations for action by other Government departments. **The Secretary of State for Trade and Industry will outline the Government's response to these proposals.**

3.17 The Government wishes to ensure that the UK's competition regime does all it can to promote competition in the economy. Questions which the Government is keeping under review include whether:

- improvements should be made to the regime for complex and scale monopolies;
- consumer bodies should play a greater role in competition policy;
- third parties harmed by anti-competitive behaviour should have an easier means of seeking redress;
- more stringent penalties for those who breach competition law would lead to a more effective competition policy;
- improvements should be made to the UK regime in the light of international best practice, and the need for increased

co-operation between competition authorities; and whether
- further steps should be taken to improve the independence and standing of UK competition authorities.

The Cruickshank review

3.18 In order to address the concerns raised by Don Cruickshank's report on competition in UK banking, published in March 2000, the Government has introduced a number of measures to improve competition in the banking industry and to deliver a better deal for consumers:

- Budget 2000 announced the Government's intention to legislate to open up access to payments systems and to oversee access charges. In December 2000, the Government published a consultation document, *Competition in Payment Systems*, which set out its proposals to give the OFT new powers to promote effective competition in payment systems for the benefit of consumers. The deadline for responses to this consultation is 20 March;
- the Government has also established an independent group to review whether self-regulatory codes, like the Banking Code, are delivering sufficiently strong benefits to consumers. This group, which is being chaired by DeAnne Julius and has members from a wide range of backgrounds, is due to report in April 2001. The Government is also seeking to benefit consumers by extending its scheme of voluntary CAT standard benchmarks to include basic bank accounts and credit cards, and published its proposals for consultation in January; and
- the Government also accepted Don Cruickshank's recommendation to refer the supply of banking services to small and medium-sized enterprises (SMEs) to the Competition Commission, which is due to produce a final report in June 2001.

ENTERPRISE AND INNOVATION

3.19 An environment which encourages people to take opportunities and risks, and rewards and supports those who do, is a crucial ingredient of productivity improvement. Not only do new entrants increase competitive pressure in markets, but also entrepreneurship drives innovation and change by encouraging the creation and introduction of new technologies and working practices.

3.20 To simplify and improve support for SMEs, and to provide the sector with a strong voice, the Government established the Small Business Service (SBS). Among its achievements in its first year, the SBS has helped to establish the £125 million UK High Technology Fund, and committed over £20 million of support from the Phoenix Fund for more than 60 innovative projects supporting enterprise in disadvantaged areas. In the White Paper on Enterprise, Skills and Innovation, the Government announced that the SBS will operate a new £75 million incubator fund to help ensure that all start-up companies likely to benefit from such facilities are able to do so.

3.21 The Government has reformed the tax framework for businesses to ensure that the right incentives are in place for enterprise. These reforms have included:

- lowering the main rate of corporation tax - at 30 per cent now the lowest among major industrialised countries - and introducing a 10p starting rate for small firms which is the lowest in the European Union;
- introducing a capital gains tax taper to encourage investment, with particular incentives for investment in business assets;
- developing the All-Employee Share Ownership Plan to promote employee shareholding;
- introducing Enterprise Management Incentives to help small higher risk companies recruit and retain employees through the use of tax-advantaged share options; and
- improving the Enterprise Investment Scheme and Venture Capital Trust scheme, and introducing the Corporate Venturing Scheme, to boost the supply of risk capital to small companies.

3.22 The Pre-Budget Report launched consultation on further improvements to ensure that the UK has a tax framework that competes with the best in the world. As a result, the Government will be:

- **abolishing from April 2001 the requirement to withhold tax on interest and royalties between companies in the UK.** This will simplify the tax framework and enhance the availability of funding from sources other than banks;
- **publishing the details of the proposed new regime for providing relief to companies for the costs of intellectual property, goodwill and other intangible assets.** A new Inland Revenue technical note, building on earlier discussions with business, sets out how the new system would operate and includes draft legislation. The Government wishes to consult with business to ensure that this new regime can be introduced as soon as is practicable;

- **allowing employers to settle unpredictable NICs liabilities on the growth in value of unapproved employee share options granted between 6 April 1999 and 19 May 2000** by making special employer contributions based on the value of the shares on 7 November 2000;
- consulting business on company taxation and the competitiveness of the UK tax system. A paper will be published in early summer that will set in a broader context the current proposals for a **relief on gains arising on the disposal of substantial shareholdings.** The objective is to achieve a more flexible and competitive company tax system for parent companies based in the UK which will provide stability for the long term.
- **extending the on-shore pooling rules with regard to double taxation relief** to allow relief for eligible unrelieved foreign tax, even if it arises at several levels in a chain of companies overseas; and
- **extending the benefit of the capital gains tax business assets taper to employees of non-trading companies, with effect from 6 April 2000.**

Encouraging SMEs

3.23 The Pre-Budget Report announced a major package of measures to allow businesses to manage their entry into the VAT system, reduce their VAT administration burden and improve their cash flow. This will include consultation in the summer on the introduction of a flat-rate scheme and changes to the annual accounting scheme for those smaller companies with a turnover of no more than £100,000. As announced in the Pre-Budget Report, legislation will also be amended to:

- **increase the VAT registration threshold, in line with inflation to £54,000,** keeping it the highest in Europe; and
- **create a new consolidated SME turnover level at £600,000** to allow more small businesses to qualify for the annual and cash accounting schemes.

3.24 In addition to these measures, the Government will be taking forward measures to enhance support for e-business.

Small business tax

3.25 The Government is committed to reducing, where possible, the regulatory burdens on small businesses. To this end it has established the Better Regulation Taskforce and the Panel for Regulatory Accountability. Continuing this commitment, **the Government will consult on a proposal to achieve a radical simplification of the way in which small businesses are required to calculate the tax due on their profits** by aligning their profits for tax purposes much more closely with those reported in their accounts. The aim of this proposal would be to reduce regulatory and compliance costs for small businesses and enhance the overall support available to small businesses from the Inland Revenue.

3.26 The Government wishes to discuss this proposal with small businesses and their advisers to ensure that policy and regulation take full account of their needs. The Government is particularly interested in suggestions for refinements and further ideas.

Enterprise Management Incentives

3.27 In Budget 2000 the Government introduced tax-favoured Enterprise Management Incentives (EMIs) to help small higher risk companies to recruit and retain the people they need to achieve their potential for growth. This has proved popular with business and nearly 500 companies have awarded EMI options. The close partnership with business in designing the scheme has helped to identify further improvements and this is reflected in Budget 2001.

3.28 In the Pre-Budget Report, the Government announced that it would consult on creating more flexibility for companies. This included a proposal to replace the limit on the number of employees who can be granted options by a limit on the total value of tax-favoured options, so that companies can allocate this in the ways best suited to their businesses. Budget 2001 confirms the removal of the limit on the number of employees and doubles the maximum value of options to £3 million per company, above the £2.5 million limit consulted on in the Pre-Budget Report.

Encouraging employee share ownership

3.29 In Budget 2000 the Government introduced the All-Employee Share Ownership Plan (AESOP), to support employers' efforts to foster a more productive and enterprising relationship with their workers. Since then, 282 applications have been received, and over 100,000 employees are already covered by the plan. **To improve the plan even further, a stamp duty exemption will be introduced for employees buying shares through an AESOP trust.**

3.30 As well as creating targeted incentives for employees to take up share ownership, the Government also aims to reduce the fiscal barriers to companies using equity remuneration to provide incentives for their workforce, thereby enhancing the UK business environment. The Government will examine the corporation tax treatment given in respect of employee share awards and share options, including whether corporation tax deduction should be made available and how access to it could be streamlined.

Directors' pay

3.31 The DTI is announcing alongside this Budget the Government's proposals for strengthening transparency and disclosure on directors' remuneration. The Government will consider further whether there is a need to legislate to strengthen directors' accountability to shareholders, including the issue of a compulsory vote on the remuneration report, in the light of the Company Law Review's wider recommendations on company law reform.

Enterprise in disadvantaged communities

3.32 The Social Investment Task Force (SITF), led by Sir Ronald Cohen, reported to the Chancellor in October 2000. Its report, *Enterprising Communities: Wealth Beyond Welfare*, recommended a five-point programme of action aimed at stimulating enterprise, investment and wealth creation in disadvantaged communities. The report's five recommendations were:

- a new Community Investment Tax Credit, to encourage private investment in enterprises in disadvantaged communities;
- a new Community Development Venture Fund - a matched funding partnership between Government and the venture capital industry;
- more detailed disclosure by individual banks of their business lending activities in disadvantaged communities, combined with a rating system to reward excellent performance;
- greater flexibility for charities to invest in community development; and
- greater support for the community development finance sector.

3.33 The Government welcomed the SITF report in the Pre-Budget Report and has since begun to take forward all five recommendations by:

- launching a consultation document on the proposal for a Community Investment Tax Credit on 1 March. This aims to attract greater flows of private investment into enterprises in disadvantaged communities. Responses to the consultation are requested by 2 July 2001;
- working closely with Sir Ronald Cohen and others on setting up the first public-private Community Development Venture Fund, which will make equity investments in enterprises with growth potential in disadvantaged areas. The Government hopes to see this first fund set up this year;
- encouraging the banks to disclose their individual business lending activities in disadvantaged communities on a voluntary basis. The Government believes that this would make a major contribution to improving the information flows in disadvantaged communities - which would in turn help to identify barriers to, and opportunities for, growth;
- welcoming the Charity Commission's planned programme of guidance, which will help unlock more charitable investment in enterprises in disadvantaged communities. This guidance means that the relief of unemployment, urban and rural regeneration and community capacity building all now count as charitable purposes. Also, many charities can now undertake "programme-related investments" - the provision of equity finance and loans, as well as grants, to further their charitable objectives; and
- encouraging the community development finance sector to form a single, high-quality and inclusive trade association.

3.34 The Chancellor recently launched the Inner City 100 which will celebrate the 100 fastest growing companies in the most disadvantaged inner cities. The Inner City 100 index will be published in autumn 2001.

3.35 Promoting enterprise is a key part of addressing social exclusion. Other elements of the Government's strategy for tackling social exclusion are set out in Chapter 5.

Encouraging innovation

3.36 Encouraging innovation and research and development (R&D) is a vital component of the Government's strategy for improving the UK's productivity performance. The Government believes that the most effective way to increase innovation is to work in partnership with business. The Government can help to ensure that the infrastructure and business environment are internationally competitive, giving businesses the platform from which to innovate. It can also help to overcome some of the barriers to longer-term investment created by the market, especially where there are wider benefits above and beyond those going to the firm making the investment. But it is business that must rise to the challenge of making the most of these opportunities.

3.37 Comparisons with other countries show that the UK business sector under-invests in R&D relative to its major competitors, and that whereas business expenditure on R&D fell as a percentage of GDP in the UK over the past two decades, it rose in most other major industrialised countries.

Chart 3.1: Business R&D expenditure as a percentage of GDP, 1981 and 1998

3.38 Relative under-investment in R&D by UK firms is translated into lower levels of innovation, with surveys[3] indicating that UK firms - particularly, but not exclusively, larger firms - tend to be less orientated towards innovative products and services than their counterparts overseas. Innovation acts as a catalyst for growth and this analysis therefore supports the need for UK business as a whole to improve its innovation and R&D performance.

3.39 The Government has already introduced an R&D tax credit for SMEs, in order to address the particular difficulty that these firms face in accessing capital to invest in innovation and R&D. **In order to complement this measure and further to improve the UK's innovation performance, the Government is publishing a consultation document, *Increasing Innovation*, which sets out the Government's proposals for a new tax credit to encourage R&D and innovation among larger firms and consults on the design of such a measure.**

3.40 Given the policy aim of providing incentives for companies to undertake more R&D and increase their commitment to innovation, the Government is minded towards an incremental R&D tax credit, assuming that a number of design issues can be successfully resolved through consultation with business. An incremental scheme would reward companies in proportion to their additional current R&D expenditure above present levels. Similar measures are already in use in countries such as France, Japan and the US.

3.41 It is envisaged that pharmaceutical companies will be able to claim the proposed incentives which are discussed in Chapter 5 and are specifically targeted at encouraging work to eradicate killer diseases in developing countries, alongside both the existing and proposed generic R&D tax credits.

3.42 The Government is also keen to ensure that businesses are not constrained in increasing their R&D and innovation through inability to find suitably skilled scientists and engineers. The UK overall has been shown to have a strong science base and the Government has sought to complement this through launching a number of initiatives to improve the skills of the workforce. However, the Government is aware of the concerns expressed that this overall healthy picture could mask skills shortages at the top end of specific scientific and technological fields.

3.43 The Government has therefore asked Sir Gareth Roberts to undertake an independent study into the provision of skilled scientists and engineers in the UK, reporting back by February 2002. This study will examine whether there are adequate mechanisms in place for businesses to identify their needs for specific scientific and technical skills, for communicating these to the higher education sector and for the sector to respond effectively.

Making the most of the radio spectrum

3.44 The Pre-Budget Report announced the Government's intention to commission a review of radio spectrum management, to advise on the principles that should underlie spectrum management and what more can be done to ensure that all users, including non-commercial users, are focused on using their spectrum as efficiently as possible. **The Chancellor and the Secretary of State for Trade and Industry have appointed Professor Martin Cave to conduct the review. As a first stage, the review will be consulting with interested parties on issues relevant to its remit, including:**

- means of ensuring that all of the spectrum, including that allocated to non-commercial purposes, is used with maximum efficiency; and
- investigating the scope for improving spectrum pricing and trading arrangements.

INVESTMENT

3.45 Empirical studies[4] show a strong correlation between capital intensity and productivity. The UK has long suffered from under-investment and as a consequence has lower capital stock than most of its main competitors. Greater macroeconomic stability and targeted reforms have helped to create an environment in which business investment has grown (see chart 3.2) but this investment will need to be sustained if the effects of underinvestment are to be reversed.

3.46 A stable macroeconomic climate is essential to continuing investment. But it is also necessary to ensure that funding for investment is available to those who need it and can best use it. This means ensuring that capital markets are able to work efficiently in allocating investment across the economy. To this end, the Government commissioned Paul Myners to conduct a review of institutional investment. The findings of his review are summarised in box 3.4.

Chart 3.2: Business investment as a percentage of GDP

Box 3.4: The Myners review of institutional investment

At the time of Budget 2000, the Government asked Paul Myners, chairman of Gartmore Investment Management, to look at whether there are factors distorting institutional investment decisions.

The final report of the review was published on 6 March 2000. The review concludes that there are a number of distortions affecting institutional investment decision-making:

- trustees are the ultimate decision-makers for pension funds, but they are typically unpaid; many have limited investment expertise and a low level of support from in-house staff;
- their investment decision-making, especially on asset allocation, is dependent on advice from a small number of advisory firms;
- sponsor companies have insuffcent incentives to encourage efficient management of pension schemes;
- the objectives given to fund managers often do not align their interests effectively with those of their institutional clients, and there is a lack of clarity about the timescales over which they are measured;
- fund managers are excessively reluctant to engage actively with companies in which they are invested;
- the Minimum Funding Requirement (MFR) distorts investment behaviour without protecting pensioners;
- there are issues concerning capital and information flows around the personal investment products market; and
- private equity investment is affected by many of these factors, but also raises specific issues as an asset class for institutional investors.

In the light of these concerns, the review makes a number of recommendations, in particular:

- a code for institutional investment decision-making, the central principles of which include:
  - decisions to be taken only by those with the right skills and expertise;
  - clear objectives and timescales for managers;
  - performance measurement of all advisers; and
  - regular reporting of investment strategy and returns to members and the public;
- the replacement of the MFR with a scheme-specific regime based on transparency and disclosure;
- incorporation of the US ERISA principles on shareholder activism into UK law, making intervention in companies, where it is in shareholders' interests, a duty for fund managers;
- the Law Commission to look at clarification of the legal ownership of surplus pension fund assets;
- reduction of the rate of tax on withdrawal of the surplus;
- a legal change which would raise the duty of care for trustees, requiring them to be familiar with investment matters where they take investment decisions;
- a proposal for an independent review of capital and information flows relating to personal investment products; and
- a number of measures which take account of the special nature of private equity as an asset class for institutional investors - including changes to the maximum number of partners in a limited partnership and to the taxation of the proceeds from the investments of such partnerships.

Initial response to the Myners review

3.47 The Government is grateful to Paul Myners for his report and intends to take forward all his recommendations. In particular, the Government:

- believes that the principles for institutional decision-making set out in the report are correct. It agrees with the review's proposal that pension funds and in due course other institutions should set out to their members, and publicly, where they do not comply with any of these. **The Government will hold a short consultation on the precise detail of the principles before promulgating them;** the Government is willing - as recommended by the review - to legislate if necessary to ensure that disclosure against them occurs. As recommended, **the Government will undertake a public assessment in two years' time of the effectiveness of the principles in bringing about**

behavioural change;

- **will legislate to require trustees to be familiar with the investment issues on which they are making decisions and to incorporate the principle of the US Department of Labor interpretative bulletin on shareholder activism into UK law;**
- agrees that it would be helpful for the Law Commission to examine whether legal change could clarify ownership of pension fund surpluses. **The Government will consult on abolishing the 20-partner limit for limited partnerships,** and also agrees that it would be helpful for the Law Commission's forthcoming review of the Limited Partnerships Act to look particularly at clarifying the scope for limited partners to play investment advisory roles. **It will also reduce regulatory obstacles to pension funds investing in private equity limited partnerships, by removing the requirement to invest through an FSA-authorised person;**
- **will, following recent reductions in the main corporation tax rate, restore the differential between this rate and the rate of taxation on the withdrawal of pension fund surpluses to its original level. The Government accepts the recommendation to change the taxation of insurance companies' limited partnership investments to taxation of the gains as distributed from the fund.** It will consult on the detail of this change and bring forward legislation in a future Finance Bill; and
- **will commission a further independent review of capital and information flows regarding personal investment products.**

Minimum Funding Requirement

3.48 The Government is also publishing a separate document alongside this Budget setting out its proposed way forward on the MFR, on which it received consultation responses from Mr Myners and others. The Government believes that the MFR should be abolished and replaced by a long-term scheme-specific approach based on transparency. The Government also wishes to draw on a number of points from consultation responses including, in particular, useful suggestions from the National Association of Pension Funds. **The Government will legislate to replace the MFR with a long term scheme-specific funding standard, with additional protective measures, including a statutory duty of care for the scheme actuary, stricter rules on voluntary wind-up and extension of compensation for fraud**.

Financing growing enterprises

3.49 To realise their growth potential, smaller enterprises are increasingly turning to external equity finance to provide the necessary capital. By linking provision of finance with business mentoring and networking benefits, venture capital and "business angel" investors can foster the growth of their investee companies. The Government has made significant progress since 1997 to improve the fiscal environment for this vital early-stage risk capital finance. It has also stimulated the creation of new public-private venture funds to address market weaknesses. These policies have contributed to a rapid increase in the supply of risk capital to UK enterprises.

3.50 As well as stimulating the supply of risk capital to enterprises, the Government is concerned to improve the effective demand. Smaller enterprises are often ill-prepared to understand how external equity investment could enable their growth, or to obtain and use such finance effectively. The Pre-Budget Report highlighted the apparent gap in the provision of effective advisory services to SMEs to enable them to become "investment ready", and committed the SBS to develop new services, in partnership with the RDAs and market practitioners, to help close the information gap. **The SBS will shortly set out the Government's objectives of building on and spreading best practice in this area, with the aim of stimulating innovative proposals from market practitioners for new pilot programmes, to be launched with SBS support by summer 2001.**

3.51 Economies of scale in raising equity finance can operate against smaller companies raising relatively small amounts of risk capital. The Government will investigate whether there is a case for reducing fiscal barriers in this area.

3.52 The Government is continuing to develop a range of public-private venture fund partnerships across the UK, in order to address specific identified "equity gaps" between the demand for finance and the commercial supply. In Budget 2000, the Government set a target of £1 billion for investment over 2001 to 2004 and, towards this aim, committed an additional £100 million of public resources in order to lever in substantial extra private investment. By this summer, the Government hopes to be nearly half way towards achieving this target.

3.53 Finally, **the Government plans to streamline further the operation of the Enterprise Investment Scheme (EIS), Venture Capital Trust (VCT) scheme and Corporate Venturing Scheme**, which provide tax incentives for investment in smaller higher risk trading companies. The changes will make the schemes more responsive to the business needs of small enterprises. The Government also plans to commission research into the economic impact of the EIS and VCT schemes.

Investment in the film industry

3.54 In order to stimulate production of British films and to promote growth, employment, and investment opportunities in the UK, the July 1997 Budget introduced an immediate 100 per cent write-off against tax of the production and acquisition costs of British films with budgets of no more than £15 million. The measure was designed to improve the effectiveness of mainly small British film production companies competing in a market dominated by large, vertically integrated, US companies that control production, distribution and exhibition.

3.55 Over the past four years there has been increasing evidence of structural change in the British film industry with the emergence of sustainable investment packages and record inward investment - over £500 million in 2000. The tax relief was due to expire in 2002, but **Budget 2001 announces a further three-year extension of the relief to 2005 to give the industry time to build on these encouraging developments**.

SKILLS

3.56 The link between the quantity and quality of skilled labour and productivity has been demonstrated by numerous studies[5]. A more skilled workforce can generate greater levels of innovation, increase workplace flexibility, enable better adaptation to new technologies and facilitate best practice and spillover effects to co-workers. But the UK has had a weak skills base over a long period and skill levels in the UK are lower than in many of the UK's main competitor countries. Around 7 million adults in the UK still lack basic literacy and numeracy skills, and intermediate skill levels compare particularly poorly with the UK's European counterparts. Equally, only 27 per cent of the UK workforce has a degree or equivalent, compared with 38 per cent in the US.

Box 3.5: Higher education ambition

Skilled graduates and postgraduates are vital for a productive economy able to take advantage of the opportunities offered by rapidly developing technologies and scientific advances. Historically, the UK has been at least on a par with its European competitors in the number of people completing higher education, but has lagged behind the US.

In the 1999 Pre-Budget Report, the Government set an ambition for higher education that, by the end of the decade, and for the first time, the majority of the UK's young people can expect to go on from school or college into higher education.

The Government is ensuring that higher education institutions have the resources and incentives to meet this aim. Two successive Spending Reviews are delivering a major funding boost for the sector, reversing more than a decade of decline in funding per student; increasing research output; and implementing a capital renewal programme. This includes spending almost £160 million more over the next three years to ensure more students from the poorest areas take up higher education places. Their current under-representation perpetuates social exclusion and is a loss to UK productivity. There will be a particular focus on improving the performance of those institutions which recruit the fewest entrants from the state education sector.

To make sure that the increase in participation is matched with a sensitivity to skills needs, the Government is helping higher education get closer to the labour market. Course curricula, for example for the new two-year Foundation Degrees, will reflect a higher degree of employer input. How graduates from each university fare in the labour market will be tracked against new Higher Education Funding Council benchmarks. The new technology institutes - announced in the recent White Paper on Enterprise, Skills and Innovation - will bring universities together with colleges and local businesses to provide specialist ICT and other high technology skills, and to work closely with local companies helping them to apply advanced technology.

Improving schools

3.57 Improving the skills base needs to start in schools. The Government has sought to drive up school standards and reverse the long-term trend of under-investment and under-achievement. In summary, the Government has:

- established the Sure Start programme to ensure that children from disadvantaged areas start school ready to learn;
- developed strategies for improving pupil attainment in literacy and numeracy at primary school, and begun to extend that approach to improve performance in the early years of secondary education;
- made a commitment to ensure that everyone can expect a minimum level of education wherever they live, including "floor" targets to improve outcomes for Key Stage 2 in English and maths and for GCSEs, backed by a substantial increase in resources announced in the 2000 Spending Review;
- set out plans to modernise and diversify the secondary system. As part of this, some schools will now be able to

specialise in the teaching of enterprise and others in engineering and science;

- revised the National Curriculum to include a new focus on enterprise skills at both primary and secondary level;
- provided for a number of changes to post - 16 provision, including the introduction of new A/AS level qualifications, the introduction of vocational A-levels and a new key skills qualification to encourage all young people to develop communication, numerical and Information and Communications Technologies (ICT); and
- invested in connecting schools to the internet. The Government is well on course to ensure that all schools are connected to the internet by 2002, and by 2004, there will be one computer for every five pupils in secondary schools across England.

Higher education

3.58 To ensure that the UK has a world class supply of highly-skilled graduates and postgraduates, the Government has set a goal for increasing participation in higher education (see Box 3.5). It is also doing more to ensure that students from under-represented groups get better access to higher education. Achieving this goal will not only increase the opportunities for young people, but will also help the UK develop the human capital it needs for higher productivity growth.

Lifelong learning

3.59 Lifelong learning, improving the skills of people already of working age, is at the forefront of education and training policy. The Government has set about transforming the arrangements for lifelong learning by establishing the Learning and Skills Council. The Council will coordinate, promote and plan post-16 education and training outside higher education, focusing particularly on employers' needs. It will seek to maximise the impact of the significant increases in funding which it will be allocated and will aim to make education and training accessible, including playing a fundamental part in the Government's National Strategy for Basic Skills, which will help 750,000 adults improve their skills by 2004.

3.60 Meanwhile, increasing numbers of adults are taking advantage of three flagship initiatives:

- Individual Learning Accounts (ILAs) provide every adult over 19 with the opportunity to organise their own learning. The first 1 million account holders receive £150 towards training if they contribute £25. There are also substantial discounts, with reductions of up to 80 per cent on selected courses. More than 700,000 people have already opened an ILA. The Government expects 1 million account holders by March 2002;
- learndirect offers flexible, internet-based adult learning through its website (www.learndirect.co.uk) and through a network of over 900 learndirect centres. Over 70,000 people have now undertaken learning through learndirect since 1 May 2000; and
- the Government has allocated £252 million to establish 1,000 ICT learning centres across the country by 2002. More than 600 centres have already been announced.

Management

3.61 Recognising the importance of high quality management and leadership skills for raising the productivity of the economy, the Government established the Council for Excellence in Management and Leadership. The Council will be reporting back to Government before summer 2001.

Box 3.6: Workforce development

In a knowledge economy there are fewer opportunities for the unskilled. Though lack of skills may not be a barrier to employment, it will hinder both individuals' earning power and their ability to respond to changing circumstances.

The lack of relevant or necessary skills in the workforce can also prevent business from exploiting new technologies and improving production and working practices that can lead to improved productivity.

The responsibility for investing in training lies with:

- individuals - if they wish to make the most of the opportunities provided (individuals with no qualifications earn on average 30 per cent less than average earnings);
- business - as good employers investing in their workforce (a study by the Institute for Fiscal Studies suggested that increasing the number of employees trained by 5 percentage points could increase productivity by 4 per cent); and
- Government - to ensure that the right opportunities and incentives are in place.

36 per cent of those in employment in the UK either have no qualifications or qualifications below level 2 (five GCSEs at

A*-C). These employees receive the least training. An employee below level 2 is one quarter as likely to receive training as a colleague with a level 2 qualification: creating a vicious circle of low-skill-no-training. As the education system improves, this proportion is falling but not fast enough to address the legacy of social exclusion and the past failings of the education system.

Chart: Percentage of employees receiving training in the last four weeks by highest qualification

Many employers recognise that more training is beneficial. However, the economic and social benefits of training for those without a minimum skill level go wider than those reaped by employers.

The National Skills Task Force (NSTF) demonstrated that individuals with families and who are in full time work may struggle to find the time to participate in learning. This suggests the need to do more in the workplace.

The current voluntary approach has secured increased participation in workplace training since 1995. But this is not enough: the scale of the problem is significant and Government agrees with the NSTF that tackling this "chronic UK problem of low skilled adults" must be a priority and that a step change on the part of all - employers, individuals and Government - is required.

The Learning and Skills Council is developing a workforce development strategy on which it will issue a consultation document in the summer. The CBI/TUC working group and the Cabinet Office Performance and Innovation Unit are also both looking at how the UK's performance in workforce skills and training can be improved. Both are expected to report in the autumn.

Government, for its part, is willing to consider what else it can contribute to extending opportunity for all in work, particularly to obtain a qualification up to level 2. The Government is willing to consider a new tax credit for such training, possibly based on the model of payable R&D tax credits. Other possibilities will also need to be considered. But Government action alone cannot bring about the sort of changes that are necessary to make a real impact on the problem of low skills. It will be important that everyone - employers, individuals and Government - takes seriously their responsibility to deliver a high skill, high productivity economy.

PUBLIC SECTOR PRODUCTIVITY

3.62 As well as working to provide the right environment and incentives for business to close the productivity gap, the Government is changing the way it works. There are a number of challenges to improving productivity in the public sector, including:

- improving incentives - which are not always as strong as within the private sector;
- reducing and improving regulation;
- improving accountability and ownership; and
- improving information.

Setting clearer targets

3.63 Clear targets are important in business planning, management, and ensuring that the public sector is accountable to those that use its services. The Government has put in place a number of initiatives designed to ensure transparent measurable targets for the public sector.

3.64 The 2000 Spending Review set new Public Service Agreements (PSAs), containing 160 outcome-focused targets for central government. Technical notes setting out how these targets will be measured have also been published on departments' websites. Service Delivery Agreements (SDAs) set out how departments will deliver their PSAs and how they will manage themselves more efficiently.

3.65 The Government is also piloting local PSAs with 20 local authorities, which stand to gain financial rewards and additional local freedoms in return for signing up to and delivering challenging outcome targets. This will reinforce the drive for continuous improvement through the Best Value performance framework which requires local authorities to draw up performance plans and undertake fundamental service reviews. Local authorities are also establishing Local Strategic Partnerships to aid strategy in coordination of local services.

Departmental Investment Strategies

3.66 Historically, the public sector's investment record has been poor. Not only does low public investment damage public sector productivity, but it can weaken private sector productivity if public services (such as the transport infrastructure) are not kept up to standard. The 2000 Spending Review set out plans that will more than double net public investment - to £19 billion by 2003-04. This programme of investment will be further boosted by the additional spending allocations announced in Budget 2001 (see Chapter 5 for more details).

3.67 The Government has put in place mechanisms to improve public sector investment. Coupled with the 2000 Spending Review increases in capital budgets the Government published Departmental Investment Strategies in November 2000, which set out departments' plans to deliver the scale and quality of the capital stock needed to underpin the Government's proposed improvements in public services. Each Strategy sets out the context that the department is working in, an analysis of the condition and use of its existing asset base, future investment plans and the systems which the department will be adopting to deliver value for money.

Public Services Productivity Panel

3.68 The Public Services Productivity Panel is a small group of senior business people, public sector managers and trade union leaders that has been established to identify ways to help improve the productivity of the public sector. Following the publication of *Meeting the Challenge*, which drew together main findings and lessons from the Panel's original work programme, the Chief Secretary to the Treasury announced a renewed and expanded Panel in September 2000. The Panel's new work programme is centred around the theme of securing ownership for performance. To support this, the Panel is undertaking a range of projects on defining and owning accountabilities, improving management flexibility to innovate and strengthening incentives for delivery. These include work on:

- *Delivering Public Service Agreements* - translating high level PSA targets into real improvements in front line service delivery;
- *The Role of External Review in Improving Performance* - identifying where and why inspection, audit and review have the biggest impact;
- *Effective Management of Partnerships* - identifying the appropriate selection and application of partnership models involving the public sector; and
- *Enhancing the Motivation of Public Sector Managers* - helping public service managers in practical ways to motivate staff and align that motivation with better performance and service delivery.

Improving incentives

3.69 As part of the work of the Panel, John Makinson, Group Finance Director of Pearson plc, produced a report, *Incentives for Change*. This report focused on how best to develop performance-based incentives in the Department of Social Security, the Employment Service, HM Customs and Excise and the Inland Revenue.

3.70 The report recommended that front-line staff should be rewarded through non-consolidated team-based bonuses, which would act as incentives for improved service delivery and overall performance. Teams' performance would be related directly to PSA targets cascaded down to them. Over the past year, all four departments have set up implementation teams and are working alongside the Treasury to develop robust mechanisms linked to PSA targets. These will need to be implemented alongside pay structures which will still motivate and reward good performance even if targets are not exceeded.

Reducing regulation in the public sector

3.71 Reducing red tape in the public sector is an important factor in creating a productive work environment. The Government has a team analysing, assessing and actively reducing red tape and bureaucracy on frontline public sector staff. Projects include work on reducing the burdens faced by General Practitioners, head-teachers, the police and local authorities.

3.72 The team has made significant progress in reducing the burdens faced by these service providers. It intends to develop further strategies to prevent the growth of bureaucracy and red tape in the public sector.

Partnerships UK

3.73 Partnerships UK was launched in June 2000 to build upon the success of the Treasury Taskforce and to provide a permanent and sustainable centre of expertise to continue the Treasury Taskforce's role in expanding the Government's Public-Private Partnership (PPP) programme. Partnerships UK has absorbed and expanded the activities and transaction staff of the Treasury Taskforce. The policy arm of the Treasury Taskforce has transferred to the Office of Government Commerce. Partnerships UK is expected to be at the forefront of the development and implementation of better, faster and more effective PPP transactions, helping to deliver value for money public services and efficient utilisation of public sector assets.

Partnerships UK will work with central and local government and with other public bodies across the public sector.

3.74 The Treasury is currently seeking private investors to take a 51 per cent stake in Partnerships UK. By selling this stake, the Treasury plans to raise a minimum of £22.5 million of equity by private placement with qualifying institutions. Following completion of the Offer, it is expected that Partnerships UK will have a capital base of £45 million. Each potential qualifying investor will be invited to invest between £1million and £5 million.

Office of Government Commerce

3.75 The Office of Government Commerce (OGC) was set up in April 2000 to provide a greater sense of direction in procurement. It aims to deliver value for money gains totalling £1billion by the end of 2002 - 03 through the dissemination of best practice and the development of government purchasing power.

3.76 In its first year, OGC has concluded a strategic partnership with Vodafone which will save the Government over £38 million over two years. OGC (through The Buying Agency) has also negotiated the Watermark contract, an important step forward in government water consumption with the potential to deliver savings of 10 per cent a year on water services, amounting to £30 million a year for central government alone.

3.77 A priority for OGC in the coming months will be the Gateway Review Process, which aims to improve the management of projects through the use of independent peer reviews. The reviews will identify and implement actions needed for project success, understand and apply best practice and ensure lessons learnt are shared.

[1] German employment figures have been revised upwards on account of a stricter application of ILO employment definitions and changes in the threshold for paying social security contributions, which have led to more workers being picked up by the administrative system. This has led to a downward revision in Germany's output per worker figures.

[2] For example S J Nickell: "Competition and Corporate Performance", *Journal of Political Economy*, 104(4) 1996.

[3] For example Eurostat: *Statistics on Innovation in Europe*, February 2001.

[4] For example N Oulton: "Why do foreign-owned firms in the UK have higher labour productivity?" in N Pain: *Inward Investment, Technological Change and Growth*, Macmillan Press 2000.

[5] For example Benhabib and Spiegel: "The Role of Human Capital in Economic Development: Evidence from Aggregate Cross-Country Data", *Journal of Monetary Economics* 34(2), 1994.

4
Increasing Employment Opportunity For All

The Government's aim is employment opportunity for all – the modern definition of full employment. In line with this, the Government's long-term ambition is that by the end of the decade there will be a higher proportion of people in work than ever before. Although macroeconomic stability is a prerequisite for achieving this aim, it must be backed up by microeconomic policies to ensure that individuals throughout the country are able to compete effectively for jobs. The Pre-Budget Report set out the challenges which the Government faces in helping people to move off welfare and into work, ensuring that work pays, easing the return to work, and enabling people to work their way up once in work. Budget 2001 sees further reforms that will help to deliver the Government's long-term ambition to see a greater proportion of people in work than ever before.

- **The new package of choices in the New Deal for lone parents, available from next month, will be extended to include help with starting up in self-employment, training, a new outreach service to attract more lone parents to the New Deal, and extra childcare support. So that as many lone parents as possible are aware of the help available to them through the New Deal, compulsory work-focused interviews will be extended to all lone parents on Income Support, nationally from April 2002, with an additional interview at the six month stage.**
- **As part of its strategy to support those in greatest need of help, the Government will invest additional resources to tackle the problems facing claimants whose drug problems may be getting in the way of their finding a job, and provide more help for ex-users to move into work.**
- **Resources will also be allocated to enhance the New Deal and other programmes over the coming three years, focusing on employer needs, the hardest to help and the most disadvantaged areas. Full details will be set out as part of the Government's welfare to work strategy for the coming three years, which will be published shortly.**
- **To make work pay, the National Minimum Wage for workers aged 22 and over will be increased from £3.70 an hour to £4.10 an hour from October 2001, with a further increase, subject to the economic conditions prevailing at the time, to £4.20 an hour from October 2002, as announced by the Secretary of State for Trade and Industry on 5 March.**
- **In addition, the 10 pence rate of income tax will be extended by £300 over indexation from April 2001 to cover the first £1,880 of taxable income.**
- **To help working families, the basic credit in the Working Families' Tax Credit (WFTC) will increase by £5 a week from June 2001, on top of increases in line with indexation from April 2001. Combined with other measures, this raises the minimum guaranteed income for a family with one member working 35 hours a week at the minimum wage from £214 a week in April to £225 a week in October 2001.**
- **To help overcome barriers to work due to childcare costs, the WFTC and Disabled Person's Tax Credit (DPTC) childcare tax credit limits will be increased from £100 to £135 a week for childcare costs for one child and from £150 to £200 a week for two or more children from June 2001.**

INTRODUCTION

4.1 The Government's aim is employment opportunity for all – the modern definition of full employment. Macroeconomic stability is a prerequisite for achieving this aim, but it also needs to be backed up by microeconomic policies to ensure that individuals throughout the country are able to compete effectively for jobs.

4.2 The Government's microeconomic strategy for ensuring employment opportunity for all comprises the following key elements:

- helping people to move from welfare into work, through policies such as the New Deal;
- easing the transition into work, by removing barriers to work and ensuring that people are financially secure when moving from welfare into work;
- making work pay, through reform of the tax and benefit system and the minimum wage; and
- securing progression in work, through lifelong learning.

Achieving high and stable levels of employment across Britain

4.3 The past few years have seen a substantial improvement in Britain's labour market. Over 1 million more people are in work now than in spring 1997. The employment rate, currently 74.6 per cent, has returned to levels typical of the 1960s and 1970s, substantially above those seen during most of the 1980s and early 1990s.

Chart 4.1: UK employment rate

4.4 Alongside record levels of employment, unemployment has fallen sharply. At 5.3 per cent, ILO unemployment is currently at its lowest rate for over 20 years. The claimant count measure currently stands at 1.005 million, down by nearly 660,000 since spring 1997 and the lowest rate since September 1975.

Chart 4.2: Unemployment rates

4.5 The stock of unfilled vacancies at Jobcentres is at record levels: the ratio of jobseekers to vacancies currently stands at just under three claimant unemployed people to each Jobcentre vacancy, compared to around 10 jobseekers to each vacancy a decade ago. This rise in the level of vacancies has benefited all regions. As shown in chart 4.3, generally the number of unemployed people chasing each vacancy has fallen fastest in those regions which previously had the highest number of unemployed people per unfilled vacancy.

Chart 4.3: ILO unemployment per unfilled jobcentre vacancy

4.6 Vacancies are now close to record levels in all regions, and trends in aggregate employment and unemployment rates continue to improve. However, as illustrated in the
Pre-Budget Report, concentrations of worklessness exist both below the aggregate level amongst some people and groups in society, and also below the regional level in disadvantaged areas. Although improvements can be seen over the last couple of years, work remains to be done here. Box 4.1 explains the Government's aim to reduce these concentrations of worklessness and the poverty they engender. The measures announced in Budget 2001 work towards this aim by building on the success of the New Deal, providing additional support for those hardest to help, and giving lone parents more of the support they need to move from welfare into work.

Box 4.1: Employment ambition – working towards full employment

The Government is committed to delivering employment opportunities for all – the modern definition of full employment. The Government's long term ambition is that by the end of the decade there will be a higher percentage of people in employment than ever before, on a sustainable basis. This means that, taking account of the economic cycle, at least three quarters of the working age population are in work by the end of the decade.

Unemployment, and more generally long-term worklessness, represent an unacceptable waste of human resources and an unnecessary source of misery and degradation for those affected. The long-term workless are distanced from the labour market. Policies aim to reintegrate them into the labour market so that the effective supply of labour is increased. This both allows further non-inflationary growth in the economy, and reduces poverty.

Reducing the number of families with no-one in work is an important part of the Government's strategy to reduce child poverty by half in 10 years and eliminate it within a generation. Extending employment opportunities for these families may also be important to break the cycle of deprivation that puts children at greater risk of detachment from the labour market in adulthood.

Opportunities in the labour market are unequal. There exists a "tail" of local areas with especially low employment rates. The employment rates of people with disabilities, lone parents, ethnic minorities and the over 50s are all well below the overall average and have been so on a continuing basis. Hence the Government's commitment to employment opportunities for all requires not just a high overall employment rate, but also a commitment to a higher

rate of employment covering groups and areas that have in the past been allowed to fall behind the rest of society.

The Government has already made significant progress in these areas with, since 1997:

- **employment up by over 1 million;**
- **unemployment down by over half a million; and**
- **the number of children in workless households down by over a quarter of a million.**

In order to maintain and build on this progress the Government, at the time of the 2000 Spending Review, committed to the following PSA targets for the period 2001–4:

- **increase employment over the economic cycle;**
- **a continued reduction in the number of unemployed people over the age of 18 over the three years to 2004, taking account of the economic cycle;**
- **reduce the number of children in households with no-one in work over the three years to 2004; and**
- **over the three years to 2004, increase the employment rates of disadvantaged areas and groups, taking account of the economic cycle – people with disabilities, lone parents, ethnic minorities and the over 50s, the 30 local authority districts with the poorest labour market position – and reduce the difference between their employment rates and the overall rate.**

WELFARE TO WORK

4.7 The labour market is dynamic, with most unemployed people who claim Jobseeker's Allowance (JSA) moving quickly back into work. However, those that remain unemployed for longer periods risk becoming detached from the labour market. In addition, there are 3.8 million people of working age receiving out-of-work benefits other than JSA, including sick and disabled people and lone parents, many of whom want to work. The Government's welfare to work strategy, outlined in the Pre-Budget Report, is designed to combat long-term unemployment and lift people out of economic inactivity by equipping them with the skills they need to find and remain in work.

4.8 The New Deal is central to the Government's welfare to work strategy, helping people to move into work, progress within employment and increase their long-term employability. The continuity and support offered by the personal adviser to each participant in the New Deal is unlike anything seen on previous programmes. The 2000 Spending Review allocated extra resources to make the New Deal a permanent deal. The success of the New Deal programmes, and how the Government is planning to build on this, are discussed in Box 4.2. The Government will shortly be publishing its comprehensive plan for the development of its welfare to work policies over the period of the next three years, 2001–04.

New Deal for young people

4.9 The New Deal for young people (NDYP) was launched nationally in April 1998. Since June 2000, the Gateway stage of the programme has been enhanced through specialist Gateway to Work provision, intensifying the support available to young people, and providing additional help with 'soft skills' such as presentation, punctuality and communication skills. So far, in total over 270,000 young people have found jobs through the New Deal, surpassing the Government's manifesto commitment to move 250,000 young people from welfare into work by the end of the current Parliament. Further details on enhancements to the NDYP will be announced shortly, including helping the most disadvantaged.

New Deal for 25+

4.10 The New Deal for 25+ (ND25+) offers intensive support to older long-term unemployed people through a personal adviser service and, since April 2000, an intensified Gateway period. **As announced in Budget 2000, the New Deal 25+ will be extended and intensified from April 2001 on a national basis,** heralding a stronger emphasis on rights and responsibilities as the sanctions regime already operating under the New Deal for young people is extended to the older group. Over 60,000 long-term unemployed people have already found jobs through the ND25+.

New Deal for lone parents

4.11 The Government recognises the problems faced by lone parents trying to balance work and caring responsibilities, and is committed to enhancing the choices open to lone parents in the labour market. Lone parents with young children are likely to face the greatest barriers to work, for example high childcare costs, and as a consequence are less likely to be in work. The

New Deal for lone parents (NDLP) provides the opportunity for lone parents to meet a personal adviser and receive help and support to improve their prospects and living standards by taking up, and increasing, paid work. Over 80,000 lone parents have moved into work through NDLP, and over half of all lone parents are now in work, for the first time in more than 20 years. Helping more lone parents into work is key to reducing child poverty, and the Government has set a target for 70 per cent of lone parents to be in work by 2010, comparable to international lone parent employment rates. **This Budget announces further measures for lone parents including extending compulsory work-focused interviews and further enhancing NDLP provision.**

4.12 The November 2000 Pre-Budget Report announced that **from October 2001, the offer of help and support from the NDLP will be made available to all lone parents who are not working, or are working less than 16 hours a week, whether or not they are on Income Support.** This will make around an additional 150,000 lone parents eligible for the help and support of NDLP. **This Budget announces that a new advisory and outreach service will be introduced later this year.** This will provide outreach services for lone parents as well as partners – especially to those living in isolated communities or from groups that do not generally come into contact with Government agencies, including those who are now eligible for the New Deal, but who are not benefit claimants. Advisers will work within the community, in partnership with initiatives such as Sure Start, and local voluntary sector organisations and community groups, to inform lone parents about the help available to move into work.

4.13 As announced in Budget 2000, **from April 2001 there will be an enhanced programme of choices available in the New Deal enabling lone parents to:**

- **move into work of 16 hours or more, with a guaranteed minimum income on the Working Families' Tax Credit;**
- **try work of fewer than 16 hours with a £20 earnings disregard and childcare help through NDLP; or**
- **undertake work-focused education and training with a £15 per week premium on top of Income Support from April 2001.**

4.14 Lone parents are often wary of the uncertainty of leaving benefits and moving into work for the first time. The financial uncertainty around starting up in self-employment can be a particularly daunting experience. **To enhance the choices available to lone parents, Budget 2001 announces further help for lone parents to move into self-employment, in line with the provision available in the New Deal for 25+, from autumn 2001.** This will provide a training course followed by six months of test trading with financial support and help to pay for childcare costs. At the end of the test-trading period, participants will be able to keep their profits and move onto the Working Families' Tax Credit.

4.15 This Budget also announces that **greater training flexibility will be introduced in NDLP,** so that more lone parents are able to take intensive short work-focused courses. This will enable lone parents to acquire the standard skills, such as basic IT qualifications, that will benefit them in the labour market.

4.16 The Government wants to ensure that all lone parents are aware of the opportunities available to them to work or study through the New Deal for lone parents. **As announced in Budget 2000, from April 2001 lone parents on Income Support with children over the age of five will be required to attend annual meetings with a personal adviser to discuss the opportunities available to them.** Early evaluation evidence from the pilot stages of ONE showed that where lone parents received work-focused interviews, they were 40 per cent more likely to move into work than those in comparison areas. To ensure that as many lone parents as possible are aware of the help and support available to help them move into work, **from October 2001 in pathfinder areas and nationally from April 2002:**

- **compulsory work-focused interviews will be extended to all lone parents on Income Support,** in line with ONE pilots; and
- **an additional interview will be introduced at the six month stage in the Income Support claim.**

Extending help with childcare costs

4.17 Evidence shows that a lack of suitable, affordable childcare is a major barrier to parental employment, particularly for women and lone parents. To complement the measures outlined above, and to support parental employment, **the Government intends to improve help with childcare costs by:**

- **extending the Jobseeker's Grant to provide help with the up-front childcare costs that many lone parents face in moving from welfare to work;**
- **increasing the limits of the childcare tax credit element of WFTC and DPTC from June 2001 to provide additional help for those with high childcare costs; and**

- **considering how to help families who need to use formal childcare in their homes.**

4.18 Lone parents can often face substantial up-front childcare costs, which could cause short-term financial difficulties that prevent them from moving into work. **Later this year, the Government will extend eligibility for the Jobseeker's Grant to lone parents who have been on Income Support for over six months.** The Jobseeker's Grant provides funds to meet immediate expenses, such as deposits for childcare or essential items to start up in self-employment. This will provide additional targeted help, on top of the two week Income Support run-on, to ensure that more lone parents are able to make the transition to work.

4.19 The childcare tax credit component of the Working Families' Tax Credit provides generous support to help working families with childcare costs. The credit is worth 70 per cent of eligible childcare costs up to limits currently set at £100 a week for a family with one child, and £150 a week for a family with two or more children. So far 124,000 families are receiving help with their childcare costs through the childcare tax credit, compared to 47,000 who benefited from the childcare disregard in Family Credit at its peak. However, the absence of affordable childcare remains a barrier to work for some families. **Budget 2001 announces that these limits in the childcare tax credit will be increased to £135 and £200 from June 2001.** These limits reflect recent evidence on the cost of childcare across the country, particularly for those with children under five.

4.20 In order to claim the childcare tax credit, families must use eligible childcare. This ensures that the childcare tax credit in WFTC and DPTC supports the National Childcare Strategy by only funding safe, good quality childcare. However, current childcare tax credit rules do not support parents who use formal childcare in their own home. This poses a specific barrier to work for families with particular needs, such as those with disabled children who need home-based care or parents who work irregular hours. **The Government will consider how these families might be helped, for example by extending the childcare tax credit to cover formal childcare in the home where it meets standards similar to those that will govern the regulation and accreditation of childminders.**

National Childcare Strategy

4.21 The Government also offers support to childcare providers in order to help meet growing parental demand for good-quality, accessible childcare. Since its launch in 1998, the National Childcare Strategy has created childcare places that have helped more than 540,000 children, which, taking into account turnover, represents a net increase in places for 343,000 children. By March 2004, the Strategy will have created additional places for 1 million children.

4.22 The Government's ambition is that by 2004 there will be a childcare place in the most disadvantaged areas for every lone parent entering employment. The 2000 Spending Review allocated an additional £255 million from 2001 to 2004 to tackle the 'childcare gap' between disadvantaged and more affluent areas. This money will help fund the Neighbourhood Childcare Initiative – a major expansion of childcare focused specifically on sustainable childcare in disadvantaged areas. The New Opportunities Fund will also provide a further £155 million from 2001 to 2004.

4.23 The Neighbourhood Childcare Initiative will:

- create 900 new Neighbourhood Nurseries, providing 45,000 full day care places in some of the most disadvantaged areas by 2004;
- provide start-up grants for 19,000 childminders each year for the next two years; and
- fund a national business support package to promote and support sustainable childcare.

New Deal for partners

4.24 For couples where one person is unemployed, the chances of the other being in work are much lower. This is also the case for working age partners of the economically inactive. For example, where the head of household is inactive, the likelihood of the other partner being in work is less than 40 per cent. The New Deal for partners was launched nationwide in April 1999. It is a personal adviser service aimed to help partners of unemployed people to move into work. **From April 2001, the New Deal for partners will be extended on a voluntary basis to all partners of sick and disability benefit claimants.**

4.25 Childless partners of the unemployed aged 18 to 24 have been able to volunteer to join the New Deal for young people. As previously announced, **from March 2001, they will become joint JSA claimants – both will have the same rights and responsibilities as the main claimant. From 2002, the Government intends to extend this approach to all childless partners of the unemployed who are 45 or under.**

New Deal for disabled people

4.26 People with disabilities are among the most disadvantaged in the labour force, being seven times more likely to be out of work than people without disabilities. According to the Labour Force Survey, 20.6 per cent of people with disabilities – some 1.4 million people – are currently without work but want to work. The Government has set a PSA target to narrow the gap between the employment rate of people with disabilities and the overall employment rate. At present, in any year only five per cent of those receiving incapacity benefits return to work. The Government has therefore set aside money from the receipts of the Employment Opportunities Fund specifically to help this group.

4.27 The New Deal for disabled people (NDDP) is testing a range of approaches – a personal adviser service, innovative schemes and benefit changes – to see what works in helping disabled people back into work. The 2000 Spending Review set aside additional resources for the extension of services for people with disabilities across the country through the NDDP and for retention and rehabilitation pilots. As previously announced, **from July 2001 the Government will extend the NDDP to include, for the first time, a gateway to engage those moving onto incapacity benefits. It will also establish a network of innovative job brokers who will help disabled people to find, secure and keep paid work.** Job brokers will provide practical assistance and help people with disabilities to calculate their financial position in work and their entitlement to the Disabled Person's Tax Credit (see paragraph 4.57), as well as working with employers to match vacancies to the skills and potential of their disabled clients.

Box 4.2: Building on the success of the New Deal

Initially, the main focus of the New Deal was on young people, with the New Deal for young people (NDYP) available nationally since April 1998. The Government met its manifesto commitment to move 250,000 young people from welfare into work by the end of the current Parliament in September 2000. Independent evaluation shows that the NDYP has had a positive impact on both the prospects of young people and the economy generally. Recent research* has shown that:

- **without the NDYP, long-term youth unemployment would have been almost twice as high;**
- **after taking account of lower social security benefit payments and higher tax revenues, worth around £3 in every £5 spent, the NDYP is likely to have cost the Exchequer less than £150 million a year; and**
- **national income is around £500 million a year higher as a consequence of the programme.**

The Government, building on the success of the New Deal for young people, is turning its focus to other groups which suffer disadvantages in the labour market, including long-term unemployed people, people over 50 without work, people with disabilities and lone parents. Evaluation of the pilot stages of the New Deal for lone parents suggests that the programme is having a real and positive effect, and over 80,000 lone parents have moved into work through NDLP.**

Chart: Long-term unemployment (over 2 years) aged 25+ and Youth unemployment (over 6 months) 18-24's

*Rebecca Riley and Garry Young, National Institute of Economic and Social Research (2000), 'The New Deal for young people: Implications for employment and the public finances', Employment Service Research and Development Report 62, December 2000.

** J. Hales et al " Evaluation of the New Deal for lone parents: Early lessons from Phase One Prototype – Synthesis Report", DSS report, March 2000.

4.28 The extension of NDDP will be delivered through partnerships between organisations in the public, private and voluntary sectors. The Government is encouraging innovation in the delivery of job-broking services and will evaluate the effectiveness of the different approaches to learn what works best, so that services for disabled people can be continuously improved. The retention and rehabilitation pilots will test integrated health and employment interventions to help people who are at risk of losing their job through sickness or disability to stay in work. The Government is also committed to helping people with severe disabilities who need additional support over and above that provided by the NDDP. **The Government also plans to take further steps to support disabled people in work through enhancements to the supported employment programme.** Full details will be announced as part of the Government's overall welfare to work strategy for the coming three years.

New Deal for the over 50s

4.29 For most of the 1980s and early 1990s, the employment rate of men aged over 50 fell, and over the same period women over 50 did not enjoy the same marked increases in labour market participation as younger women enjoyed. Despite recent improvements, the employment rate of people aged between 50 and retirement age remains low. The New Deal for the over

50s (ND50+) was rolled out nationally in April 2000 to address these below-average employment rates, via a package involving personal advice, help with job search, a new employment credit and in-work training and support. Up to the end of January 2001, around 27,000 people have returned to work through the ND50+.

Worklessness in deprived areas

4.30 Since 1997, the stable macroeconomic environment has resulted in falling unemployment throughout every region of the UK. Nevertheless masked behind this overall picture of falling regional inequality are localised pockets of high unemployment and high deprivation. These areas are failing to keep up with the increase in national prosperity that macroeconomic stability has delivered.

4.31 Most of these areas are in inner cities, but some are seaside towns or former colliery areas. Many contain large numbers of people from ethnic minorities, lone parents and people with disabilities. These are groups which have low employment rates even in more prosperous areas. However, nearly all such areas face multiple disadvantages with not only high unemployment, but also low employment, large numbers of people dependent on benefits and often poor housing, health and transport.

4.32 The Government is committed to meeting the challenge of regenerating such areas. But the traditional solution of moving jobs into these disadvantaged communities is not enough. It is striking that, almost without exception, these communities are side-by-side, or at least within easy travelling distance of, areas with high levels of vacancies. Simply moving jobs into these disadvantaged areas may result in their being filled by people from outside the area, merely reinforcing a patchwork picture of deprivation and prosperity existing side-by-side. So the Government has taken the view that solving such a complex problem requires both measures to regenerate disadvantaged areas and steps to ensure that those living in these areas can take advantage of nearby vacancies.

Action Teams and Employment Zones

4.33 The Government has established Employment Zones in 15 areas of England, Scotland and Wales that suffer from particularly high levels of long-term unemployment, coupled with Action Teams in these and a further 25 communities with the highest unemployment and the lowest employment. Together, they set out to improve the employability of those living in disadvantaged areas by:

- working closely with employers;
- using funding in more imaginative and innovative ways;
- targeting areas and groups which need help the most, including ethnic minorities; and
- working in partnership with private and voluntary sector organisations.

4.34 Employment Zones are designed around the belief that what is needed are local solutions to local problems – the belief that what may succeed in moving people from welfare to work in one local area may be very different to what was required in another.

4.35 Action Teams concentrate their resources on working with the long-term unemployed and inactive, searching for suitable vacancies and bringing the two together. In addition, Action Teams tackle barriers to employment, for example by providing funding for transport to enable people to access nearby vacancies. Together Employment Zones and Action Teams represent a dynamic and innovative resource to tackle some of the UK's most deep-seated and protracted employment problems.

4.36 Budget 2001 funds the extension of Action Teams over the Spending Review period, along with the creation of new Action Teams. Full details will be announced as part of the Government's plans for its welfare work policies 2001–04.

4.37 To complement Employment Zones and Action Teams, Local Employment Plans will be developed, formulating local solutions to local employment problems by drawing on analysis of the key employment issues (e.g. skill shortages, vacancies or levels of employment) in a particular local area. It is envisaged that Local Strategic Partnerships, which have representation from all the key stakeholders and which played a key role in taking forward Neighbourhood Renewal Strategies, will take responsibility for developing these Local Employment Plans, in partnership with other stakeholders.

Job Transition Service

4.38 Some of the most difficult employment problems have occurred as a result of large-scale job losses in areas particularly dependent on one industry or one company. **As announced in the Pre-Budget Report, the Government is introducing a new service where large-scale redundancies occur particularly in high unemployment areas or where there is a high dependency on one industry.** The service will provide help for people made redundant to move into new jobs, preventing them from becoming detached from the labour market, and also provide extra help for those affected indirectly, such as the long-term unemployed. The service will build on existing provision, including Rapid Response Units, and work closely with other government departments and agencies, including the Regional Development Agencies and Learning and Skills Councils, and tap into existing resources where possible.

Engaging employers

4.39 Employers are central to the Government's welfare to work strategy. In today's labour market, many sectors have high levels of vacancies. By working with employers, provision can be tailored to the needs of particular industry sectors, ensuring a better fit between the needs of employers and the skills and experience of people looking for work. A number of such sectoral initiatives are already underway. **The Government will look to build on this approach, supporting sectoral strategies linked to the needs of local labour markets.**

4.40 Some industries, such as IT, have been traditionally reluctant to hire long-term workless people, even in the face of skills shortages. Overcoming their concerns about the abilities of people moving from welfare into work could unlock a wider range of opportunities and help employers fill their vacancies. As part of its wider sectoral strategy, the Government will seek to work with such employers to demonstrate the potential business advantages to them of widening the groups of people from whom they hire.

Reaching the hardest to help

4.41 The Government is committed to ensuring employment opportunity for all, including those in greatest need of help. As part of its strategy, **it will invest additional resources to help the 30,000 claimants whose drug problems may be getting in the way of their finding a job, and provide more help for ex-users to move into work.**

ONE and the new Agency

4.42 To continue delivering work-focused support for people of working age, later this year a new agency will be established which draws together the Employment Service and the parts of the Benefit Agency that support people of working age. The new agency will build on the experience of the ONE pilots in combining advice on benefits and work in one place to forge a culture which puts work first. This will represent a fundamental shift in the way that Government has traditionally supported people – moving away from a system that asks simply "what money can we pay you?" to one that says "how can we help you become more independent?". The agency will continue to develop the partnership approach to working with the private and voluntary sectors, which the Government has adopted in implementing its welfare to work policies.

Funding Welfare to Work

4.43 The Welfare to Work programme is currently funded from receipts of the one-off Windfall Tax on the excess profits of the privatised utilities. This Windfall Tax raised a total of £5.2 billion. **From April 2001, the programme will be funded from the new Employment Opportunities Fund,** which brings together remaining Windfall Tax receipts and additional resources allocated in the 2000 Spending Review. This Employment Opportunities Fund, worth a total of around £1 billion in 2001-02, increasing to around £1.4 billion in 2002-03 and 2003-04, is part of the Government's long-term investment strategy and will ensure successful employment initiatives will continue to be funded in the future.

Box 4.3: Self-employment

The Government's aim is a new culture of enterprise, open to all, in every part of the country. People on benefit who want to move into self-employment can face particular difficulties getting their businesses off the ground, and the Government has introduced a number of measures to help address this, including:

- **advice, training and test trading through the New Deal and Work-Based Learning for Adults;**
- **flexible benefit rules to help when people are first setting up their businesses;**
- **additional financial help during the transition from benefit to work; and**
- **ongoing financial support providing a guaranteed income while in self-employment.**

During the period of test trading available through the New Deal and Work-Based Learning for Adults, people can receive an allowance equivalent to their benefit while their profits are put into a special account which can be accessed once they move off the allowance. Six months test trading is a key feature of the self-employment route of NDYP, and from April 2001 it will be available to those starting their own businesses through ND25+. And, as outlined in paragraph 4.14 above, further help with self-employment will be extended to lone parents who have been on Income

Support for over 18 months, in line with ND25+. Help to move into self-employment is provided for other groups in England via Work-Based Learning for Adults, which includes a three month test-trading period.

The Government aims to strike the right balance between making benefit rules as clear and transparent as possible and making them flexible enough to ensure that people are provided with enough help when they are first setting up their businesses. That is why JSA claimants preparing for self-employment can continue to claim benefit for up to eight weeks but not actively seek work during the period that they are preparing a business plan. From April 2001, lone parents, disabled people and others with restricted work choices will be able to keep £20 a week of any earnings without losing any benefit.

Additional help is also provided during the period when people first move off benefit into self-employment through the wider transition to work package announced in Budget 2000. From April 2001, people moving into self-employment will be eligible for the new £100 Job Grant (lone parents will retain their two week Income Support run-on instead), as well as a four week run-on of Housing Benefit and Income Support for Mortgage Interest. These additional payments will help provide a secure income in the crucial first weeks of trading.

For self-employed people with children, the Working Families' Tax Credit provides a longer-term income bridge. This principle will be extended to people without children, through an employment tax credit, due to be introduced in 2003.

Table 4.1a: Allocation of the Windfall Tax 1997-98 to 2000-01

£million	**1997–98**	**1998–99**	**1999–00**	**2000–01**	**1997–2001**
Spending by programme[1]					
New Deal for young people	50	200	310	400	**970**
New Deal for 25+	0	10	90	110	**220**
New Deal for over 50s	0	0	5	20	**20**
New Deal for lone parents	0	20	40	50	**110**
New Deal for disabled people[2]	0	5	20	20	**40**
New Deal for partners of unemployed people	0	0	5	20	**20**
New Deal for Schools[3]	90	270	260	800	**1420**
Childcare	0	20	10	5	**30**
University for Industry[4]	0	5	0	0	**5**
ONE pilots[5]	0	0	0	5	**5**
Action Teams (Budget 2000)	0	0	0	10	**10**
Enterprise Development	0	0	0	10	**10**
Total Expenditure	**140**	**530**	**750**	**1470**	**2890**
Windfall Tax receipts allocated beyond 2000–01					**2310**
of which carried forward into the EOF					**1720**
Windfall Tax receipts	2600	2600			**5200**

[1] *Rounded to the nearest £10 million, except where expenditure is less than £5 million. Constituent elements may not sum to totals because of rounding. Outturns for 1997–98, 1998–99, and 1999-00; estimated outturns for 2000–01.*

[2] *Includes £10 million in 1999–00, an element of the November 1998 announcements on Welfare Reform.*

[3] *Capital spending on renewal of school infrastructure, to help raise standards.*

[4] *Start-up and development costs. Other costs of the UfI are funded from within departmental expenditure limits.*

[5] *Funding for repeat interviews. Other funding comes from the Invest to Save budget.*

Table 4.1b: The Employment Opportunities Fund

£million	2001–02	2002–03	2003–04
Indicative Allocation within EOF[1]			
New Deal for young people	350	280	280
New Deal for 25+	190	230	180
New Deal over 50s	20	20	20
New Deal for lone parents[2]	100	180	250
New Deal for disabled people	50	70	70
New Deal for partners of unemployed people	20	30	30
Action Teams	40	50	50
Job Transition Service	5	5	5
ONE pilots	5	0	0
Modernising the Employment Service	40	5	0
Unallocated[3]	230	530	490
Total WTW in EOF	**1040**	**1390**	**1370**
Enterprise in deprived areas	10	10	0
Total EOF	**1050**	**1400**	**1370**
of which, expected to be financed by Windfall Tax receipts:	**1050**	**670**	**0**
Estimated Windfall Tax Margin[4]	590	0	0

[1] *Rounded to the nearest £10 million, except where expenditure is less than £5 million. Constituent elements may not sum to totals because of rounding.*
[2] *Includes indicative allocations for work-focused interviews for lone parents with children under five.*
[3] *Includes the costs of establishing the new working age agency and retention and advancement pilots.*
[4] *Includes amounts for New Deal for Schools and to fund programmes in Northern Ireland.*

EASING THE TRANSITION TO WORK

4.44 The transition back into work can be difficult, especially for people who have been out of work for a long time. They have to manage until their first pay cheque, and they may have extra expenses, such as buying clothes for work. As a result, people may prefer the certainty of an income from benefits to the risks of taking a job, even though they would be better off in work. Some groups also face specific barriers – for example, families with children have to find affordable childcare. The Government has therefore introduced a number of reforms to improve and simplify the schemes available to help ease the move into work, providing additional financial support during the transition period in as straightforward and automatic a way as possible. **Budget 2000 announced that, from April 2001:**

- **a Job Grant of £100 will replace Jobfinder's Grant and Jobmatch,** providing a single transitional payment, available much more widely and without the complex eligibility criteria of the previous schemes;
- the rules of the Housing Benefit Extended Payment scheme for recipients of Income Support and Jobseeker's Allowance – which allows maximum Housing Benefit to continue for the first four weeks of work – will be **simplified to ensure that payments are as near automatic as possible,** reducing the likelihood of rent arrears building up whilst claims for in-work support are processed;
- **the Income Support Mortgage Interest (ISMI) scheme will be extended to provide a four week ISMI run-on for those entering work.** The existing linking rules will also be improved so that everyone receiving ISMI will be able to requalify for it directly if they return to benefits within one year of taking a job;
- those facing restricted work choices, such as lone parents, carers or people with disabilities, **will be able to keep £20 a week of any earnings gained whilst trying out work without losing their Income Support or Jobseeker's Allowance;** and
- Budget 2000 also announced that **from April 2002 the process for re-claiming benefit for people on Jobseeker's Allowance and Income Support returning to benefit after taking up full-time work for periods of up to 12 weeks will be streamlined.** This aims to encourage benefit claimants to report starting work, which may be temporary or insecure. The Government is also attracted to the principle of introducing a similar arrangement for

Housing Benefit.

Further details on these measures can be found in the Pre-Budget Report. Further details on help with childcare can be found in paragraphs 4.17 – 4.20 above.

The informal economy

4.45 The report of Lord Grabiner, following his review of the hidden economy, suggested that people can become trapped in the hidden economy because they are not aware of the opportunities that are available to them. In response, the Government set up a confidential helpline and provided advice for people starting up their own business on tax, national insurance and tax credits. To combat persistent tax offences and benefit fraud, the Government undertook measures including:

- making fraudulent evasion of income tax a statutory offence;
- requiring the newly self-employed to notify the Inland Revenue within three months of starting up a business;
- requiring people suspected of doing undeclared work while signing on to attend the Jobcentre frequently, at unpredictable times; and
- giving investigators the power to trace people who only give 'phone numbers when advertising for customers by making subscriber checks of the telephone directory.

In addition, the Government is also legislating for a "two strikes and you're out" approach for benefit fraud – removing people's right to claim for a specified time if they have been convicted twice.

MAKING WORK PAY

4.46 Evidence shows that people are reluctant to move into work if the financial gains are small. The situation where the gains to work are too small to provide incentives for someone to move into work is known as the unemployment trap.

4.47 Those in work may be discouraged from working longer hours or taking a better paid job, as it may leave them little better off than before as a result of higher tax payments and reduced benefits. This situation is known as the poverty trap.

4.48 To realise the aim of employment opportunity for all, active labour market policies aiming to reattach people to the labour market need to be supported by policies that reward work. The Government is committed to tackling the unemployment and poverty traps by making sure that work pays more than welfare, and providing people with incentives to move up the earnings ladder.

Ensuring fair pay for all

4.49 The National Minimum Wage was introduced in April 1999 to ensure fair minimum standards of pay and underpin the Government's tax and benefit reforms. In March 2001 the Government received Volume I of the Low Pay Commission's Third Report. Two years on from the introduction of the National Minimum Wage it has been possible to make a more definite assessment of its initial effects. The Report found that the National Minimum Wage has been a success and has not had any discernible effects on overall employment, inflation or the wider economy. In the light of this assessment, the Secretary for Trade and Industry announced this week that the Government will **increase the rate for adult workers aged 22 or over to £4.10 an hour from October 2001 and, subject to the economic conditions prevailing at the time, £4.20 from October 2002.**

4.50 Workers aged 18-21 and trainees (workers aged 22 and over in the first six months of employment and receiving training leading to a recognised qualification) are entitled to a minimum rate of £3.20 an hour. The Low Pay Commission will report on the case for a further increase of the youth development rate in Volume II of their Third Report. The Government will receive this in May 2001, at which point it will consider the Low Pay Commission's recommendations.

4.51 As a result of the introduction of the National Minimum Wage, around 1.3 million low-paid workers were entitled to higher wages. The Low Pay Commission's Third Report concludes that people earning less than the minimum wage in 1998 enjoyed a wage increase of over 15 per cent between 1998 and 1999, three times the increase of those paid above the minimum wage. By removing the worst excesses of low pay, the National Minimum Wage has been a significant factor in bringing about the reversal of the trend over the last two decades, whereby the biggest gains in pay went to the highest paid. Increases in pay across the earnings distribution for the year to spring 2000 show that the earnings of the bottom ten per cent increased almost twice as fast as the top ten per cent.

4.52 The National Minimum Wage has been particularly helpful to women in low-paid work who number around 70 per cent of beneficiaries. In narrowing the gender pay gap, the Low Pay Commission conclude that the minimum wage has had the greatest effect on women's pay since the Equal Pay Act of 1970. In addition, the Low Pay Commission expect the minimum wage to have reduced the earnings gap of workers with disabilities and those from ethnic minorities.

Equal pay

4.53 Thirty years after the Equal Pay Act, women's earnings continue to lag behind those of men. The Government is committed to driving forward action on equal pay, and the Department for Education and Employment has been consulting on proposals for speeding up and simplifying the equal pay tribunal process.

Making work pay for all

4.54 The Government has introduced a series of reforms to the tax and benefit system to help make work pay for people at all levels of the labour market, but with a particular focus on those on low incomes. The 10 pence starting rate of income tax was introduced in April 1999, and in April 2000 the basic rate of income tax was cut to 22 pence – the lowest rate for 70 years. **To further extend the benefits of the 10 pence rate, Budget 2001 widens the starting rate band by £300 over and above indexation, from £1,520 to £1,880 from April 2001, at a full year cost of £1 billion a year.** The introduction of the 10 pence rate halved the marginal tax rate for over 2 million low paid workers, and the further widening will halve the marginal tax rate for a further 450,000 people. In total, around 25 million tax payers will benefit from the extension of the 10 pence band.

4.55 In addition to reducing income tax, Budget 99 announced a series of reforms to employees' National Insurance Contributions (NICs) to help ensure that jobs at the lower end of the earnings distribution pay better. In April 1999, the entry fee on employee NICs was abolished. In April 2000, the point above which employees pay NICs was increased to £76 a week, and the upper earnings limit (UEL), which had historically been set at between $6^1/_2$ and $7^1/_2$ times the threshold, was consequently increased to £535. **As announced in Budget 99, from April 2001 the Primary Threshold above which employees pay National Insurance Contributions (NICs) will be further increased and aligned with the income tax personal allowance at £87 a week, and the UEL will be increased to £575** (just over $6^1/_2$ times the threshold). As a result of these reforms, by April 2001, around 1 million lower paid employees will be taken out of having to pay NICs altogether, while maintaining the benefit entitlement position for all those earning above the Lower Earnings Limit.

Additional targeted support

4.56 Families with children have, in the past, faced particular work incentive problems. To address these problems, the Working Families' Tax Credit (WFTC) was introduced in October 1999. Today more than 1.1 million families are benefiting from the WFTC, around 300,000 more than received Family Credit at its peak. **Budget 2001 announces that from June 2001, working families will receive additional support through a £5 increase in the basic credit in WFTC, on top of increases in line with indexation which apply from April 2001.** This means families will be receiving on average around £35 a week more than under Family Credit, compared to £30 now. In addition, the minimum income guarantee, for a family on WFTC with one member working 35 hours per week at the minimum wage, will rise from £214 a week in April to £225 a week in October 2001. Chapter 5 looks at how the components of WFTC have increased the support for families with children, and details of how the childcare tax credit component of WFTC is being extended are provided in paragraph 5.3.

4.57 The Disabled Person's Tax Credit (DPTC), launched alongside the WFTC, helps to provide support for workers with disabilities. Currently, over 25,000 disabled workers are benefiting from DPTC, 37 per cent more than were receiving Disability Working Allowance in July 1999, with an average claim of £72 a week. **Budget 2001 announces that from June 2001, disabled workers will also receive additional support through a £5 increase in the basic credits in DPTC, on top of increases in line with indexation which apply from April 2001.**

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

4.58 The Government's making work pay package clearly highlights the rewards of work over welfare, and the Government can now guarantee a minimum level of income for people with children moving into work. These guaranteed minimum levels of income are set out in Table 4.2, for a family with one child with one person working 35 hours a week at the National Minimum Wage.

Table 4.2: Weekly minimum income guarantee

	October 2000	**April 2001**	**October 2001**

WFTC family (working 35 hours)[7]	£208	£214	£225
WFTC family (working 16 hours)[8]	£152	£154	£166
DPTC family (working 35 hours)	£240	£246	£257
DPTC family (working 16 hours)	£184	£186	£198

[7] *These Minimum Income Guarantees are for families with one child and someone working 35 hours a week at the minimum wage.*

[8] *These Minimum Income Guarantees are for families with one child and someone working 16 hours a week at the minimum wage.*

4.59 As shown in chart 4.4, from October 2001 a family with two children earning less than £310 a week will have a negative overall effective tax rate, including the effects of Child Benefit. In other words, they will pay less in income tax and NICs than they receive in tax credits and Child Benefit.

Chart 4.4: Net tax rate for a family with two children

4.60 The reforms outlined above are helping to ensure that work pays more than welfare, thereby addressing the problems of the unemployment trap. The gain to work has increased, while security for those out of work has been maintained and enhanced. As shown in chart 4.5, by October 2001, a couple with two children will have to earn just over £150 a week in order to be £40 better off in work rather than on benefits, compared with nearly £260 a week in 1997.

Chart 4.5: Gains to work before and after reforms

4.61 The Government's reforms to the tax and benefit system have also helped to tackle the poverty trap. Low-income families, who often face very high marginal deduction rates[9] and the greatest poverty trap, now keep more of each additional pound that they earn. In 1997, nearly 750,000 families faced marginal deduction rates of over 70 per cent. As a result of measures introduced in this and previous Budgets, this number has been reduced by nearly 500,000.

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

Marginal deduction rate[1]	**Before Budget 1998[2]**	**After Budget 2001[2]**
100 per cent or more	5,000	0
90 per cent or more	130,000	40,000
80 per cent or more	300,000	210,000
70 per cent or more	740,000	255,000
60 per cent or more	760,000	900,000

[1] *Cumulative figures for working households.*

[2] *The before and after figures are based on 1997–98 and 2000–01 caseload and take-up estimates respectively.*

Increasing the labour supply

4.62 One of the overall objectives of the Government's reforms of the tax and benefit system is to increase the labour supply by increasing the number of people seeking work. The Treasury has estimated the impact on the entire package of measures to make work pay since 1997, including the reductions in income tax and NICs[10] as well as WFTC and DPTC. Cautious estimates show that labour supply may increase by 160,000 people as a result of the changes to the tax and benefit system.

Box 4.4: Extending the principle of the Working Families' Tax Credit to those without children

While the WFTC has helped to make work pay for families with children, the gains to work from low-paid jobs for those without children can still be low. The chart below compares the ratio of in-work to out-of work income for a single earner couple with and without children. Up to incomes of around 50 per cent more than the minimum wage, a couple with one child sees a higher proportionate gain to work than the couple without children.

Chart

There are also significant numbers of working people without children who live in poverty. Around $1^{1}/_{4}$ million people without dependent children live in households where someone is in work and income is below 60 per cent of the median.

To counter the problems of poor work incentives and poverty among people without children, the Government announced in Budget 2000 that the principle of in-work support through tax credits will be extended to people without children from 2003. This employment tax credit will complement the integrated system of support for children (see box 5.2), helping to ensure higher incomes for workers in low-income households both with and without children.

The Government is carefully considering the detailed design issues surrounding an employment tax credit, including how far to extend support to those without children, to make sure that it effectively and efficiently delivers the Government's aims of providing work incentives and tackling in-work poverty. Many of the key issues were set down in the Treasury paper Tackling Poverty and Making Work Pay – Tax Credits for the 21st Century, published in March 2000. More details on these tax credits will be published in the summer.

SECURING PROGRESSION IN WORK

Skills and lifelong learning

4.63 Moving from welfare to work is the first step in moving out of poverty. But the Government also wants to enable people to remain in work and to progress up the earnings ladder. By training and improving their skills, individuals can strengthen their position in the labour market. Yet opportunities for training are unevenly distributed. An employee with qualifications below level 2 is more than four times less likely to receive training than a colleague with level 2 qualifications.

4.64 To address this problem, the Government has set about transforming arrangements for lifelong learning by establishing Learning and Skills Councils, and investing in initiatives such as Individual Learning Accounts, learndirect, and ICT learning centres. Further details on these can be found in Chapter 3. In recognition of the need for real change in the area of basic skills, the Government is considering what further actions are necessary – including from government – to ensure that everyone in work is equipped with the training and skills necessary to progress in work, as Chapter 3 describes.

Basic skills screening

4.65 In accordance with the Government's objective of improving basic skills, the 2000 Spending Review also set aside money for basic skills screening of JSA claimants at the six month point. This means that those on both the New Deal for young people and the New Deal for 25+ are screened after the first six months of their JSA claim. Moreover, from April 2001, screening for basic skills needs will be extended to include clients on the New Deal programmes for over 50s, lone parents, partners and disabled people.

4.66 As previously announced, the Government will also pilot basic skills screening earlier on in the JSA claim, after 13 weeks (as opposed to six months) and pilots will also be established to test the use of incentives and sanctions as a way of promoting basic literacy and numeracy attainments among the unemployed.

4.67 Both the New Deal for young people and the New Deal for over 50s offer a £750 in– work training grant. This access to training through the New Deal programmes helps people develop their skills, thereby providing opportunities for people to climb the earnings ladder. This approach is also being piloted in the New Deal for lone parents.

Helping people to remain in and progress in work

4.68 Jobs can be particularly insecure during the first few months – around 25 per cent of people who move from JSA into work return to unemployment again within 3 months and
40 per cent within one year, thereafter the return to unemployment slows. Compounding this is the fact that entry-level jobs are far more likely to be unstable, for example, temporary or low paid. Helping people to remain in work is a precondition to helping them to stay out of poverty.

4.69 Evidence suggests that some people experience a low pay-no pay cycle, where they move from one low paid job into unemployment, and re-enter work in another low paid job. Those who experience a spell of unemployment seem to move into lower waged jobs. The duration of unemployment can cause a further negative effect on wages. For some, low pay can be persistent, perhaps over an entire working life.

4.70 Welfare to work policies and measures to make work pay have been shown to be effective at helping people to move into employment. Over the next three years, the Government will pilot ways to help people to progress in work. These pilots will be run as a demonstration project to learn more about what works.

4.71 The Government will consult widely – drawing in particular on the Employment, Retention and Advancement project in the US – in order to develop the best policies to complement lifelong learning measures.

[9]The marginal deduction rate measures the proportion of any marginal increase in income lost through reduced benefit entitlement and higher tax payments.

[10]The analysis excludes the impact of the National Minimum Wage.

5
Fairness for Families and Communities

The Government is committed to building a fairer and more inclusive society in which everyone can contribute to, and benefit from, the country's rising economic prosperity. The Pre-Budget Report set out the challenges the Government faces in tackling child poverty and supporting families, providing security for pensioners, rewarding work and saving, delivering world-class public services, and concentrating extra help on the people and communities that need it most. Budget 2001 builds on the reforms achieved so far.

Supporting families with children and tackling child poverty by:

- introducing the Children's Tax Credit at £10 a week - £1.50 more than previously planned - also reflected in higher Income Support and Jobseeker's Allowance child credits;
- raising the Children's Tax Credit by a further £10 to £20 a week - making it worth up to £1,000 a year - in the year of a child's birth from April 2002;
- increasing the basic credits in the Working Families' Tax Credit and Disabled Person's Tax Credit by £5 a week above inflation from June 2001; and
- announcing a rise in maternity pay from £60.20 to £100, an extension of the period of paid maternity leave from 18 to 26 weeks, and the introduction of two weeks' paid paternity leave.

Helping pensioners by:

- as announced in the Pre-Budget Report, increasing the basic state pension for single pensioners by £5 a week to £72.50 a week, with a further £3 a week increase to follow in 2002;
- as announced in the Pre-Budget Report, raising the Minimum Income Guarantee to £92.15 a week for single pensioners and £140.55 a week for couples in April 2001, and at least £100 a week for single pensioners and £154 a week for couples by April 2003; and
- raising the age-related personal tax allowances by £240 above indexation in 2003-04.

Delivering high quality public services by:

- allocating an additional £$2^1/_3$ billion over three years to investment in schools, hospitals and tackling drug-related crime.

Creating a modern and fair tax system by:

- introducing a new scheme to allow national museums and galleries to reclaim VAT;
- replacing general betting duty with a gross profits tax, thereby abolishing all tax on punters; and
- tackling tax abuse and avoidance.

INTRODUCTION

The previous chapters discuss the action the Government is taking to build a strong and stable economy for the long term, based on high and stable levels of growth and employment. This chapter describes how the Government is acting to ensure that this strong, productive economy is underpinned by a fair and inclusive society in which everyone has the chance to fulfil their potential and improve their quality of life - regardless of gender, disability, ethnicity, age, family circumstance or where they live. It sets out the Government's approach to, and support for:

- families and children;
- people with disabilities;
- pensioners;
- savings;
- high quality public services;
- strengthening community life; and
- a fair and modern tax system.

SUPPORT FOR FAMILIES AND CHILDREN

5.1 Over the past two decades, families with children lost out in the tax and benefits system and the proportion of children living in low-income households more than doubled. At the same time, families with children have taken a decreasing overall share of national income. Between 1979 and 1995-96, average incomes after housing costs rose by 35 per cent for working households with children, and by 43 per cent for those without. Since 1997, the Government has been determined to provide more support for families with children.

5.2 The Government has made a firm commitment to help families with children through the tax and benefit system. In doing so, it is guided by the following principles:

- recognising the costs and responsibilities which come with parenthood, by providing extra financial support for all families with children; and
- targeting help on those who need it most, when they need it most. This includes families on lower incomes, and those with a new baby.

5.3 The Government has introduced a series of reforms to support all families with children, reflecting its belief that that while parents are responsible for the upbringing of their children, government should contribute towards the costs. Budget 2001 builds on the achievements so far:

- record increases in universal Child Benefit, which have seen the rate for the first child rise by 26 per cent in real terms since 1997. **As announced in Budget 2000, Child Benefit will rise in line with indexation from April 2001: to £15.50 for the first child and to £10.35 for subsequent children;**
- introducing the Children's Tax Credit from April 2001, replacing the married couple's allowance abolished in April 2000. **Budget 2001 announces that the Children's Tax Credit will be introduced at £10 a week - £1.50 more than previously planned - thereby fulfilling the aim of providing a family tax cut of up to £520 a year from which around 5 million families can benefit.** This will be equivalent to a reduction in the basic rate of income tax of nearly 3p for a single-earner family on average earnings;
- to increase support for families with the youngest children, Budget 2001 announces that from April 2002 **the Children's Tax Credit will be increased by £10 a week for families in the year of a child's birth.** The credit will be worth up to £1,000 for around 500,000 families each year;

- the introduction of the Working Families' Tax Credit (WFTC), which is benefiting more than 1.1 million families, around 300,000 more than received Family Credit at its peak. **Budget 2001 announces that the basic credit in WFTC will be increased by an additional £5 over inflation from June 2001, with a similar increase in the basic credits in the DPTC**. This means families will, on average, be receiving around £35 a week more than Family Credit, compared with £30 now; and
- increases in Income Support and other income-related benefits have meant that rates for children under 11 have been increased by 72 per cent in real terms since 1997. As families on income-related benefits will not benefit from the increase in WFTC or the Children's Tax Credit, **Budget 2001 announces a £1.50 increase in the child allowances in Income Support and Jobseeker's Allowance from October 2001, to match the rise in the Children's Tax Credit in this Budget.**

Box 5.1: Financial support for families and the work-life balance

In the past, parents have not had enough choice over how to balance work and caring for their children. In some families both partners had to work because in-work benefits were not generous enough. Yet for couples on the lowest incomes, and many lone parents, high marginal deduction rates and insufficient help with childcare costs meant that for women in particular, taking a job was often not financially worthwhile. Maternity provision was poor, so mothers on low incomes were forced either to return to work very early after the birth of a child, or to give up their jobs and claim benefit instead. Provision for paternity leave was negligible.

The Government's reforms have begun to correct these failings.

- The new Children's Tax Credit, available to families with one earner or two, will provide up to £520 a year for 5 million families. Budget 2001 announces that from April 2002, this will be increased to £20 a week, up to £1000 a year, for families in the year of a child's birth.
- This Budget announces extended and increased rates of Statutory Maternity Pay, plus two weeks' paid paternity leave. Together with changes already announced, including a new flexibility in WFTC that allows parents to reclaim as soon as a child is born. This means that parents now receive much better financial support when the challenges of balancing work and family are often greatest.
- The increased generosity in the WFTC means that lower-income parents are better supported if one chooses to stay at home, or if one or both decide to work fewer hours. From April 2001, the WFTC guarantees a minimum income of £214 for a family with one child and one partner working 35 hours a week at the minimum wage. To get this income under Family Credit, both partners would have had to work, one full-time and one 20 hours at the minimum wage. Similarly, part-time work of 16 hours now guarantees a minimum income of £154. A family would have needed to work 20 hours under Family Credit to generate this income.
- The reforms have also ensured that for the lowest-income working families, mothers who choose to go back to work keep more of what they earn. Cuts in national insurance, the new 10p income tax band, the lower taper on the WFTC, and the childcare tax credit all help to make work more attractive for people working part-time and/or on lower hourly wages, many of whom are women.

Supporting parents around the time of a child's birth

Help for low-income mothers

5.4 Mothers on low incomes face particularly difficult and restricted choices about how they support their children in the early months. In the past, the tax and benefit system has not provided adequate support: financial help has not been available quickly enough and some of the lowest-paid women have been excluded from maternity pay and tax credits.

5.5 In order to direct more help at the poorest families, the Government has already:

- extended the Maternity Allowance to women earning less than the lower earnings limit but at least £30 a week;
- introduced a new Sure Start Maternity Grant to replace the old maternity payment, then increased it to £300 from December 2000. The Government announced in the Pre-Budget Report that, **from October 2001, the £500 capital limit will be abolished;** and
- provided further support through tax credits. **From April 2001, mothers will be able to apply for the WFTC when they are on maternity leave** (entitled to either Maternity Allowance or Statutory Maternity Pay) rather than having to wait until they return to work. Also, for the first time, **families will be able to make a new WFTC claim as soon as a child is born**, getting a credit for the new baby immediately, rather than having to wait until their current award comes to an end.

5.6 This Budget builds further on these reforms. **From April 2002, the Government will increase the Sure Start Maternity Grant by £200 to £500** - five times the level in 1997. Around 215,000 families on income-related benefits and tax credits will benefit from the grant every year. Payment is linked to contact with a healthcare professional, to ensure expert advice on child development and services.

Maternity pay and parental leave

5.7 The Government has introduced further reforms to benefit working parents. It has increased statutory maternity leave from 14 to 18 weeks, and has introduced new rights to parental leave and to time off to look after dependants. However, the Government believes that the current system does not provide parents with sufficient support in balancing work and family responsibilities. For example, too many mothers:

- are forced to return to work when their new baby is very young. Just over half of women taking maternity leave take 18 weeks or less. The most common reason given for returning to work early is financial need; or
- lose touch with the labour market completely. A third of women who worked during pregnancy do not return to work after maternity leave. The evidence shows that it is in the first few years after giving birth that the pay gap between

men and women widens. Also, a drop in pay is more likely when a woman breaks the link with her previous employer after having a baby.

5.8 In Budget 2000, the Chancellor announced a review to consider what further improvements might be made to maternity pay and parental leave. The review, which has been led by the Secretary of State for Trade and Industry, published a green paper in December 2000 - *Work and Parents: Competitiveness and Choice* - outlining several options for reform. The Government will bring forward detailed proposals in the light of the consultation exercise. In the meantime, **Budget 2001 sets out reforms of financial support for families in this area.**

Maternity pay

5.9 Good maternity provision gives women a real chance to stay at home during the crucial first months after giving birth, and can ease the choice over whether to return to work afterwards. The Government has therefore decided to:

- **increase the flat rate of Statutory Maternity Pay (after the first six weeks it is paid at a flat £60.20 a week) and Maternity Allowance.** The rate will rise to £75 a week from April 2002, then, allowing time to legislate for reform of the structure of the system, to £100 a week from April 2003. All 360,000 women entitled to Statutory Maternity Pay or Maternity Allowance each year will get either the new flat rate or, as under the current rules, 90 per cent of their previous earnings if that is lower; and
- **extend the period of maternity pay,** at this enhanced rate, from 18 to 26 weeks, from April 2003. All mothers on Statutory Maternity Pay or Maternity Allowance will be entitled to a further 8 weeks of pay.

Paid paternity leave

5.10 The Government intends to do more for working fathers too. Offering a period of paid leave after the birth would enable fathers to have the choice to spend more time with their partner and new child. **The Government will therefore introduce, from 2003, the right to two weeks of paid paternity leave for working fathers, paid at the same flat rate as Statutory Maternity Pay.**

Paid adoption leave

5.11 Since 1999, adoptive parents have been entitled to parental leave, but they do not receive any statutory paid leave in the vital first months after adopting their child. The Government's review has found widespread support for change. **The Government will therefore introduce paid adoption leave from 2003, paid for the same period and at the same flat rate as SMP, starting when the child is first placed with the family. Adoptive parents will be able to choose which of them takes time off work and receives the payment.**

Extra help for employers

5.12 The Government recognises the valuable role that businesses play in administering SMP. In turn, maternity provision and other family-friendly policies are an important way for businesses to retain and motivate their employees. Many employers go far beyond the statutory minimum, seeing this as good business sense and an opportunity to boost their profitability and productivity.

5.13 Because small businesses can face particular difficulties in administering maternity pay, firms with an annual National Insurance liability of £20,000 or less can qualify for Small Employer Relief. This allows them to claim back in full the SMP they pay (larger employers are reimbursed 92 per cent of their costs), plus a percentage on top in compensation. In order to offer greater support to smaller firms, **the Government will, from 2002, double the threshold for Small Employer Relief to £40,000. This will allow an extra 11,000 firms a year to qualify for extra compensation. It means that around 60 per cent of the employers paying SMP every year will qualify.**

5.14 Alongside these improvements in financial support for parents, the Government will also announce reforms to the framework of parental and maternity rights and entitlements. As noted above, the full detail of all the reforms will be announced in the light of the responses to the green paper consultation. The Government will work closely with employers, parents and other experts in an attempt to simplify the current system, minimise the costs of change and make it as easy as possible for businesses to build their own provision on top of the new arrangements.

5.15 The Government's improvements in provision for families around the arrival of a new child, including the Children's Tax Credit, worth up to £1,000 for families in the year of a child's birth, mean that from 2003:

- reforms to Statutory Maternity Pay and Maternity Allowance will give up to £1,200 extra to all the 360,000 mothers a year who get maternity pay;

- taking maternity pay and the increased Children's Tax Credit together, there will be up to £2,200 extra in the first year for families with a new baby; and
- with the WFTC and higher Statutory Maternity Pay most women who were working beforehand will be guaranteed a minimum income of £200 a week for up to 6 months after the birth.

Box 5.2: A new framework of support for families with children

Substantial progress has been made in achieving the Government's goals of supporting families with children and tackling child poverty. However, further progress is restricted by the nature of the instruments the Government has at its disposal. In a modern economy, the tax and benefits systems must work together to help tackle poverty and provide opportunity.

The Government intends, from 2003, to introduce a single new tax credit for families with children. This will bring together the different strands of support for children in the Working Families' Tax Credit, Disabled Person's Tax Credit, Income Support/Jobseeker's Allowance and Children's Tax Credit, building on the foundation of universal Child Benefit. This new tax credit for families with children will be paid direct to the main carer in the family, and provide a seamless and secure means of support. The new system will also assess eligbility on the basis of household income. It will be complemented by the new employment tax credit, discussed in Box 4.4.

The Government is carefully considering the detailed design parameters for the new credits, and has received a number of representations in response to the Treasury paper *Tackling Poverty and Making Work Pay - Tax Credits for the 21st Century*, published in March 2000. The experience of other countries that have also introduced similar tax credits for children, such as Canada and Australia, is also being examined. To further aid discussion, more details on the new tax credit for children and employment tax credit will be published in the summer.

The effect of the Government's financial measures to support families with children

5.16 Chart 5.1 shows that financial support available through the tax and benefits system has increased for all families with children, while the greatest increases have been targeted on families on lower incomes.

Chart 5.1: Financial support for the first child, in 2001-02 prices

5.17 Chart 5.2 shows the impact of the reforms by decile on families with children.

Chart 5.2: Gains for families as a result of children's measures by 2001

5.18 With the latest increases, as a result of the Government's tax and benefit reforms over the Parliament as a whole:

- families with children will be, on average, £1,000 a year better off;
- a family with two children on half average earnings of £12,700 will be £3,000 a year better off in real terms; and
- a family on average earnings of £25,400 and with two children will be £520 a year better off, as well as having the lowest direct tax burden since 1972.

5.19 Chart 5.3 shows the effects of the Government's personal tax and benefit reforms on households of working age, whether or not they have children.

Chart 5.3: Gains for working age households by 2001

The challenge of abolishing child poverty

5.20 The Government wants every child to have the best possible start in life, and has pledged to abolish child poverty within a generation and to halve it within ten years. The 2000 Spending Review introduced a new milestone with a Public Service Agreement target to reduce by at least a quarter the number of children living in households with an income of less than 60 per cent of the median by 2004.

5.21 Child poverty is a complex problem and therefore requires a multi-dimensional approach. The Government's strategy includes:

- ensuring a decent family income, with work for those who can and extra support for those who cannot;
- access to excellent public services - including a world class education system for all, ensuring that children from poor backgrounds have the skills and education they need to break the cycle of disadvantage;

- targeted interventions such as the Sure Start Programme and Children's Fund, for those with additional needs and at key stages in life; and
- harnessing the power and expertise of the voluntary and community sectors, providing support for innovation and good practice, and fostering a strategic partnership with these sectors to fight child poverty.

5.22 The Government's second annual report on tackling poverty and social exclusion[1] sets out the progress the Government has made in these areas and the scale of the task ahead.

Importance of a good education

5.23 Education has a vital influence on a child's life chances. It is critical to employment opportunity and to the well being of people throughout their lives. The Government is determined to remove educational barriers that prevent equal life chances for all.

5.24 As described in the Pre-Budget Report, the national literacy and numeracy programme has been instrumental in raising attainment at age 11. The Government is now extending the principles of the programme to the early years of secondary school. In addition, it has set out plans to diversify the system, with each school developing its own unique ethos and approach.

Box 5.3: Child poverty ambition

The Government has set a long-term ambition to abolish child poverty in a generation and halve it in ten years. Child poverty is a multi-dimensional problem, but low income is a fundamental issue. A substantial body of evidence shows that children who grow up in low-income households experience disadvantage and lack of opportunity that affects not only their own current and future experience as adults but also the life chances of their children.

Budget 2001 announces £1.1 billion extra in direct financial support to families, to secure and build on measures to date, as the economy continues to grow. Tax and benefit reforms announced in this Parliament will lift over 1.2 million children out of relative poverty. Budget 2001 tax and benefit changes will lift 170,000 children out of poverty.

Number of children lifted out of poverty

	Below 50% median	**Below 60% median**	**Below 70% median**
Children lifted out of low-income households by measures announced in this Parliament	2.0 million	1.2 million	500,000

Incomes are measured after housing costs and include the self-employed.
Thresholds are the same as those used in "*Opportunity for All*".

Families with children in the poorest fifth of the population will on average be £1,700 a year better off, a real increase of around 15 per cent in their incomes, as a result of personal tax and benefit reforms announced in this Parliament. These families include around 4 million children.

In addition, the Government has started to make significant progress on tackling the causes of poverty and persistent poverty:

- since spring 1997, the number of children in workless households has fallen by over 300,000 and the lone parent employment rate has risen above 50 per cent for the first time in over 20 years;
- since 1997, the number of children in families claiming out of work benefits for two or more years consecutively has fallen by over 200,000 - more than 10 per cent.

5.25 The Government is reforming the incentives and conditions faced by teachers to ensure that all pupils benefit from good quality teaching. It has already introduced performance-related pay, training salaries and "golden hellos" for shortage subjects. **The targeting of incentives is being extended. As announced in February 2001, for newly-qualified teachers covering shortage subjects, student loans will be repaid by the Government over a 10-year period.**

5.26 To improve and modernise school buildings, the Government increased capital spending on schools threefold between 1996-97 and 2000-01; in England, £7.8 billion will be spent on school buildings over the next three years, with a further £1.1 billion for ICT.

Targeted services to tackle child poverty

Sure Start

5.27 Sure Start is a radical strategy that aims to tackle the causes of poverty and social exclusion. Local, community-led programmes work in partnership with parents-to-be, parents and children to promote the physical, intellectual and social development of babies and young children - particularly those who are disadvantaged - so that they can flourish at home and when they get to school.

5.28 The 2000 Spending Review more than doubled planned expenditure to provide for at least 500 local programmes by 2003-04. 260 local programmes have already been announced and will be operational by April 2002 - 129 are already delivering services to over 10,000 children in disadvantaged areas each month, with over 2,000 new children being contacted each month. Under these local programmes, almost all parents are visited within two months of the birth of their baby.

Children's Fund

5.29 The 2000 Spending Review announced £450 million for a new Children's Fund, over the three years to 2003-04. The majority of the Fund will be targeted at increased preventative services for children (primarily those aged 5 to 13) and their families, helping them before they hit crisis. Part of the Fund, £70 million over three years, will be distributed directly to local community groups through a network of local funds administered by the voluntary sector, for children of all ages.

5.30 The Children's Fund sets out to provide improved joined-up support for children, young people and their families. The Government wants to see local agencies working alongside voluntary and community groups, faith groups, children, young people and parents. Guidance for partnerships for increased preventative services has been issued to an initial 40 local authority areas. The Fund will be rolled out across the whole of England by 2003-04. Children's Fund partnerships are expected to provide services such as mentoring, after school clubs and parenting support.

FAIRNESS FOR PEOPLE WITH DISABILITIES

5.31 The Government is determined to increase opportunities for people with disabilities to live fulfilling and independent lives. The New Deal for Disabled People, described in Chapter 4, is helping those who want to work, with advice and support specific to their needs. The Disabled Person's Tax Credit, also discussed in Chapter 4, increases the gains to work for people with disabilities. From January 2000, the maximum earnings disregard in the Independent Living Fund was increased from £30 to £106.50 a week. This further removes barriers to work for people with disabilities, and ensures that work pays for those Fund beneficiaries who wish to take up employment.

Disability Income Guarantee

5.32 The Government is also providing greater security for those people with disabilities who cannot work. Budget 2000 announced that **from April 2001, severely disabled people under 60 years of age on income-related benefits will receive a guaranteed income,** delivered through a new premium, of at least £142 a week for single people, and £186.80 a week for couples. Families with severely disabled children will benefit from an extra £11.05 a week for each disabled child. Also from April 2001, the Government will be providing new and additional support for severely disabled people through the Disabled Person's Tax Credit and Working Families' Tax Credit. Enhanced disability tax credits will be awarded when adults or children are entitled to the highest rate care component of Disability Living Allowance.

Support for families with disabled children

5.33 The Government recognises that families with disabled children are often under extreme pressure and need extra help. From October 2000, the disabled child credit in the Disabled Person's Tax Credit was extended to families in receipt of the Working Families' Tax Credit. **From April 2001, the disabled child premium in income-related benefits and tax credits will be increased to £30 a week for each eligible child, an increase of £7.40 more than the normal uprating.** Over 100,000 families will gain. **From April 2001 the Government is extending the Disabled Living Allowance higher rate mobility component to severely disabled children aged 3 and 4, providing extra help worth £38.65 a week. Also from April 2001, reforms to Incapacity Benefit will provide up to £26.40 a week more for people who were disabled before the age of 20,** once they have been on Incapacity Benefit for a year.

5.34 In June 2000, the Government announced a package of measures aimed at easing the burdens on families with children suffering from vaccine damage. From July 2000, the one-off payment under the Vaccine Damage Payment (VDP) scheme was increased to £100,000 (a threefold increase from 1997 levels) and previous VDP recipients will also receive top-up awards to bring the value of their payment (at current prices) up to the new level. **The Government intends to bring forward legislation to reduce the disability threshold for eligibility to VDP from 80 per cent to 60 per cent and to extend the time limit for making a claim to encompass all young people up to the age of 21.**

Help for carers

5.35 In November 2000, the Government announced a series of reforms to help carers. **From April 2001 the earnings threshold in Invalid Care Allowance will be raised from £50 to £72 a week.** This will make it easier for carers to combine work and caring. **As soon as is practicable, the Government will extend eligibility to Invalid Care Allowance to carers over 65 and introduce an 8-week run-on after the death of the person being cared for. From April 2001, the Carers Premium in Income Support will be raised by over £10 per week to £24.40,** benefiting over 210,000 of the poorest carers.

FAIRNESS FOR PENSIONERS

5.36 In the Pre-Budget Report, the Government announced a comprehensive set of reforms for pensioners, based around the principles of:

- ending pensioner poverty;
- enabling today's workforce - tomorrow's pensioners - to plan ahead to make decent provision for their own retirement, protecting themselves against poverty in the future;
- rewarding today's low and modest income pensioners who have worked hard to provide for their own retirement; and
- treating pensioners in the tax system fairly, and paving the way to further tax and benefit integration.

Tackling pensioner poverty

5.37 The Government's first priority has been to help those in greatest need. Over the past 20 years, the gap between rich and poor pensioners has grown. Like those of working-age, the richest fifth of pensioners are now three times better off than the lowest fifth. Too many pensioners have not shared in the rising prosperity of the country.

5.38 To address this growing divide, the Government reformed Income Support to introduce a more generous Minimum Income Guarantee (MIG). The MIG has raised the income of poorer pensioners and has risen in line with earnings, ensuring that the incomes of these pensioners have kept pace with the incomes of the wider population. Around 2 million pensioners now benefit from this additional support.

5.39 The current system, however, continues to penalise low-income pensioners who have worked hard to build up savings for their retirement. This is why, as a first step, the Government has taken action on the capital rules attached to the MIG. Currently these capital rules allow pensioners to have only £3,000 of savings without any reduction in benefit. Savings over that level reduce benefit entitlement. With over £8,000 of savings, MIG entitlement is removed altogether. **As announced in Budget 2000, from April 2001, the Government will double the lower limit to £6,000 and increase the upper limit from £8,000 to £12,000 to reward savers.**

5.40 The Pre-Budget Report announced further action to tackle pensioner poverty from this April by **aligning the lower rates of the MIG to equal its highest rate, and raising this above and beyond earnings. From April 2001, the new, simplified MIG will be £92.15 a week for single pensioners, and £140.55 a week for couples.** Based on current projections, following the introduction of a new Pension Credit as set out below, from April 2003 the earnings-linked guaranteed minimum income will be at least £100 a week for single pensioners, and at least £154 a week for couples.

Security for all pensioners

5.41 The Government is also committed to ensuring security in retirement for all pensioners, not just the poorest. It has therefore introduced:

- Winter Fuel Payments, set in the Pre-Budget Report at £200 for December 2000, paid to every household with someone aged 60 or over - 8.5 million in total - each winter. The level of future payments will be set by the Secretary of State for Social Security later in the year;
- free TV licences for households with someone aged 75 or over. Over 3 million households are benefiting - almost half of which are in the bottom three income deciles;
- free eye tests for all those over 60;

- **free passes giving an entitlement to concessionary travel for all pensioners from April 2001;**
- measures to combat fuel poverty through the Home Energy Efficiency Scheme, the Government's Affordable Warmth Programme, a reduced VAT rate of 5 per cent to grant-funded installation of heating systems and a reduced rate of VAT on domestic fuel; and
- plans for a new pensioner organisation to transform the way that the Government provides services to pensioners.

5.42 The extension of the 10p income band tax in Budget 2001 by £300 over inflation will benefit over 3 million pensioners. By next year, seven out of ten pensioners will pay no tax at all, or tax at the 10p rate.

5.43 The Government has proposed further radical reform through a new Pension Credit from 2003, as set out below, in order to bring substantial gains not just to the poorest but also to those on low and modest incomes. Ahead of the introduction of the Credit, the Government is taking further action to help these pensioners, as announced in the Pre-Budget Report. **The Government will therefore increase the basic state pension by £5 to £72.50 a week in April 2001, and by a further £3 to £75.50 a week in April 2002 for single pensioners.** For couples this will mean an increase of £8 to £115.90 a week in April 2001, and a further £4.80 to £120.70 a week in April 2002. Based on current forecasts, from April 2003 the basic state pension will be at least £77 a week for single pensioners and £123 a week for couples, reflecting the return to normal price uprating from 2003.

5.44 The Government's tax and benefit reforms mean that, compared to 1997, from April 2001:

- the average pensioner household will be £600 a year, over £11 a week, better off;
- virtually all pensioner households will be better off than they would have been with an earnings link in the basic state pension; and
- around 2 million of the poorest pensioner households will be at least £800 a year better off - a real terms rise in living standard of at least 17 per cent. Younger couples on the MIG will see a gain of over £1,400 a year in real terms since 1997.

5.45 Chart 5.4 shows the distributional impact of these reforms.

Chart 5.4: Overall gains for pensioner families from pensioner policies including Budget 2001 changes

5.46 Next year the Government will be spending £4.5 billion a year extra in real terms on pensioners as a result of policies since 1997. In 2002-03, this will rise to £5.5 billion extra a year. This will get £2 billion more next year to the poorest third of pensioners - five times more than an earnings link in the basic state pension would have given them.

Helping tomorrow's pensioners through second-tier pensions

5.47 To help protect future pensioners from the poverty and inequality many of today's pensioners have had to bear, the Government is providing today's workers with the opportunity to build up a decent second-tier pension by the time they retire, through:

- SERPS reform, which will provide more support than in the past for moderate and lower paid workers, and for carers and the disabled. Some 18 million people stand to gain from the introduction of the State Second Pension in April 2002; and
- stakeholder pensions, which will provide a safe, flexible, low-cost way to save for retirement for moderate and higher earners, from this April.

Next steps: the Pension Credit - rewarding low and modest income pensioners

5.48 The Government believes that there is more to do to tackle pensioner poverty and inequality, and to help ensure all pensioners share in rising prosperity. This means providing greater support, not only for the very poorest but also for those on low and modest incomes.

5.49 To achieve this, the Government is determined to tackle both the unfairness of the current system, which means that pensioners on the MIG see little or no gain from having saved, and its complexity, which deters many pensioners from claiming their entitlement. In November 2000, the Secretary of State for Social Security published, for consultation, detailed proposals for a Pension Credit to be introduced from 2003. The Pension Credit (see Box 5.x) will:

- reward low and modest retirement incomes above the level of the basic state pension - a cash reward for every pound of second-tier pension, earnings or investment income for those on the Credit;
- modernise the system by abolishing the capital rules and weekly means-test, and instead bring the system closer in

line with the tax system, improving its transparency and administration, and paving the way for further tax and benefit integration; and

- act to end pensioner poverty by simplifying and increasing the MIG, and by linking this to the rise in earnings throughout the next Parliament.

5.50 Based on current assumptions about future growth in prices and earnings, and taking account of the further changes the Government plans to make, when introduced from 2003 the Credit will:

- reward pensioners whose savings, second pensions or earnings give them incomes of up to around £135 a week for single pensioners and £200 a week for couples;
- mean that no single pensioner need live on less than £100 a week - £154 a week for couples; and
- thereby entitle half of all pensioner households - around 5.5 million individual pensioners - to more support.

Help for pensioners who pay tax

5.51 In the same way that the Pension Credit will deliver year-on-year increases to poor and modest income pensioners, so the Government intends to help older taxpayers too.

5.52 Most pensioners have no income tax to pay. But for those who do, **the Government has decided to raise the age-related personal allowances in 2003-04 by £240 over and above indexation.** On current forecasts, that would take the allowances to £6,510 for those aged 65 to 74 and to £6,800 for those aged 75 or more. The Government has also decided **to increase the allowances by reference to the rise in earnings rather than prices throughout the next Parliament.** In the same way that a pensioner on an income of £130 a week will be entitled to a Pension Credit of £2 a week extra, so a pensioner paying tax at 22 per cent on an income of £170 a week will receive £1 extra a week in 2003-04 through this more generous tax allowance. Over 3 million pensioners aged 65 or more will benefit from the increase.

Box 5.4: How the Pension Credit will work

The proposed Pension Credit will reward pensioners for having built up savings during their working lives, or for carrying on working beyond retirement age.

Under the current system, pensioners on the MIG lose a pound of benefit for every extra pound of their second pension or earnings income. Many also either see their benefit dramatically reduced, or are excluded altogether, simply because they have quite small amounts of capital.

The Pension Credit will instead look more fairly at the income a pensioner has to live on. It will simplify the system, fixing awards for longer periods of time, in place of intrusive means-testing, to give pensioners the security they need. It will also end the pound for pound withdrawal in the MIG. At present, many pensioners are no better off from having saved. Under the proposed system a pensioner's post-Credit income will be at least 60p above the guaranteed minimum income level for every pound of second pension, savings or earnings income they build up above the level of the basic state pension.

For illustration, under current arrangements a pensioner in 2003 with basic state pension of £77 a week and occupational pension of £20 a week would have her income topped up by £3 to the level of the MIG, at £100 a week. She would see no gain at all from her occupational pension. Under the Government's proposals though, she will receive £15 a week of Pension Credit, taking her income to £112 a week.

The Government proposes to link the Credit to the growth in average earnings. This means that all pensioners receiving the Credit will receive, year on year, a larger increase in support from the state than they would receive from an earnings link in the basic state pension.

Chart: Illustrative gains from the Pension Credit in 2003 for a single pensioner

5.53 The Pension Credit and associated changes represent a further step in the Government's programme of bringing the tax and benefit systems closer together. Over time, it is the Government's intention to take tax and benefit integration further: in particular, to make receipt of the Credit more automatic, to take steps to reduce overlap between the two systems, and ultimately to merge support for older people through the credit and the tax system to create a seamless and integrated system of support.

SUPPORTING SAVERS

The Government's savings strategy

5.54 The Government's strategy for saving was set out in a paper, *Helping People to Save*, published alongside the Pre-Budget Report. The Government wants more people to enjoy the benefits of having savings for independence throughout their lives, for security if things go wrong, and for comfort in old age. ISAs and stakeholder pensions help spread tax-advantaged saving to more groups. The Pension Credit will ensure that people who have saved for their retirement are not unfairly penalised. The Government is also tackling a number of other problems that may have discouraged saving in the past, including poor returns for small savers, inaccessible and inflexible savings products and a lack of effective competition in the financial services industry.

5.55 These measures fit within the Government's overall strategy to encourage saving:

- creating the right environment for saving;
- creating the right incentives for people to save; and
- providing information and education to help people make the right saving choices.

5.56 The right environment for saving involves a stable macroeconomy with low inflation, employment opportunity for all, a well-regulated and efficient market in financial services, and flexible and accessible savings products. The right incentives are created by a tax and benefit system which supports saving and does not penalise savers, along with lower charges to enhance the rewards to saving. Clear, impartial information and greater financial literacy enable people to make the right saving choices.

Individual Savings Accounts (ISAs)

5.57 A key part of this strategy was the introduction of Individual Savings Accounts (ISAs). These have proved extremely popular, with 8.5 million people opening accounts and over £28 billion invested in their first year - a third more than was invested in Tax Exempt Special Savings Accounts (TESSAs) and Personal Equity Plans (PEPs) during their last, and most successful year. The success of ISAs has continued this year, with £20 billion invested in ISAs during the first three quarters of 2000-01 - nearly £3 billion more than had been invested by this time last year.

5.58 ISAs - particularly mini cash ISAs - have succeeded in attracting relatively more low-income and younger savers than TESSAs and PEPs. More than a quarter of mini cash ISAs have been taken out by those earning less than £11,500 a year, compared with around one in five TESSAs and one in six PEPs.[2]

5.59 As well as spreading tax relief more widely, ISAs have also proved to be more generous than a continuation of the old PEPs and TESSAs regime. In this tax year, savers will have paid almost £100 million less in tax than would have been the case with PEPs and TESSAs. Next year, they will pay almost £300 million less. But the Government is going further than this. **As announced in the Pre-Budget Report, the £7,000 per year contribution limit will be extended for five years, together with the higher £3,000 limit for cash.** By 2006, savers will have gained a total of £700 million from this measure. In total, the introduction of ISAs means that, in 2005-06, savers will be receiving £800 million a year more in tax relief than if PEPs and TESSAs had remained.

10p rate of income tax for savers

5.60 Budget 2001 anounces a further change that will help savers. **The extension of the 10p rate of income tax by £300 over and above indexation from April 2001 will apply to savings income and benefit around 1 million savers, many of whom are pensioners.**

Stakeholder pensions

5.61 One of the key aims of the Government's savings strategy is to help people provide for financial security and comfort in old age. To achieve this, the Government gives generous tax reliefs to pensions, on the grounds that these provide a secure income throughout retirement. The Government is committed to extending the benefits of pension saving to previously excluded groups, particularly through the introduction of stakeholder pensions. These are regulated, low cost, good value and flexible products to provide a retirement income.

5.62 Stakeholders will be particularly suitable for moderate earners without a current pension. From October 2001, employers with 5 or more employees that do not offer an employer's pension to all employees will have to offer access to a stakeholder to eligible employees. This will make stakeholders available through the workplace to the majority of those currently without a private pension.

5.63 Those without earnings will also be able to contribute at least £3,600 a year to a stakeholder pension. So, for the first time, people caring for children, on a career break or studying will have access to a tax favoured retirement savings product. In addition, members of employers' schemes earning less than £30,000 per year will also be able to contribute to a stakeholder pension alongside their occupational scheme.

5.64 The Government is on track to meet its target - to make stakeholders widely available from this April. There are already 30 approved stakeholder schemes with 9 more applications pending.

Individual Pension Accounts

5.65 To enhance the transparency and flexibility of pension saving, Individual Pension Accounts (IPAs) will be available from April 2001. An IPA is a new way of holding assets inside a pension scheme. It is a package of investments - like a stocks and shares ISA, but for pension savings. **Budget 2001 introduces measures to exempt transactions in collective investment schemes from stamp duty reserve tax where the units and shares involved are held in IPAs.** This will remove a significant distortion in the competition between unit-linked life insurance based products and pensions using pooled funds.

Annuities

5.66 Pensions provide a secure income throughout retirement. Where a pension fund has been built up through a defined contribution scheme, an annuity is currently the only financial product that can guarantee this, as it guards against the risk of someone's savings running out during their lifetime. This is especially important given recent increases in longevity.

5.67 The Government has received representations on proposals for annuity reform. This is a complex area and many of the ideas submitted would have substantial costs, running into many hundreds of millions of pounds. The Government, however, appreciates that concern has been expressed and will continue discussions with interested parties on workable and affordable alternatives. In the meantime, the Government believes that developments in the annuity market can help to address some of the concerns that have been expressed.

5.68 The Government is keen to enable those buying annuities to make better-informed decisions on the basis of transparent products and clear information. It therefore welcomes recent moves by annuity providers to develop more flexible annuity products that will enable those pensioners for whom it is desirable to remain invested in equities. As the annuity market grows, it should aim to meet the demand for greater investment choice and higher returns. **The Inland Revenue will continue to work with the industry to ensure that the tax rules do not unnecessarily restrict the development of these products and this market.**

5.69 The Government is also concerned that some people may not be exercising their open market option - to purchase an annuity from another provider to the one with whom they invested their pension. Pensioners could be substantially worse off for not shopping around when buying their annuities. **The Government will therefore be working with the regulators to consider whether more needs to be done to encourage and enable consumers to shop around.**

Fair treatment for savings

5.70 The Government will also ensure that small savers are not unfairly penalised by the tax and benefit system. The Pension Credit will provide fair treatment for pensioners with savings, and other changes will also benefit low-income families who save. **By October 2001 the Government will abolish the £500 capital limits in the Sure Start Maternity Grant and Funeral Payments to ensure that families on low incomes with small amounts of savings receive support from the Government to help cover the costs associated with the birth of a baby or the death of a close relative.** This will benefit up to 25,000 low-income families every year. The next phase of modernising the social security and tax credit system offers an opportunity for a thorough review of the treatment of income and capital in assessing entitlement to support for working-age families.

Information on financial products

5.71 Within its wider regulatory role, the FSA is responsible for promoting understanding of the financial system. Following consultation, the FSA is moving closer to launching published tables of information about several ranges of retail financial products. **Those to be made available first, in the summer of 2001, will cover endowment policies, investment bonds, mortgages, personal pensions and pooled fund ISAs.** The tables will be accurate, authoritative and kept continuously up to date on the FSA website.

Encouraging small savers

5.72 The Government's priority for saving is to encourage people on low or moderate earnings to save. It is already beginning to achieve this with ISAs. From April 2001, 4 million people on low or moderate earnings without access to good occupational pension schemes will have access to stakeholder pensions which will offer a low cost, flexible and secure way to save for retirement. The Government intends to consult the financial services industry to look at further ways of encouraging people on low and moderate incomes to save. This could build on the experience of matched funding policies, such as the Individual Development Accounts operating in the US.

HIGH QUALITY PUBLIC SERVICES

5.73 The Government's aim is to deliver high quality public services that everyone can rely on. By maintaining economic stability and sound fiscal management, the Government was able last year to announce sustained and sustainable increases in the resources available for Britain's priority public services over the coming three years.

5.74 The 2000 Spending Review provided for average annual real growth in spending for the three years from 2000-01 of 5.2 per cent for education, 5.6 per cent for health, 20 per cent for transport, 12 per cent for housing, and 4.2 per cent for the criminal justice system. **As a result of the prudent management of the public finances, Budget 2001 can add to these resources by allocating an extra £2$^{1}/_{3}$ billion over the next three years.**

5.75 The money will go straight to the front line, giving those who are managing services the resources they need to deliver results and meet targets. It will provide, over the next three years, on top of the plans announced last July:

- **an extra £1 billion for education.** In England, additions of £837 million over three years will go to schools. £600 million over three years will go direct to head teachers to modernise buildings and equipment, and improve pupil attainment. This will mean primary schools will receive additional direct payments of between £3,000 and £13,000 a year; and secondary schools will get additions of between £10,000 and £23,000 a year. A further £200 million fund over 3 years will help schools implement new recruitment and retention incentives for teachers. The Secretary of State for Education and Employment will announce further details of these allocations;
- **an extra £1 billion for health.** In England, additions of £835 million over three years will go direct to the NHS. £450 million over three years will go to frontline hospital investment to help pay for new equipment such as scanners, and replace old Nightingale wards. Each of the acute hospital trusts will get between £$^{1}/_{2}$ million and £1 million a year. A further new fund for recruitment and retention will help to tackle shortages of key staff in the health service. The Secretary of State for Health will announce further details of these and other allocations; and
- **an extra £$^{1}/_{3}$ billion to help tackle drugs.** In England and Wales, additions of £220 million over three years will go straight to Crime and Disorder Reduction Partnerships to help local communities drive out drugs and drug-related crime. Each of the 376 Partnerships should get up to £0.5 million over three years and those with larger areas and the worst problems to tackle, up to £1 million over 3 years. Further resources will also be provided to support voluntary action against drugs by leaders of the business and sporting world. Ministers will announce further details of these measures shortly.

5.76 The Pre-Budget Report confirmed that the Chancellor was commissioning a long-term assessment of the technological, demographic and medical trends over the next two decades that will affect the health service. This review will be led by Derek Wanless, former Group Chief Executive of Nat West Bank, who will report to the Chancellor in time for the start of the next Spending Review in 2002.

STRENGTHENING COMMUNITY LIFE

Local PSAs

5.77 The 2000 Spending Review announced the introduction of local Public Service Agreements in 20 pilot local authorities - a new initiative to strengthen links between central and local government and promote better outcomes. In return for committing to targets local authorities will be able to negotiate the removal of rules and regulations that hinder performance, and stand to gain financial rewards for improved outcomes. The Government plans to extend this approach to an additional 130 local authorities over the following two years.

5.78 Local Strategic Partnerships made up of public, private, community and voluntary sector partners in each local authority area will work to co-ordinate work on ensuring public services meet the needs of residents.

5.79 Chapter 3 describes the measures the Government is taking to encourage enterprise in disadvantaged areas, and Chapter 6 sets out the Government's approach to improving the environment in our towns and cities, working towards a genuine urban renaissance. Chapter 5 describes how the Government is working with local people to deliver better public services for all.

5.80 Conditions in Britain's most disadvantaged communities are unacceptably poor. For example, child poverty in the poorest 10 per cent of wards is three times the national average. Those living in poorer neighbourhoods often have to put up not only with a rundown physical environment and limited opportunities, but also the worst public services. The Government is committed to tackling social exclusion and helping to build stronger communities across Britain.

Public services to tackle social exclusion

5.81 The 2000 Spending Review set specific PSA targets to ensure that everybody, wherever they live, can expect a decent minimum level of public services. These 'floor' targets are designed to close the gap between our most deprived communities and the rest of the country by improving health, education and employment outcomes, reducing crime and improving the condition of social housing.

Neighbourhood Renewal Fund

5.82 The Neighbourhood Renewal Fund will provide £900 million over the next three years to the 88 most deprived areas in England. This will provide additional help to Local Authorities and other key partners to make early progress in improving services to those most in need.

Action Plan for Neighbourhood Renewal

5.83 The Government launched the Action Plan for Neighbourhood Renewal in January 2001. The report set out the Government's vision to narrow the gap between poor neighbourhoods and the rest, so that within 10 to 20 years, no one should be seriously disadvantaged by where they live. Improved mainstream services are a key element of this strategy.

5.84 As part of their wider role, Local Strategic Partnerships (LSPs) will be expected to take an overarching view, considering all the interlinked problems in an area to ensure that all aspects of action to tackle social exclusion work on a co-ordinated basis. LSPs will help rationalise this work and reduce bureaucracy. The consultation period on draft guidance is now completed and the final version will be published shortly.

5.85 The Government recognises that community involvement is crucial for the successful implementation of local policies and additional resources have been allocated to ensure meaningful participation. The Community Empowerment Fund, worth over £35 million in three years, will be available for the 88 most deprived communities from April 2001. This will ensure that local people and the community sector have the resources to play a role in LSPs, on a par with statutory partners. Community Chests also offer £50 million over the next three years to support community projects such as mother and toddler groups and self-help programmes in disadvantaged areas.

An urban renaissance

5.86 The Urban White Paper, published in November 2000 set out a comprehensive strategy to maximise the potential of all towns and cities. The Government wants to build upon lessons learnt from successful places and narrow the gap between them and the rest. The strategy aims to make all urban areas attractive places, in which people want to live, work and spend their leisure time.

Strengthening rural communities

5.87 The Government's vision for the countryside, as set out in the Rural White Paper in November 2000, is of thriving rural communities with access to high quality public services, a diverse rural economy providing high and sustainable levels of employment, an enhanced and sustainable environment which all can enjoy, and a countryside which can shape its own future with its voice heard by Government at all levels. To help deliver this vision, the Government has allocated more than £600 million over the next three years for implementation of the England Rural Development Programme.

5.88 The Government recognises the severe difficulties currently being experienced by farmers and farming communities as a result of the outbreak of Foot and Mouth Disease. It is working hard with the industry to re-establish conditions in which the countryside can prosper, both contributing to and benefiting from rising economic prosperity.

Strong communities and the voluntary sector

5.89 Budget 2000 introduced an enhanced package of tax reliefs aimed at getting Britain giving more to charity. As a result of the Government's reforms, donations to charities by UK taxpayers - large and small, regular and one-off - can now attract tax relief.

5.90 The Government has received a number of representations seeking extension of the reliefs to amateur sports clubs that play a valuable and important role in promoting the health and cohesion of their local communities but do not attract tax relief, because they are not recognised as charitable. **Over the next few months the Government will consult on the best way for tax relief to help community amateur sports clubs that make a positive contribution to their local communities.**

TACKLING GLOBAL POVERTY

5.91 The Government applies the same principles of fairness that underpin its domestic agenda to its work in the international community. The Government has been a leading advocate of debt relief through the Heavily Indebted Poor Countries (HIPC) initiative. It was at the forefront of the international effort that saw 22 countries start to receive debt relief worth around $50 billion by the end of last year, and to benefit from the UK's policy of 100 per cent bilateral debt relief. In December 2000, the Chancellor announced that, for those countries that cannot yet benefit from debt relief - for example because of involvement in conflict - all debt payments to the UK Government would be held in trust, and returned when they are able to put in place an effective strategy for reducing poverty.

Meeting the 2015 International Development Targets

5.92 The Government is committed to meeting the 2015 International Development Targets, which include halving the proportion of people living in extreme poverty and providing universal access to primary education. On 26th February 2001, the Chancellor and Secretary of State for International Development hosted a major international conference to promote more effective action in the fight against child poverty. The heads of international organisations such as the IMF, World Bank, UNICEF, UNDP and OECD, along with governments, faith groups and non-governmental organisations from both developing and developed countries met to discuss what action each needs to take to ensure the targets are met.

Fund for education in the Commonwealth

5.93 75 million children in Commonwealth countries lack a basic education. **At the 26th February conference, the Government announced that a fund will be created, for Her Majesty the Queen's Jubilee Year, to speed the introduction of universal primary education in the Commonwealth.** The fund will help to build fair and effective education systems and create new opportunities for disadvantaged groups. The business community will be encouraged to support this effort.

A new commitment to fight the diseases of poverty5.94 Every year 6 million people die from HIV/AIDS, malaria and tuberculosis, almost all in the world's poorest countries. At the 26th February conference, the Chancellor and Secretary of State for International Development set out a comprehensive strategy to step up the fight against these killer diseases. They announced a new international initiative to secure the resources to purchase existing medicines, and to create the market required to stimulate research into new vaccines. The Government is also investing in the health care systems required to ensure that drugs and vaccines are delivered effectively. Since 1997 the Department for International Development has invested £1 billion in primary health care systems, delivered through bilateral cooperation. A comprehensive study by the Cabinet Office's Performance and Innovation Unit, working closely with the Department for International Development and the Treasury, will examine further options, and draw up plans for a comprehensive global strategy.

5.95 Budget 2001 sets out proposals for further incentives to create affordable health interventions for the poorest countries:

- **a new tax credit for research and development on drugs and vaccines for the diseases of poverty.** The credit will be additional to existing incentives, and to any further tax credits for research and development introduced following the consultation process announced in this Budget. Companies undertaking research into specified diseases will be eligible for an extra 50 per cent relief on qualifying expenditure. The Government will consult on the details of the new credit, the coverage of which will depend upon the response from the pharmaceutical industry. The Government will consider extending the credit to cover activity undertaken overseas by UK firms, although this will depend upon assurances from the industry that it will respond to this wider coverage with genuinely new commitments; and
- **a new incentive to encourage the pharmaceutical industry to raise the level of donations of drugs and vaccines,** and to do so in a more consistent manner, in support of developing countries' own health strategy and the needs of their people. Where drugs, vaccines and associated medical equipment are donated to designated international aid agencies and public health authorities, the value of the items donated will not be brought into charge to tax. Ancillary

expenditure, such as distribution and transport costs, will be fully tax deductible.

A MODERN AND FAIR TAX SYSTEM

5.96 The opportunity to make the sustained increases in investment in public services described above has been hard-won, partly by maintaining economic stability and high levels of growth, but also through prudent management of the public finances based on a tax system in which everyone pays their fair share. Building on the reforms of the last three Budgets, Budget 2001 announces further measures to modernise the tax system and tackle tax avoidance.

Modernising VAT

Museums

5.97 The Government is committed to universal access to the main national museums and galleries. However, the current VAT rules mean that museums and galleries which do not charge for admissions cannot recover all the VAT they incur on the things that they buy.

5.98 The Government has therefore decided to introduce a new scheme that will refund national museums and galleries the VAT they incur on their purchases when they allow the public free admission, thereby removing this barrier to free entry. The Government will be consulting museums and galleries on the details of the scheme, which will be introduced by September 2001. Eligible museums and galleries that do not currently charge will be able to reclaim the VAT they incur from 1 April 2001.

Vehicles adapted for disabled persons

5.99 There is currently a zero rate of VAT on the sale of motor vehicles designed and adapted for use by people with disabilities. **The Government has decided to modernise this zero rate by widening the range of vehicles available to be purchased VAT free by disabled people from 1 April 2001.**

Children's car seats

5.100 Around 6,000 children under eight years old are killed or injured each year on Britain's roads. It is vital that child car seats are correctly fitted and used to help protect children from harm when travelling by car. **The VAT rate on children's car seats will be reduced from 17.5 per cent to 5 per cent.** This will reduce the cost of buying an essential piece of safety equipment, and encourage parents to buy better quality car seats, which can often be easier to fit.

Modernising relief for children's clothing5.101 The zero rate of VAT on children's clothing and footwear provides valuable support to families by cutting the cost of buying essential goods for their children. However, some clothes and shoes, particularly those worn by today's bigger and taller children, fall outside the scope of the zero rate. **From 1 April 2001, the rules relating to this zero rate will be updated and simplified.** This will allow more children to benefit from zero-rating and reduce the costs to business of administering the relief.

Excise duties

Alcohol

5.102 Britain's several hundred small breweries make a valuable contribution to employment and community life. **To support this industry, the Government is minded to introduce a reduced rate of duty on the beer produced by small breweries,** and will be considering the scope for doing so in the coming year. In addition, **the Government has once again decided to freeze the duty rate on spirits** in order to strengthen both the international competitiveness and domestic base of the UK spirits industry. **Duty on beer, wine and other alcoholic drinks will also be frozen.**

Tobacco

5.103 Smoking is the single greatest cause of preventable illness and premature death in the UK, killing 120,000 people every year. The duty on cigarettes has so far risen by 30 per cent in real terms since May 1997, encouraging existing smokers to smoke less or quit and discouraging children and young people from taking up the habit, thereby helping to prevent many more premature deaths. Maintaining the real price of cigarettes and tobacco supports these vital health objectives. **Tobacco duty will therefore be increased in line with inflation from Budget day.** The Government will also continue to crack down on the supply of cheap smuggled tobacco.

Tobacco smuggling

5.104 It is widely recognised that tobacco smuggling not only undermines the Government's health objectives, but brings with it widespread and serious criminality. In March 2000, the Government announced its *Tackling Tobacco Smuggling* strategy, which is designed first to slow the growth in tobacco smuggling, which has been on a strong upward trend, and then to put it into decline within three years. The strategy provided £209 million for investment in 1,000 extra staff and new equipment such as X-ray scanners.

5.105 This strategy is at an early stage but is beginning to show results. In the first nine months of 2000-01, Customs seized more than 2.1 billion cigarettes destined for the UK market: 1.4 billion in the UK itself and 700 million through joint operations with overseas enforcement agencies. Customs investigators have also broken up 38 major organised crime gangs involved in the smuggling and supply of huge volumes of illicit cigarettes.

5.106 As announced in Budget 2000, "UK duty paid" marks are being introduced on packets of cigarettes and hand-rolling tobacco to help in the identification of smuggled goods. **From 1 July 2001, it will be a criminal offence to transport, sell, offer for sale or allow the use of premises for the sale of unmarked cigarettes and hand-rolling tobacco.** This will deter individuals and retailers from selling unmarked goods, and encourage owners of pubs and managers of workplaces to prevent sales taking place on their premises.

5.107 Smuggling is provisionally estimated to have accounted for 22 per cent of the UK cigarette market in 2000, close to Customs' target of 21 per cent. The strategy is in its first year, and as more front-line staff are put in place, new X-ray scanners come on line, and pack marks are introduced, Customs will be able to take even more effective action against the criminals involved in tobacco smuggling.

Betting

Moving to a gross profits tax

5.108 In March 2000, the Government launched a consultation exercise on the scope for modernising general betting duty. In considering its response to that consultation, the Government's objective has been to deliver a business environment in which the British betting industry can compete in both the domestic and international markets, taking full advantage of the opportunities offered by the development of e-commerce, while ensuring that the future revenue stream from betting is protected.

5.109 To deliver this objective, general betting duty will be replaced with a gross profits tax by 1 January 2002 thereby abolishing all tax on punters. Under the new system, the current duty of 6.75 per cent on total stakes will be replaced with a 15 per cent tax on bookmakers' gross profits, defined as the difference between the stakes laid with them and the winnings they pay out.

5.110 This reformed structure makes it possible for bookmakers to absorb the tax and to end the 9 per cent "deduction" that they currently charge on stakes. It therefore makes it possible for bookmakers to develop their domestic and international business from an onshore base, competing from a position of strength in the growing global market for telephone and internet betting.

5.111 As a result of the changes announced in Budget 2001, the largest UK bookmakers have said that they will relocate their offshore operations to the UK. They expect to take advantage of the new duty system, the UK's reputation as a centre of bookmaking integrity and expertise, and the skilled staff and IT infrastructure that is available from a UK base to grow their e-commerce businesses, bringing international business and increased employment opportunities to the UK. The extra domestic and international betting turnover the reform will generate should enable both the betting and racing industries to prosper. Government revenues will share in the gain from increased turnover in the medium term.

Tackling tax avoidance

5.112 Budget 2001 announces further measures to tackle tax avoidance and close loopholes. These are detailed in Chapter A of the Financial Statement and Budget Report.

[1] *Opportunity for All*, Second Annual Report 2000, Department of Social Security (Cm4865).

[2] Inland Revenue analysis of the NOP Financial Research Survey for 1999-2000.

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6
Protecting the Environment

The Government is committed to improving the quality of life for everyone by ensuring that growth occurs in a sustainable way, balancing economic, social and environmental considerations. The Pre-Budget Report set out the challenges the Government faces in tackling climate change and improving air quality, regenerating Britain's towns and cities and protecting the countryside. Budget 2001 implements and delivers further reforms in environmental policy to build on the achievements to date.

To help tackle climate change and improve air quality:

- **introducing the climate change levy package from 1 April 2001;**
- **an emissions trading scheme;**
- **Green Fuel Challenge to promote cleaner fuels;**
- **a new Green Technology Challenge to further promote cleaner technologies;**
- **tax incentives for businesses to promote greener modes of travel; and**
- **fuel duty differentials to promote use of cleaner and alternative fuels.**

To help regenerate Britain's towns and cities:

- **a stamp duty exemption for all property transactions in Britain's most disadvantaged areas;**
- **a cut in VAT to 5 per cent to encourage renovation and conversion of existing property;**
- **100 per cent capital allowances for creating flats over shops; and**
- **150 per cent accelerated tax credits to help clean-up contaminated land.**

To help protect Britain's countryside:

- **the introduction of the aggregates levy and the associated Sustainability Fund from April 2002;**
- **acceptance of voluntary proposals from industry to reduce the environmental impact of pesticides use; and**
- **a pre-announced annual increase in landfill tax to £12 per tonne, and plans to consult on future reform of the landfill tax credit scheme while challenging industry to allocate more tax credits towards sustainable waste management.**

THE IMPORTANCE OF PROTECTING THE ENVIRONMENT

6.1 The Government is committed to sustainable development. Economic and social progress should be achieved while protecting and, where possible, enhancing the environment. Society needs to make more productive use of existing natural resources by engaging in more environmentally friendly practices and investing and developing new and renewable technologies. This will help to achieve a better quality of life today and for generations to come.

6.2 The quality of the environment affects everyone's quality of life, directly through – for example – the air and water they consume, and also through longer-term influences such as climate change.

Climate change

6.3 Global temperatures are rising. The 1990s are likely to have been the warmest decade of the past 1,000 years. A recent report from the Intergovernmental Panel on Climate Change (IPCC) has suggested that, during the 21st century, global temperatures could rise by as much as 5.8 degrees Celsius. This is almost double the IPCC's 1995 estimate. Climate change will affect the world in upredictable and potentially extreme ways.

6.4 Emerging evidence suggests that severe weather events are becoming more frequent and that the situation is likely to get worse. Increases in temperature, drought, flooding and rising sea levels will affect people's health and way of life and will, in particular, threaten coastal communities. The floods experienced in recent months have highlighted how vulnerable Britain is to severe weather events.

Air quality

6.5 Poor air quality poses risks to human health, quality of life and the natural environment. But air quality in the UK is improving. The underlying downward trend in the number of days of poor air quality in urban areas continued in 2000 with, on average, 17 days of moderate or worse air pollution, the lowest figure since the series began in 1993. Rural areas suffered moderate or worse air pollution for 25 days on average, compared with 48 days in 1999. Pollution in rural areas is mainly caused by ozone, which varies with weather conditions and pollutants blown from mainland Europe. But although the overall picture is improving, more still needs to be done. Short-term air pollution episodes are associated with 12,000 to 24,000 premature deaths and 14,000 to 24,000 hospital admissions and re-admissions for respiratory and cardiovascular problems each year. Emerging evidence suggests that the health effects of exposure to long-term pollution are significantly greater.

Pressures on the environment in towns and cities

6.6 The Government wants to tackle the urban decline experienced in many towns and cities. In England, alone:

- 58,000 hectares of brownfield land are either vacant, derelict or available for redevelopment – and this amount is growing;
- over 750,000 homes are empty – with approximately a third being vacant for at least a year;
- 1.3 million properties in urban areas are unfit for human habitation; and
- there is a substantial amount of empty or under-used commercial property with potential for conversion to mixed uses, including housing.

6.7 Failure to make the most of land and buildings in urban areas affects the quality of the environment and continues to create pressure for greenfield development. There were some 20 million households in England in 1996. This is projected to grow by 3.8 million by 2021. This challenge is further exacerbated by the growing problem of low demand for housing in particular areas. Yet recent research by Heriot-Watt University[1] estimated that around 47,000 homes in the social rented sector and 375,000 homes in the private rented sector are in low-demand or unpopular neighbourhoods. Making the most of these resources and improving the quality of the urban environment will help to reduce the exodus of population from some towns and cities.

Pressures on the rural environment

6.8 The demands of an increasingly affluent population for new housing and infrastructure have inevitably put pressure on the rural environment. Recent changes in Government policy – particularly in respect of planning guidance and the Government's target of 60 per cent of additional housing to be built on previously developed land – are succeeding in refocusing the priorities of the developer and increasing the re-use of land.

6.9 Industry and commerce in England and Wales alone produce around 80 million tonnes of waste each year. Households produce a further 28 million tonnes. Disposing of this waste, particularly through heavy reliance on landfill, places further pressure on scarce land in the countryside. The decomposition of biodegradable waste also releases methane, a powerful greenhouse gas.

6.10 The extraction of aggregates, the vast majority of which takes place in quarries in the countryside damages biodiversity, causes noise and creates dust and visual intrusion.

6.11 Modern agricultural methods including the use of pesticides are associated with significant negative environmental impacts on biodiversity and water quality. For example, the number of farmland birds declined by 36 per cent between 1970 and 1998 and the number of wildlife species has also been declining, particularly since the 1970s.

THE GOVERNMENT'S STRATEGY

6.12 The Government has put in place a clear strategic framework for tackling these threats to the environment and the quality of life. This strategy rests on four main pillars:

- identifying problems and risks;
- setting objectives and targets where appropriate;
- appraising, selecting, consulting and implementing the most appropriate set of policy instruments (such as taxes, charges, permit trading, regulation, public spending or voluntary agreements) for the circumstances; and
- evaluating the success of policies, modifying them where appropriate and applying experience from one area of policy to another.

6.13 The Pre-Budget Report set out this strategy in more detail. Tables 6.1 and 6.2 at the end of this chapter list the measures which have or are being put in place by the Government to meet each of its key environmental objectives and assess their environmental impacts. Budget 2001 represents the next step in implementing this strategy.

6.14 The Government's strategic framework for delivering its environmental objectives is set out under the following themes:

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

TACKLING CLIMATE CHANGE AND IMPROVING AIR QUALITY

Climate change targets

6.15 The UK climate change programme[2] contains a package of policies and measures to reduce greenhouse gas emissions across all sectors of the economy. Together these measures will cut the UK's greenhouse gas emissions by 23 per cent below 1990 levels by 2010, comfortably beyond the UK's legally binding Kyoto target of 12.5 per cent reductions. On the same basis carbon dioxide emissions will fall to 19 per cent below 1990 levels by 2010, representing significant progress towards the more demanding domestic goal of 20 per cent reduction set by the Government. Box 6.1 illustrates the UK's emissions projections and targets.

Box 6.1: Emission projections and targets

The charts below shows the projected effect in 2010 of all the quantifiable measures set out in the UK climate change programme. These estimates exclude other non-quantifiable measures, such as public awareness campaigns, that will reduce emissions further so that the UK's carbon dioxide emissions should reach 20 per cent below 1990 levels by 2010.

Chart 6.1: Projections of UK greenhouse gas emissions

Chart 6.1b: Projections of UK carbon dioxide emissions

[1] *The six greenhouse gases are carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, and sulphur hexafluoride.*
[2] *Includes the effects of the renewables obligation, the climate change levy (including the exemptions for CHP and renewable energy), and the fuel duty escalator.*
[3] *Assumes that emissions would reduce linearly between 2000 and 2010. Includes the predicted effect in 2010 of all the quantifiable measures set out in the UK climate change programme.*

6.16 The Government recognises that far greater cuts in greenhouse gas emissions will be needed globally to avoid dangerous climate change. It believes that longer-term targets should be set internationally, recognising that climate change is a global problem requiring global solutions, but the climate change programme also begins to put in place policies that will be needed over this longer period.

Air quality targets

6.17 The Air Quality Strategy for England, Scotland, Wales and Northern Ireland published last year set health-based air quality objectives for eight key air pollutants – benzene, 1,3-butadiene, carbon monoxide, lead, nitrogen dioxide, ozone, particles and sulphur dioxide to be achieved between 2003 and 2008. The Government is currently reviewing the objective for particles with the intention of consulting on proposals for a new, more stringent objective at the end of June 2001. This will take full account of the emerging evidence which suggests that long-term exposure to particle air pollution can have a significant effect on health. At the same time the Government intends to consult on proposals for a new objective for polyaromatic hydrocarbons.

6.18 All sectors of the economy need to a play a part in tackling climate change and air quality. The Government has put in place a range of policies to generate improvements across the UK. These include policies relating to business, households and transport.

Business

Climate change levy

6.19 The climate change levy (CCL) is designed to encourage the non-domestic sector to become more energy-efficient and so reduce carbon emissions. The levy and its associated measures have a key role in the UK climate change programme, making significant contributions to the targets set under both the Kyoto Protocol and the targets set for the UK by the Government. The levy package as a whole is expected to save at least 5 million tonnes of carbon (MtC) a year by 2010.

6.20 The climate change levy will come into effect on 1 April 2001 and will apply to non-domestic use of energy. All revenues will be recycled back to business through a 0.3 percentage point cut in employers' national insurance contributions and additional support for energy-efficiency measures and energy-saving technologies. The products subject to the levy are electricity, gas, liquified petroleum gas (LPG) and solid fuels, at the following rates:

Electricity	0.43 pence per kWh
Gas	0.15 pence per kWh
LPG	0.96 pence per kg (equivalent to 0.07 pence per kWh)
Solid fuels	1.17 pence per kg (equivalent to 0.15 pence per kWh)

6.21 To avoid increasing fuel poverty and to encourage a more sustainable transport system the levy will not apply to energy used by the domestic sector and public transport. There will also be an exemption from the levy for energy generated from 'new' forms of renewable sources such as wind and solar power, and electricity produced in 'good quality' combined heat and power (CHP) plants.

The negotiated agreements

6.22 To protect the competitiveness of UK industry, the Government has recognised the need for special consideration of energy-intensive industries exposed to international competition. An 80 per cent discount on the rate of the levy is available to energy-intensive sectors that agree challenging targets with Government to increase energy-efficiency and reduce emissions.

6.23 Targets have now been agreed with 44 sectors eligible for CCL negotiated agreements. These challenging targets will deliver reductions in emissions of at least 2.5 MtC a year by 2010 – equivalent to about 50 per cent of all emissions reductions resulting from the levy package. Sector level agreements have been signed with 29 sectors including steel, chemicals, paper and cement, and are rapidly being concluded with the others. Applications from over 7,000 prospective participant companies or sites have already been received and these are being processed so that applicants will benefit from the lower rates when the levy is introduced.

Improving energy efficiency

6.24 Independent research[3] shows that an average business can save 15 to 20 per cent of its energy costs through greater energy-efficiency. The Government has put in place an integrated package of measures to help businesses use energy more effectively – so reducing their liability for CCL and protecting the environment. These measures include providing energy-efficiency advice and encouraging investment in energy-saving technologies described below.

6.25 The Carbon Trust will come into operation on 1 April 2001 and will be headed by Ian McAllister, Chairman of Ford UK. Initially the Trust will concentrate on short-term measures in support of saving energy, including providing energy-efficiency advice to business. However the remit of the Trust is wide ranging and also looks longer-term towards helping the UK move to a low carbon economy. Over three years, £100 million of the CCL revenues will be directed to the Carbon Trust, in addition to funding for the Energy Efficiency Best Practice Programme.

Investment in energy-saving technologies

6.26 The Government is directly helping business to reduce energy by providing **100 per cent first year capital allowances for investments in designated energy-saving technologies.** Eight technology categories are eligible: motors; refrigeration; lighting; boilers and add-ons; variable speed drives; thermal screens; pipe insulation; and good quality CHP. Investments will qualify from publication of the Energy Technology List. Details of the scheme and the full list of eligible products and technologies will be published by 1 April 2001.[4] The list will be revisited annually to enable further technologies to be added if they are proven to provide cost effective improvements and satisfactory methods of certification. The Carbon Trust will work with interested parties to advise Government to ensure that the list reflects the most effective products and technologies.

6.27 Businesses that invest in these low carbon technologies will obtain significant cash flow benefits because they will receive tax relief for their investment much earlier than would otherwise be the case. The exact cost of the scheme will depend on take-up but is estimated at around £70m in 2001–02, rising to £130 million in 2002–03. The enhanced capital allowances will encourage business to invest in energy-saving technologies which can help reduce their energy costs, reduce their CCL payments, and benefit the environment.

Renewable energy

6.28 The Government has set an ambitious target for 10 per cent of the UK's electricity to be supplied from renewable sources by 2010, subject to the costs to consumers being acceptable. This is a significant challenge. By the end of 1999, renewable energy sources represented only 2.8 per cent of the total electricity generated in the UK. The 10 per cent target represents sales of around £1 billion a year, requiring investment of £3 billion or more in electricity generation.

6.29 The CCL exemptions for new forms of renewable electricity will provide extra encouragement to generators of renewable energy. This is additional to the capital grant funding of some £100 million over the next three years arising from the 2000 Spending Review and support from the New Opportunities Fund, as well as the Renewables Obligation currently being finalised by the Department of Trade and Industry, which will require electricity suppliers to secure a specified proportion of electricity from renewable generators. To further develop this market the Government has also announced **a new £100 million fund that will be used to promote environmental technologies, including additional support for renewables, such as off-shore wind, energy crops and solar power.**

Green Technology Challenge

6.30 The Government recognises that many environmental improvements by business require investment, and it has introduced enhanced first-year capital allowances (as described above) to encourage investment in certain energy-saving technologies and products. It believes that there is a case for extending the availability of such allowances to achieving certain other environmental objectives and other technologies. These proposals will need to represent good value-for-money, be properly targeted on achieving appropriate objectives, and be designed in such a way as to continue to encourage investment in the best available technologies. **The Government therefore proposes to consult, during the summer, on setting up a Green Technology Challenge (GTC), with the intention of offering enhanced first-year capital allowances for further environmental objectives and new technologies.** The GTC will also be designed to complement the steps being taken as a result of the Green Fuels Challenge, described below.

Emissions trading

6.31 The Government sees a key role for emissions trading as part of the long-term solution to reducing greenhouse gas emissions and is committed to developing a successful emissions trading scheme. The Government believes that an early start will secure important advantages to business, the financial services sector, and to Government. Entry to the trading scheme will be open to any entity responsible for emissions in the UK. In addition, companies in CCL negotiated agreements will be able to use emissions trading as a way of reducing the costs of meeting their negotiated agreement targets.

6.32 The Government welcomes the considerable effort of businesses involved in the Emissions Trading Group (ETG), and respondents to the consultation document on the rules of the scheme which was published alongside the Pre-Budget Report.[5] The responses to the consultation are currently being considered. The Government will shortly set out rules for the scheme, which will see companies adopting binding emissions targets from next year. The Government will continue working with the ETG over the coming months to ensure that the progress so far is translated into a successful operating scheme that can be launched in spring 2001.

6.33 In order to encourage as wide a particpation in the scheme as possible and, to maximise the environmental benefits, the 2000 Spending Review announced that £30 million would be available in 2003–04 to provide a financial incentive for firms to join. The Government will ensure that this incentive is worth the equivalent of £30 million after corporation tax.

Households

6.34 Encouraging greater energy-efficiency in the home is key to reducing fuel poverty and carbon emissions. The Government's draft Fuel Poverty Strategy published on 23 February 2001 sets out the role of improving energy-efficiency in ending fuel poverty and reducing carbon emissions. A number of measures have been introduced to ensure that households play their part in meeting the UK's emission targets while protecting the most vulnerable in society.

VAT on energy–saving materials

6.35 Budget 2000 reduced the rate of VAT from 17.5 per cent to 5 per cent on the installation of specific energy-saving materials (insulation, draught stripping, hot water and central heating system controls and solar panels). It also introduced a 5 per cent reduced rate of VAT for the grant-funded installation of new central heating systems and their maintenance and repair, and heating appliances (for example, electric storage heaters and gas fired boilers) in the homes of the less well off. For programmes such as the Home Energy Efficiency Scheme (HEES) in England, which provides central heating systems for low-income, older and other vulnerable householders at risk of ill-health from cold homes it is estimated to have benefited some 20,000 households.

Capital allowances for Affordable Warmth

6.36 To underpin the Government's Affordable Warmth Programme (AWP) Budget 2000 introduced capital allowances to support the installation of leased heating systems for homes occupied by people on low incomes. The AWP will facilitate the introduction of new, energy efficient central heating systems in up to 1 million homes by 2005. Households will benefit from warmer homes, more efficient heating and lower fuel bills, and will contribute towards reducing greenhouse gas emissions.

Transport

6.37 Increased economic activity and growing incomes have generated higher demand for personal travel and the transportation of goods. Between 1968 and 1998, passenger and freight travel almost doubled. A safe, clean, convenient and efficient transport system is crucial to sustaining economic growth and promoting social inclusion, while safeguarding the environment. Box 6.2 identifies the programmes that the Government has put in place to tackle the problems of congestion, pollution, and social exclusion caused by excessive use of transport. The Government has introduced a number of measures, and is taking further steps in Budget 2001 to ensure that all sectors of the economy, including motorists, companies and hauliers play their part in delivering such a sustainable transport system.

Box 6.2: Sustainable Transport

The Government's Ten Year Plan for Transport is a long-term investment plan to modernise the transport system, tackle congestion, pollution and social exclusion. It is estimated to reduce emissions by 1.6 MtC by 2010. All modes of transport will benefit from an estimated £180 billion of public and private funding over the next 10 years – a 75 per cent increase in real terms on the previous 10 years.

Public transport:

- **providing investment to support a 50 per cent expansion in rail passengers and 80 per cent in rail freight, and existing rail franchises will be re-let by the Strategic Rail Authority to facilitate public and private investment in 6,000 new carriages and trains, plus modernising and upgrading the rail network;**
- **a step change in provision for Local Transport Plans, providing funding for new light rail lines, improved bus services, up to 100 new park and ride services, and a new urban bus challenge fund; and**
- **a further £30 million a year for the Rural Bus Subsidy Grant to support services into market towns and extending the Rural Bus Challenge supporting a wide range of flexible community transport projects tailored to the needs of local people.**

Road network:

- **targeted increases in the capacity of the strategic road network with better network management to reduce delays and improve reliability, with sufficient funding for 30 bypasses and widening some 5 per cent of the network; and**
- **around 200 major local road improvements, including over 70 bypasses, as part of local transport plans, for safer and cleaner town centres.**

Cleaner technologies:

- **by 2003–04 more than doubling annual spending on cleaner vehicle initiatives. Two such initiatives are Clean Up – a programme to tackle urban pollution from urban vehicles to help meet local air quality objectives – and Power Shift – to support the introduction of cleaner road transport fuels such as gas and electricity. Additional support will also be given to encourage the early introduction of technologies such as fuel cell and hybrid vehicles.**

Motorists

6.38 Motorists can contribute to protecting the environment by using cleaner fuels, cleaner technologies and more efficient cars. Measures announced in Budget 2001 will reduce the tax on motorists by an equivalent of 4 pence per litre on petrol duty while also helping to improve local air quality.

Fuel duties

6.39 Fuel duties have played an important role in helping the UK meet its Kyoto target for reductions in greenhouse gas emissions. Taking this and the introduction of other measures for addressing climate change into account, along with recent oil prices, as announced in the Pre-Budget Report **Budget 2001 freezes duties on petrol, diesel, other road fuels and non-road fuel oils (such as red diesel) in cash terms.** This reduces duty in real terms by around 1 pence per litre.

Box 6.3: oil prices

Increases in oil prices in recent months have enabled the Government to introduce carefully targeted reductions in fuel duty while continuing to work towards protecting the environment, consistent with economic and social objectives.

Chart: Brent spot oil price

Ultra-low sulphur fuels

6.40 Duty differentials play an important role in encouraging the rapid use of more environmentally friendly fuels and have stimulated the development of new technology to reduce pollution.

ULSP

6.41 Ultra-low sulphur petrol (ULSP) offers environmental benefits over ordinary unleaded petrol when used in modern cars fitted with three-way catalytic converters. Research suggests that it can lead to a reduction in emissions of nitrogen oxides of up to 6 per cent, carbon monoxide of around 11 per cent and hydrocarbon emissions of up to 14 per cent. Further reductions are expected from new petrol cars meeting Euro III/IV standards, using the latest catalyst converter technology. ULSP also enables the use of new, fuel-efficient technologies such as Gasoline Direct Injection (GDI) which can deliver substantial CO_2 savings.

6.42 Budget 2000 announced a duty differential of 1 pence per litre in favour of ULSP relative to unleaded petrol. This came into effect on 1 October 2000. The Pre-Budget Report proposed that the duty rate on ULSP would be cut further subject to oil companies making this cleaner fuel widely available across the UK. The Government is satisfied that this condition has been met by the major petrol retailers and that it will be met by independent retailers shortly. ULSP is expected to account for 100 per cent of the UK petrol market by June 2001 enabling the UK to meet the mandatory EU 2005 petrol specification four years ahead of schedule. **Budget 2001 therefore cuts duty on ULSP by 2 pence per litre.**

Unleaded petrol

6.43 The Government has recognised that the final stages of transition to ULSP have the potential to create competitive distortions in the market. Although the oil companies will have converted their retail sites to ULSP by the end of March, some smaller retailers will need more time. During this transitional period, those retailers with stocks of ULSP would be able to sell petrol 2 pence per litre cheaper than retailers who, for sound logistical reasons, have not yet been able to secure regular supplies of this cleaner fuel. To enable the introduction of ULSP to proceed as smoothly as possible and to ensure that motorists across the country can benefit, **Budget 2001 introduces a temporary 2 pence per litre duty cut on ordinary unleaded to take effect from Budget Day until 14 June 2001.**

ULSD

6.44 Ultra-low sulphur diesel (ULSD) now accounts for all diesel consumed by road vehicles in the UK following the successful introduction of a fuel duty incentive from 1997.[6] This enabled the UK to meet the EU mandatory 2005 diesel specification more than five years ahead of schedule.

6.45ULSD provides particulate emission savings from existing diesel vehicles and allows the use of advanced emission-abatement technology such as particulate traps, which reduce emissions by up to 90 per cent. As proposed in the Pre-Budget Report, in parallel with the cut in duty on ULSP of 2 pence per litre, **Budget 2001 cuts duty on ULSD by 3 pence per litre** to maintain the existing balance between duty rates on the main forms of petrol and diesel.

Lead replacement petrol

6.46 Lead replacement petrol (LRP), a form of higher octane unleaded, was introduced to replace leaded petrol for those older cars unable to run on unleaded. An environmental assessment carried out following the Pre-Budget Report shows that higher octane unleaded petrol, including LRP, does not cause significant environmental concerns over and above the use of ordinary unleaded. **Budget 2001 therefore abolishes the higher duty rate for higher octane unleaded petrol.** Duty on this petrol will now only be charged on the basis of the sulphur and aromatics content of the fuel. This will also provide an incentive to reduce sulphur levels in higher octane fuels.

Green Fuel Challenge

6.47 Looking ahead, the Government is also keen to stimulate interest in developing and producing profitable alternative fuels which offer environmental benefits over current conventional fuels. In the Pre-Budget Report the Government therefore launched a 'Green Fuels Challenge' (GFC) inviting industry to come up with practical proposals for such fuels, the most promising of which would be considered for duty reductions in Budget 2001.

6.4864 proposals were put forward in response to this GFC covering a range of potential alternatives. As a result, Budget 2001 introduces a series of duty cuts for alternative fuels for the short, medium and longer-term.

Bio-diesel and road fuel gases

6.49 For the immediate future and the short to medium-term, the Government will make reductions in duty on bio-diesel and road fuel gases - compressed natural gas (CNG) and liquefied petroleum gas (LPG):

- Budget 2001 **announces a new duty rate for bio-diesel set at 20 pence per litre below the ULSD rate to be introduced in Budget 2002.** This will offset the additional production costs of bio-diesel and permit the UK to benefit from the reduced greenhouse gas emissions that this fuel can offer. Bio-diesel sourced from waste vegetable oils will also provide a useful outlet for oils which may otherwise be poured away into landfill sites or disposed of down the drain; and
- the cut by 29 per cent in duty on road fuel gases in Budget 99, followed by a duty freeze in Budget 2000, has encouraged individuals and companies to convert to these less environmentally damaging fuels. Car manufacturers and fuel suppliers have responded favourably to this demand. In order to maintain the existing duty differential between road fuel gases and the most commonly available petrol and diesel, **Budget 2001 cuts duty on road fuel gases to 9 pence per kilogramme.** Furthermore, to provide the stability needed to encourage growth in the road fuel gas market, **duty on road fuel gases will not be increased in real terms until 2004 at the earliest**.

Pilot projects for alternative fuels

6.50 Other proposals made under the GFC offer potential for the medium to long-term but still require considerable research and development. To stimulate further work in the field of alternative fuels, **Budget 2001 introduces enabling legislation to allow for the introduction of duty reductions or exemptions for pilot projects.** Pilot projects for hydrogen, bio-ethanol, methanol and biogas are expected to be introduced during the course of 2001.

6.51 Overall this approach towards green fuels provides for environmental benefits in the short term from LPG, CNG and bio-diesel, looks to new fuels for the medium-term with bio-ethanol and biogas, and paves the way for the future with the fuel-cell favourites of methanol and, most significantly, hydrogen. This demonstrates the Government's ongoing commitment to delivering both air quality and climate change benefits through increased use of more environmentally friendly alternative fuels in the UK and supports the UK's early steps towards a hydrogen-based fuel economy. The Government also proposes to consult on how to encourage the development, delivery and take-up of new alternative green fuels and techology.

6.52 Following the success of the GFC, and intended partly to complement the steps being taken as a result, the Government will be consulting during the summer on launching a Green Technology Challenge, to consider the possible environmental objectives and technologies to be encouraged through enhanced first-year capital allowances (described above).

VED for cars

6.53 Budget 2000 announced a major reform to vehicle excise duty (VED) for new cars. **The introduction of a four-banded graduated VED system for all new cars purchased from March 2001** means that the rate of VED new cars now pay is linked to carbon emission levels and the type of fuel used. The least polluting vehicles will pay up to £70 a year less under this system. This will encourage the purchase of cars with better fuel efficiency and lower carbon emissions, and cars using fuels and technology which are better for local air quality.

6.54 Budget 99 introduced a reduced rate of VED for cars with engines up to 1,100cc, benefiting 1.8 million car owners. In Budget 2000, the threshold of the lower rate of VED for existing cars was increased from 1,100cc to 1,200cc, resulting in a lower VED rate for some 2.2 million smaller cars. Owners of qualifying vehicles are currently being contacted by the Driver and Vehicle Licensing Agency and will receive a rebate in respect of their existing licences, backdated to March 2000.

6.55 The Pre-Budget Report proposed extending the small car rate further to 1,500cc, subject to consultation with motoring organisations. **Budget 2001 cuts VED by £55 for cars with engine size between 1,200cc and 1549cc,** backdated to 1 November 2000, providing benefit to a further 5 million car owners. This new rate will come into force on 1 July 2001, and rebates will be paid to owners of qualifying vehicles in that month. Together with measures announced in Budget 99 and Budget 2000, this will mean that around a third of existing cars in total will qualify for the lower rate of VED for smaller engine cars.

6.56 Budget 2001 goes further to shift tax away from ownership. **The Government has also decided to freeze all car VED rates until Budget 2002, which is equivalent to a cut in real terms of up to £5.** In addition, **VED on motorbikes will also be frozen in cash terms.**

Companies

6.57 Of the estimated 375 billion miles of car travel in the UK each year, some 16 per cent are driven for business use. The type of car chosen by a company for their employees also has an effect on the private car purchase, both through the second-hand car market and the pressure that fleet-purchasers can exert on manufacturers.

Company car tax

6.58 Budget 2000 announced a major reform of company car taxation: **from April 2002, the income tax charge on a company car will be based on a percentage of the car's list price graduated according to the level of the car's CO_2 emissions** measured in grams per kilometre (g/km). The charge will build up from 15 per cent of the car's price to a maximum of 35 per cent – in 1 per cent steps for every 5g/km CO_2 above a specified level. Diesel cars will pay a supplement of 3 per cent of the car's price compared to petrol cars (up to a maximum of 35 per cent) to take account of their higher emission of particulates and pollutants which have adverse impacts on local air quality.

6.59 The Government has published draft regulations on the Inland Revenue website[7] to waive this diesel supplement for clean diesel cars achieving Euro IV emission standards to encourage their early introduction. The regulations also introduce discounts for cars powered by electricity or gas, and hybrid petrol/electric cars which can reduce the car benefit tax below the normal minimum of 15 per cent of the car's price, providing further incentives to choose more environmentally friendly company cars.

6.60 This comprehensive change to the company car tax system is estimated to save around 0.5 to 1.0 MtC per year by 2011–12. It is regarded as crucial in shaping the future car fleet of the UK given that over 50 per cent of new cars are bought by companies.

Authorised mileage rates

6.61 To complement these reforms to company car taxation, the Government is restructuring the system of authorised mileage rates through a two-stage reform. As announced in the Pre-Budget Report, **to provide an early incentive to use cleaner cars for business trips, from April 2001 drivers of small cars will benefit from an increase in the current two lower engine size bands to 40 pence for the first 4,000 miles and 25 pence for further miles. The rates for the two higher bands will be frozen.**

6.62 For the second stage of the reform, **the Government will be introducing a new statutory system of mileage rates from April 2002.** They will provide a greater incentive to drive cleaner vehicles for business trips by offering a single tax and NICs free rate of 40 pence per mile for the first 10,000 business miles per year for all sizes of car; and a lower rate of 25 pence per mile for any additional business miles above the first 10,000 miles.

Fuel scale charge

6.63 The forthcoming tax year will be the fourth of a five year programme of annual increases announced in Budget 98 to discourage giving or receiving free fuel for private use in a company car.

Green travel

6.64 The Pre-Budget Report announced the introduction in Budget 2001 of a series of measures to promote environmentally friendly travel:

- **removing VAT from the purchase of adult cycle helmets with effect from 1 April 2001** to improve road safety and encourage cycle use;
- **increasing the income tax and NICs free mileage rate employers can pay for cycle use for business trips to 20 pence per mile from April 2002;**
- as part of the reform of authorised mileage rates **introducing a new passenger rate of 2 pence per mile per passenger to encourage car-sharing on business trips from April 2002;** and
- **lowering the threshold for works buses qualifying for tax exemptions from 12 to 9 passenger seats from April 2002** to assist and encourage employers in smaller companies to set up Travel Plans to help their employees to travel to work without using their cars.

6.65 Budget 2001 goes further, by:

- **adjusting the zero rate of VAT on passenger transport to cover smaller vehicles with 9 or more passenger seats from 1 April 2000,** increasing the range of alternative transport options, especially in rural and remote areas;
- following consultation, **increasing the passenger rate employers can pay, tax and NICs free, to 5 pence per mile per passenger;** and
- **allowing employers to provide other benefits-in-kind associated with green commuting.**

6.66 The Government will consult on whether the tax treatment of employer subsidised contract buses should be aligned with that for employer provided works buses, in allowing employees free or reduced cost travel to work. It will also work with taxi companies, local authorities and other bodies to explore ways of encouraging less-polluting taxis in our major cities.

Haulage industry

6.67 Efficient freight transport plays a key role in a successful sustainable economy. UK industry – from agriculture to high technology – relies on having efficient transport for raw materials, manufactured components and final products. Freight transport itself needs to be environmentally sustainable. In recent years, the Government has created incentives for the haulage industry to switch to less environmentally damaging ULSD and to fit low-emissions technology. The Government's Ten Year Plan for Transport will also increase the efficiency of freight transport and reduce its environmental impacts. However, the Government has decided to go further in helping the haulage industry become more internationally competitive and less environmentally damaging. Taken together, the measures announced in Budget 2001 should reduce costs for British business in ways which help the environment.

VED for lorries

6.68 In the Pre-Budget Report, the Government announced its intention to build on previous changes to lorry VED by engaging in comprehensive reform. As a first step, the Government announced that hauliers would receive a rebate of up to 50 per cent of their VED payments for licences in force on 30 November 2000. By mid-February, over £200 million had been paid out to nearly 110,000 hauliers. The transitional arrangements announced in the Pre-Budget Report remain in place with lorry VED rates reduced by up to 50 per cent from 1 December 2000.

6.69 The Pre-Budget Report launched a consultation exercise on plans for a comprehensive reform of lorry VED, to reflect better the environmental and track costs of different lorries. The Government's proposals have been warmly welcomed by the industry. In light of the consultation **Budget 2001 introduces a new system of lorry VED which will come into effect from 1 December 2001.** The new lorry VED rates are shown in Chapter A of the FSBR. These rates will reduce the total burden that lorry VED imposes on the haulage industry and at the same time improve the environmental signals that hauliers face to use lorries which cause less road damage and pollution. As a result of these reforms, UK lorry VED rates will be amongst the lowest in Europe for the cleanest and least-damaging lorries.

6.70 However, the Government wants to go further in improving the environmental signals from the VED system. Euro emission standards are a much better criterion for judging the cleanliness of lorries than the current Reduced Pollution Scheme. **The Government therefore plans to offer reduced VED rates for lorries meeting the new Euro IV standard from around 2004.** Before then, the Government will review the future of the current reduced pollution scheme in delivering further environmental benefits.

6.71 The Government will also review the current payment methods for lorry VED, aimed at making payment of lorry VED easier for small haulage firms especially.

6.72 The Government will also continue to work towards the proposal, as set out in the Pre-Budget Report, of introducing some form of road-user charge for lorries, such as a 'vignette', to ensure that all users of UK roads contribute towards the cost of the damage that they impose in the UK.

Haulage Modernisation Fund

6.73 The **Pre-Budget Report announced a new three-year £100 million Haulage Modernisation Fund (HMF) across the UK.** The Government has been in discussions with the Road Haulage Forum on how to spend this fund most effectively. As a result, the Government will, as a first step, make available in England, up to:

- £30 million for targeted support for retrofitting older lorries operating in areas of poor air quality such as Air Quality Management Zones, where nitrogen oxide and particulate emissions are most damaging. This will also enable hauliers to qualify for up to £500 lower VED rates;
- £15 million for fuel efficiency advice for hauliers, which should deliver savings of around 5 to 10 per cent in carbon emissions and similar reductions in the typical haulier's fuel bill;
- £5m for training initiatives for new drivers to help the industry meet new skills and manpower requirements;
- £3 million for increasing Government enforcement of haulage industry regulations across the UK, at the industry's request; and
- £2 million for various supporting measures, including funding a pilot scheme for the industry's proposal to take responsibility for raising standards and improving business performance.

6.74 These measures build on the DETR's Clean Up programme to accelerate the take-up of new and cleaner technologies, which is already set to benefit from a doubling of resources to £30 million over the next three years. The HMF is expected to save at least 0.1 MtC a year. The remaining third of the HMF in England will be allocated at a later date when both the Government and the industry will have a clearer view of future requirements.

VED for tractors

6.75 The Government announced in the Pre-Budget Report that, subject to consultation, VED on tractors would be abolished. After consulting with interested parties, including farming representatives, the **Government has decided to abolish VED on tractors, similar agricultural vehicles and all other vehicles that currently qualify for the £40 special concessionary VED rate from 1 April 2001.** This will save farmers £40 per year for every tractor, equivalent to over £10 million per year in total. The DVLA will automatically rebate owners of such vehicles for outstanding months on their VED discs in May, backdating this to 1 March 2001. To help the fight against crime, it will remain necessary to licence these vehicles annually.

6.76 The Government recognises the agricultural industry's concerns over outstanding classification issues surrounding definitions of agricultural vehicles. Accordingly the Government will undertake further discussions with industry and will aim to conclude these by this autumn.

VED on other vehicles

6.77 The Government has also decided to reduce VED rates on some recovery vehicles in the light of the reductions in lorry VED. In total, these reductions will lead to recovery vehicles paying one third less in VED in real terms. **VED rates on buses will also be frozen in cash terms until Budget 2001.**

REGENERATING BRITAIN'S TOWNS AND CITIES

6.78 The Government is committed to reversing the physical, economic and social neglect which characterises some parts of Britain's towns and cities. The Urban White Paper, published in November 2000, set out a comprehensive strategy for achieving this aim. The Urban Taskforce, chaired by Lord Rogers, has made an important contribution to this debate in its report of June 1999 "*Towards an Urban Renaissance*" which made 105 recommendations aimed at reversing decline and attracting people back into towns and cities.

6.79 The Government has put in place a number of policies to help regenerate towns economically, socially and physically:

- economic regeneration – by encouraging enterprise and innovation in urban areas through the proposed Community Investment Tax Credit and Regional Development Agencies set out in Chapter 3;
- social regeneration – tackling social exclusion and deprivation through direct investment in public services and infrastructure through programmes such as the Neighbourhood Renewal Fund as set out in Chapter 5;
- physical regeneration – by introducing targeted tax cuts in stamp duty and VAT, and introducing capital allowances and tax credits as set out below.

6.80 The Pre-Budget Report announced a number of tax measures, to be introduced in this Budget, worth over £1 billion over five years to help regenerate towns and cities. The promotion of physical regeneration – helping to bring derelict and under-utilised land and property back into productive use – will also reduce the pressure for unnecessary development in rural areas. It is intended that these measures will come into operation shortly after Royal Assent.

Stamp duty relief for disadvantaged areas

6.81 To help assist with the refurbishment and return to use of existing properties, and aid new developments, **Budget 2001 abolishes stamp duty on all property transactions in the most disadvantaged parts of the UK.** This will encourage businesses and families to locate in these areas, reviving depressed property markets and providing employment. The relief will be targeted at the areas most in need of regeneration, at the level of particular wards. A list of areas which will qualify for the relief will be published in due course.

Tax relief for cleaning up contaminated land

6.82 The Government wants to improve the confidence of owners and investors to bring contaminated land back into productive use and assist with the costs of doing so. **Budget 2001 introduces a 150 per cent accelerated payable tax credit for owners and investors for the costs they incur in cleaning-up contaminated sites.** The measure will make the development of these sites more viable, helping to tackle the legacy of previous industrial uses and reduce the pressure to develop greenfield sites.

Tax relief for creating flats over shops

6.83 To support the redevelopment of vacant and underused space over shops and other commercial premises, **Budget 2001 introduces 100 per cent capital allowances for owners and occupiers for the costs of creating flats over shops and similar commercial premises for letting,** enabling them to obtain up-front tax relief on their spending.

VAT relief for residential conversions

6.84 To help bring vacant homes back into use and provide a more diversified use of land the Pre-Budget report announced that the Government would introduce:

- **a 5 per cent reduced rate of VAT for the cost of converting residential properties into a different number of dwellings;** for example, a house into flats;
- **an adjustment to the zero rate of VAT to provide relief for the sale of renovated houses that have been empty**

for 10 years or more.

6.85 In addition, Budget 2001:

- **extends the 5 per cent reduced rate of VAT to the renovation of homes empty for three years or longer** to bring more properties back into use; and
- **extends the 5 per cent reduced rate of VAT to cover conversions of residential property into residential communal homes such as care homes and homes with multiple occupation,** helping those who are unable to live alone.

6.86 The VAT package will create up to 3,700 homes each year through better use of the UK's existing housing stock. The Government is also considering a reduced rate of VAT for 'granny annexes'.

Urban Regeneration Companies

6.87 Urban Regeneration Companies (URCs) are a new form of delivery for area regeneration schemes. They are independent bodies that engage the private sector alongside key public sector partners. They were proposed by the Urban Task Force and piloted in Liverpool, East Manchester and Sheffield. Monitoring of the pilots has demonstrated the potential added value of this approach. A programme of around 12 further URCs will be launched over the next two to three years in priority areas for regeneration. **In order to encourage public-private sector partnerships the Government will consider the scope for providing a corporation tax relief for company donations to URCs and similar bodies across the UK.**

Grants for listed places of worship

6.88 The Pre-Budget Report announced that the Government was attracted to the idea of a reduced rate of VAT for the repair and maintenance of listed buildings which are used as places of worship and would be approaching the European Commission to make clear its priorities. The Commission has indicated that this will be considered in their general review of reduced rates for VAT which will take place in 2003, and the Government will continue its discussions with the Commission on this issue.

6.89 However, **in the interim period, the Government is introducing a UK wide grant scheme to help congregations with these costs. The Department for Culture, Media and Sport will be consulting on the details but the effect of the grant will be to reduce the VAT cost to 5 per cent for new work undertaken from 1 April 2001.**

PROTECTING BRITAIN'S COUNTRYSIDE

6.90 The Rural White Paper published in November 2000 sets out the Government's rural policy framework for delivering a countryside that is sustainable: economically, environmentally and socially. The measures introduced by the Government to regenerating towns and cities will also reduce the pressure for development in the countryside.

The aggregates levy

6.91 The Government is committed to maximising the use of recycled aggregate and other alternatives to primary aggregate in order to reduce the environmental impacts of quarrying such as damage to biodiversity and visual intrusion. As announced in Budget 2000, **the aggregates levy will be introduced in April 2002 at £1.60 per tonne.** The revenues raised from the levy will be returned to business and the local communities affected by quarrying through a 0.1 percentage point cut in employers' NICs and a new Sustainability Fund. The levy will ensure that the environmental impact of aggregates extraction are more fully reflected in prices and encourage a shift in demand away from primary aggregate towards alternatives such as recycled construction and demolition waste and china clay waste. It will also encourage the more efficient use of all aggregates, greater resource efficiency in the construction industry, and the development of a range of other alternatives including the use of waste glass and tyres in aggregate mixes.

6.92 The Government has received representations suggesting that the environmental benefits of the levy could be enhanced by introducing a differential rate for aggregates extracted from quarries with the lowest environmental costs, or so called "green" quarries. The Government is attracted to this idea in principle, but previous analysis has suggested that there would be a number of practical difficulties with a differential rate. These relate to assessing compliance, defining environmental performance, the treatment of imports, and UK competition policy. However, the Government will continue to explore options for a differential rate with interested parties which overcome these problems.

Sustainability Fund

6.93 The Sustainability Fund will be introduced in April 2002 alongside the aggregates levy. A consultation document was issued in August 2000 on the best use of the Fund and a summary of responses was published alongside the Pre-Budget Report. In light of the representations made the Pre-Budget Report announced that £35 million per year would be allocated to the new Fund.

6.94 Since the Pre-Budget Report, the Government has been considering the key priorities for the Fund. The consultation exercise highlighted support for a number of options, including the promotion of conservation and increased biodiversity, and programmes geared towards overcoming market barriers to increased reuse and recycling of construction and demolition wastes. The Government will continue to explore the scope for setting up a UK-wide Fund with shared objectives that maximises the environmental benefits of the Fund and complements the objectives of the aggregates levy. The Government intends to consult on the detailed proposals for the fund in due course.

Waste

6.95 Industry and commerce in England and Wales produce around 78 million tonnes of waste a year. Local authorities collect a further 28 million tonnes, principally from households, and this is growing by around 3 per cent a year. The EU Landfill Directive has set binding targets to reduce the amount of biodegradable municipal waste landfilled relative to 1995 of 75 per cent reduction by 2010, 50 per cent by 2013 and 35 per cent by 2020. All sectors of the economy will need to work together to reduce, re-use and recover value from waste material, in particular through recycling or composting. Box 6.4 identifies programmes the Government has put in place to meet these objectives.

Tradeable permits

6.96 The Government will introduce a system of tradeable permits to meet its targets under the Landfill Directive. These will give local authorities the greatest amount of freedom in how they meet their landfill targets, setting each authority a limit on the amount of biodegradable waste they can landfill. Authorities most successful at reducing landfill will be able to trade permits with those with a greater reliance on landfill. The scheme is expected to be operational by 2003 and will assist in reducing the cost to the UK of securing the benefits of a reduction in landfill.

Landfill tax

6.97 By making waste producers take account of the environmental costs they impose on the rest of society when they discard waste to landfill, the landfill tax encourages efforts to minimise the amount of waste generated and to develop more sustainable forms of waste management such as recycling, composting and recovery. An assessment of the landfill tax by ECOTEC in 1998 indicated that it may have led one third of companies to introduce or step up efforts to minimise, reuse or recycle wastes.

6.98 In line with the Government's Budget 99 commitment to adopt a landfill tax escalator of £1 per tonne a year for five years until 2004, **the current standard rate of landfill tax will increase from £11 per tonne to £12 per tonne with effect from 1 April 2001.** The lower rate of tax that applies to inert waste will remain at £2 per tonne.

Box 6.4: Programmes to promote recycling

- **Waste Strategy 2000 introduced statutory performance standards for local authorities requiring an increase in household recycling and composting from 1998-99 levels of 9.4 per cent to at least 17 per cent by 2003-04 and 25 per cent in 2005-06. Public awareness of the need to recycle and reduce waste has been raised by the Government's "Are you doing your bit?" advertising campaign.**
- **The Waste Resources and Action Programme (WRAP) launched in November 2000 promotes more sustainable waste management, by aiming to remove barriers to waste minimisation, re-use and recycling, and by working to create stable and efficient markets for recycled materials and products. £40 million of government funding is available over the next three years, but the programme is also expected to attract funding from other sources, including the private sector.**
- **The Government announced £150 million of New Opportunities Fund money in October 2000 to support projects for green regeneration. £50 million is available for community recycling schemes as part of this wider initiative.**

Landfill tax credit scheme

6.99 The Government is committed to meeting the challenging targets for waste recycling set out in Waste Strategy 2000. In the Pre-Budget Report, the Government announced that it would explore how resources going through the Landfill Tax Credit Scheme (LTCS) could be better used to increase recycling rates, particularly of household waste.

6.100 As an initial step the Government will shortly be challenging the waste industry to meet demanding targets to allocate a greater proportion of tax credits towards sustainable waste management projects and especially projects which promote recycling.

6.101 The Government believes that local authorities have a key role in promoting household recycling and would like to see them benefit from funds in the LTCS. In the longer-term the Government is therefore attracted to replacing all or part of the LTCS with a public spending programme to direct resources towards Government priorities on sustainable waste management. The Government will consult with interested parties on how this transition can be managed to ensure that worthwhile projects continue to attract funding both under the current scheme and under any replacement regime.

Pesticides

6.102 The Government is committed to a policy of minimising the adverse environmental impact of pesticides, consistent with adequate crop protection. The Government believes that a tax on pesticides could, in conjunction with other measures, be a useful tool in addressing the environmental impact of pesticides use.

6.103 Since the November Pre-Budget Report 1999 the Government has been exploring with the agrochemical industry whether its objectives could be better achieved through a partnership approach. The Crop Protection Association (CPA) published proposals for a formal package of voluntary measures in April 2000 and the Government invited interested parties to comment. Additional work by the CPA, in conjunction with other stakeholders, led to the production of revised proposals in October 2000. The Government welcomed these but still felt they could be improved. Following further discussions the CPA and a number of other stakeholders submitted proposals for a revised package in January 2001.

6.104 The Government welcomes the latest set of voluntary proposals for reducing the environmental impact of pesticides use from the industry and the commitments made by the various stakeholders. **The Government would like to see the voluntary package for pesticides implemented nationwide as soon as possible, subject to its concerns over delivery and monitoring being met.** Progress of the package will be reviewed in the run up to Budget 2002 to assess whether a voluntary approach is delivering significant environmental benefits, over and above those that would result from a pesticides tax.

ENVIRONMENTAL APPRAISAL OF POLICY MEASURES

6.105 The Government is committed to appraising the environmental impact of all proposed Budget measures. The Government has refined its appraisal tables in light of suggestions from the Environmental Audit Committee (EAC) and others. Table 6.1 shows how Government policies fit into the overall framework of its environmental strategy. Table 6.2 describes the environmental effect of measures introduced in recent Budgets which have a significant effect on the environment or which serve an environmental purpose[8].

6.106 The Government has made available documentation about the environmental appraisal methodology underlying its estimates including those set out in the climate change programme, the associated paper on the derivation of carbon savings, the Department of Trade and Industry's working paper on emissions projections, the memorandum to the EAC on the environmental appraisal of the fuel duty escalator and an Inland Revenue paper providing an "*Integrated Impact Assessment*" of the company car tax reform. In addition, the Government has recently provided the Trade and Industry Committee with a memorandum which includes analysis of the fuel duty escalator. This will be available when their report on the impact on trade and industry of motor fuel taxation is published.

Table 6.1: The Government's Budget measures and policy objectives

Policy objective	Corresponding Budget measure	Other relevant policy initiatives affected	Sustainability development indicator[1]
Tackling climate change and improving air quality	• Climate change levy and related measures • Emissions trading • Reforms to company car tax	• Climate change programme[2] • Emissions Trading	• CO_2 emissions • Days of air pollution • Electricity from renewable sources

	• VED reforms • Green travel plans • Authorised mileage rates • Reduced rate of VAT on the installation of energy saving materials • Fuel duty differentials	Consultation Document[3] • Ten Year Plan for Transport[4] • Air Quality Strategy[5]	• Energy efficiency of vehicles
Regenerating Britain's cities	• Capital allowances for flats over shops • Tax relief for cleaning up contaminated land • Stamp duty exemption for disadvantaged communities • Reforms to the VAT treatment of conversion and renovation activity	• Urban White Paper[6]	• New homes built on previously developed land • Homes judged unfit to live in
Protecting Britain's countryside	• Aggregates levy • Aggregates Sustainability Fund • Landfill tax increases • Reforms to landfill tax credit scheme • Pesticides voluntary package	• Waste Strategy[7] • A Better Quality of Life[8] • Rural White Paper[9]	• Household waste and recycling • Construction and demolition waste going to landfill • Waste arisings and management

[1]The full set of indicators is published in *Quality of Life Counts*, DETR April 2000.

[2]*Climate Change Programme,* DETR November 2000.

[3]*Emissions Trading Consultation Document,* DETR November 2000.

[4]*Ten Year Plan for Transport,* DETR July 2000.

[5]*Air Quality Strategy for England, Scotland, Wales and Northen Ireland*. January 2000.

[6]*Urban White Paper,* DETR November 2000.

[7]*Waste Strategy*, DETR May 2000.

[8]*A Better Quality of Life*, DETR May 1999.

[9]*Rural White Paper*, DETR November 2000.

Table 6.2: The environmental impact of the Government's Budget measures

Measure	**Environmental impact[1]**	
• Climate change levy package[2]	Levy and exemptions[3] Negotiated agreements[4] Energy efficiency measures	Savings of at least 2.0 MtC Savings of at least 2.5 MtC Savings of at least 0.5 MtC
• Emissions Trading Scheme	A successful scheme is estimated to deliver emission savings of at least 2MtC by. 2010[5]	
• Company car tax reform[6]	Estimated to produce savings of around 0.5 to 1 MtC in the medium to long run	
• Green travel plans • Authorised mileage	Reductions in CO_2 and air particulates	

allowances	
• Reforms to car and lorry VED	Reductions in emissions of CO_2, NO_X and particulates
• Road fuel duty escalator	The road fuel duty escalator over the period 1996 to 1999 is estimated to produce carbon savings of 1 to 2.5 MtC[7] by 2010 and small reductions in emissions of local air pollutants.
• Road fuel duty differentials[8]	The ULSP differential is estimated to reduce NO_X emissions by 1 per cent, reduce CO emissions by 4 per cent and reduce VOCs emissions by 1 per cent in 2004. The ULSD differential is estimated to result in a reduction of 8 per cent in emissions of particulates and up to 1 per cent of NO_X emissions. The road fuel gas differential will result in a reduction in emissions of particulates and NO_X. The real reductions in duty on ULSD and ULSP are estimated to increase carbon emissions by between 0.1 and 0.7[7,9] millon tonnes by 2010. The temporary cut in unleaded petrol will have zero impact on emissions in 2010. The duty cut in LRP will not have a significant impact on emissions.
• Green fuels challenge	Reductions in emissions of CO_2, NO_X and particulates. Waste policy benefits.
• Haulage Modernisation Fund	1 per cent reduction in particulate emissions by 2004, and reductions in NO_X and CO_2. Fuel efficiency training is expected to reduce emissions by around 0.1 MtC.[10]
• Reduced rate of VAT on the installation of energy saving materials	Reduction of 0.1 MtC[11] by 2010.
• Reduced rate of VAT on domestic fuel and power	Estimated to increase carbon emissions by 0.2[3] MtC by 2010.
• Capital allowances for flats over shops • Tax relief for cleaning up contaminated land • Stamp duty exemption for disadvantaged areas • Reforms to the VAT treatment on conversion and renovation activity	This package of measures will lead to: • reduced pressure on the countryside due to increase in the number of empty and derelict properties brought back into use; • increase in clean up of contaminated land; and • regeneration and improved functioning of property markets in Britain's most disadvantaged communities
• Aggregates levy and Sustainability Fund	Reductions in noise, dust, visual intrusion, damage to wildlife habitats and other environmental impacts.
• Landfill tax and LTCS	Encourages waste producers and the waste management industry to switch away from landfill towards waste minimisation, re-use and recycling.

[1] These estimates are subject to a wide margin of error.

[2] There are a number of difficulties involved in estimating the emission savings from the individual components of the climate change levy, including the need to avoid double counting. The figures are calculated using cautious assumptions and are shown for illustrative purposes only.

[3] Based on the DTI energy model.

[4] Estimates still to be finalised.

[5] Based on independent modelling commissioned by DETR.

[6] This measure is part of a package of measures, including the changes to VED and the ACEA voluntary agreements.

[7]Based on DTI and DETR models.

[8] Using the NETCEN emissions model – further detail on the methodology used in the model is provided in NETCEN's January 2000 report UK Road Transport Emissions Projections.

[9] Do not take account of the reduction in emissions by incentivising gasoline direct injection technology.

[10] DETR estimates.

[11] Based on HM Customs and Excise modelling.

[1]*Law Demand Housing and Unpopular Neighbourhoods,* DETR June 2000.

[2]*Climate Change: The UK Programme* DETR November 2000.

[3] Source: ETSU, based on surveys and audits across industry.

[4] The Energy Technology List will be available at www.eca.gov.uk or via the Environment and Energy Helpline on 0800 585794.

[5]*A Greenhouse Gas Emissions Trading Scheme for the United Kingdom, Consultation Document*, DETR, November 2000.

[6] A more detailed assessment of the incentivisation of USLD was published alongside the Pre-Budget Report, *Using the tax system to encourage cleaner fuels: the experience of ultra-low sulphur diesel*, HM Customs and Excise.

[7]www.inlandrevenue.gov.uk.

[8] There are large uncertainties involved in trying to estimate the behavioural responses to the Budget measures, and it is not always possible to quantify the individual environmental effects of individual Government policies, particular when introduced as part of a package. Wherever possible, an attempt is made to separate out the effects of individual measures, but it should be noted that these are subject to large margins of error.

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ILLUSTRATIVE LONG-TERM FISCAL PROJECTIONS

The Government's budgetary decisions must be consistent with long-term sustainability in order to promote long-term economic growth and intergenerational equity. The illustrative long-term fiscal projections presented in this annex assist the Government in assessing the sustainability of its fiscal policies. The key points are:

- **the impact of an ageing population on the UK's public finances is expected to be less marked than in most other EU countries and manageable, allowing the Government to target resources on low and middle income pensioners while maintaining long-term sustainability;**
- **given the projected profile for transfers and tax revenues, current consumption can grow faster than real GDP in the long run without jeopardising the fiscal rules;**
- **meeting the fiscal rules on cautious assumptions with a margin of error means that:**
    - **the Government is well placed to deal with spending commitments that might arise in the future which are not yet accounted for; while**
    - **net debt is projected to remain below 40 per cent of GDP in the long run.**

INTRODUCTION

A1 When setting fiscal policy the Government has to ensure that its decisions provide stable public finances in the short and medium term. However, the Government also has to ensure that its policy decisions are consistent with a sustainable long-term framework. Failure to do so could not only have detrimental effects on long-term economic growth (as the financial burden would be shifted to future generations) but would also be inconsistent with the principles of fiscal management set out in the *Code for Fiscal Stability*.

Code requires illustrative long-term projections

A2 For this reason, the Code requires the Government to publish illustrative long-term projections covering a period of at least ten years. The projections published in Budget 99 and Budget 2000 showed that the UK's long-term fiscal position was relatively favourable and that, as a result, current consumption could grow at a faster rate than GDP, without jeopardising the Government's fiscal rules.

A3 By incorporating updated spending and revenue projections and latest policy settings, this annex provides up-to-date information on the sustainability of UK fiscal policy. To ensure the comparability of this year's set of projections with those of previous years, the underlying assumptions and methodology used remain virtually unchanged. The new set of projections shows that, as expected, given that the factors affecting long-term sustainability remain relatively stable over time, the UK's long-term fiscal position remains sound.

A4 In recent years there has been an increased focus on long-term fiscal sustainability issues not only in the UK but also in other countries, including EU Member States. It is now widely recognised that the long-term sustainability of public finances plays a major role in providing the necessary environment to achieve long-term economic growth, prosperity for all and fairness between generations. The Government will continue to analyse long-term spending and revenue trends to ensure that the public finances remain sustainable.

DEMOGRAPHIC TRENDS

The UK's population is ageing

A5 Like most other EU and OECD countries, the UK will face a major demographic challenge in the decades ahead from an ageing population. Whereas only one in seven people in the UK were aged 65 or over in 1980, that share had risen to nearly one in six in 2000 and is predicted to rise to nearly one in five by 2020. Over the same period, life expectancy at birth will have risen sharply from 70.2 years in 1980 to 77.8 years in 2020 for males, and from 76.2 years to 82.5 years for females. The median age is projected to be 42.6 years in 2020, some 8 years higher than in 2000. Chart A1 shows the UK's age structure in 2000 and at the end of the projection period presented in this annex, 2031.

Chart A1: UK population by age and sex

A6 The UK's population is ageing less rapidly than the populations of most other EU Member States. As a comparison, the old-age dependency rate (the number of people aged 65 and over as a percentage of those aged 20 to 64) is set to rise from 26.4 per cent in 2000 to 32.0 per cent in 2020 in the case of the UK, compared with a projected rise from 26.7 per cent to 35.1 per cent over the same period in the EU as a whole. The difference will be even more pronounced further in the future.

A7 Even though the UK faces a less severe demographic challenge than many other European countries and the impact of an ageing population on the public finances is predicted to be manageable, there is no room for complacency. Demographic developments will still have implications for government spending and revenue (for example, in the form of greater demand for services for the aged), thereby emphasising the importance of a sound long-term strategy for the public finances.

METHODOLOGY AND ASSUMPTIONS

A8 The Treasury's model for producing long-term fiscal projections examines the sustainability of the public finances by determining at what rate current consumption (current spending on health, education, infrastructure, etc.) can grow while still allowing the Government to meet its fiscal rules. To achieve this, the Treasury projects the evolution of taxation and transfer payments and capital consumption (depreciation) in the coming decades on the basis of prudent and cautious assumptions. The difference between the former and the latter two then indicates the financial resources available for current consumption. This methodology is unchanged since Budget 2000, where it was set out in detail in Box A1 of the EFSR (page 129).

A9 The taxation, transfers and capital consumption projections are based on current policy settings. In other words, it is assumed that the Government will leave current policy unchanged in the future. This does not imply though that policy will in fact remain unchanged. Indeed, it is unlikely to do so over the next 30 years. Rather, the projections intend to show how the public finances are likely to develop if policy remained unchanged. As it is difficult to represent current policy from a modelling perspective, a number of assumptions (set out below) are made to approximate the current settings. It is important to note that the outcome of this set of projections - as with all projections - is driven by the underlying assumptions.

Economic assumptions

A10 Table A1 sets out the key economic assumptions underlying the projections[1]. With the projections covering a time span of 30 years, a wide range of assumptions can be considered to be plausible. Consistent with the approach to projecting the public finances in the short and medium term, the assumptions used here represent a cautious case. For example, the expected effects of the Government's reforms to increase labour market activity and productivity are not taken into account. The key economic assumptions have not been changed. This is partly because the economic fundamentals have remained unchanged but also to ensure comparability between this year's projections and those presented in Budget 2000.

Table A1: Long-term economic assumptions

	Average annual real growth, per cent	
	2006-07 to 2010-11	**2011-12 to 2030-31**
Productivity	2	13/4
Labour force	1/4	0
GDP	21/4	13/4
Inflation	21/2	21/2

Cautious economic assumptions

A11 Importantly the long-term rate of economic growth used in the projections - at $1^{3}/_{4}$ per cent a year from 2011-12 - is lower than the Government's neutral projection of trend economic growth[2]. This reflects the use of cautious assumptions for both labour force and productivity growth, the latter the main driver of economic growth in the UK. The use of cautious assumptions can be justified on several grounds, including the greater degree of uncertainty involved when projecting long-term trends. Furthermore, a number of the effects driving economic growth higher - for example higher productivity growth and a rising female participation rate - may not continue into perpetuity. For these reasons, long-term productivity and labour market growth are cautiously assumed to stabilise some $^{1}/_{4}$ and $^{1}/_{2}$ percentage points respectively below the rates used in the neutral projection of trend growth.

Taxation and spending assumptions

A12 Tax revenues are subject to a number of short and long-term influences which make them difficult to project. For example, changing patterns of income and expenditure give rise to considerable uncertainty about tax bases. For this reason, current receipts as a share of GDP are projected to remain constant from 2006-07 onwards (beyond the medium-term projection) without making assumptions about the source of that revenue. This approach, for the purposes of long-term projections, is equivalent to saying that the Government will continue to raise the same relative amount of revenue as in 2005-06, offsetting possible changes in the tax base by changing policy in a revenue neutral way.

A13 Current spending is assumed to grow in line with current receipts from 2006-07 onwards. This implies that the current budget is projected to be in balance from then. As current consumption is calculated as the difference between receipts and other spending, the main spending assumptions relate to transfers and capital consumption.

A14 Transfers are made up of three separate components: social security transfers (calculated in conjunction with the Department of Social Security), interest payments and other transfers. The calculation of interest payments requires assumptions both about interest rates and the level of investment. As for the short-term forecasts, interest rates are modelled using market expectations and the existing spread of financial assets to which those rates apply. The share of net investment in GDP is assumed to remain constant from 2005-06 to 2030-31.

A15 To calculate capital consumption, the Treasury uses the forward profile for investment that provides information on additions to the capital stock. The consumption of both the existing stock of assets and these new additions is then calculated on the assumption that future public sector asset lives are broadly similar to those evident in the past.

THE BASELINE PROJECTIONS

The fiscal rules are met comfortably

A16 Chart A2 shows the projected evolution of total current spending, transfers, current consumption and net debt between 2000-01 and 2030-31, given the baseline assumptions. As a percentage of GDP, total current spending is projected to increase between 2000-01 and 2005-06 before stabilising. Transfers are predicted to fall until 2020-21 before increasing slightly towards 2030-31, while net debt will fall in the coming years before gradually rising towards 40 per cent of GDP by 2030-31. Current consumption is projected to rise from 18.8 per cent of GDP in 2000-01 to 21.8 per cent in 2020-21 before falling towards the end of the projection period. Despite the slight drop towards 2030-31, current consumption as a percentage of GDP will be markedly higher than in 2000-01. This relative expansion reflects the fact that current consumption can grow at a markedly faster rate - at an average $2^{1}/_{2}$ per cent a year between 2000-01 and 2030-31 - than the assumed average real GDP growth rate of 2 per cent while still meeting the fiscal rules. This means that the Government is in a good position to deal with spending commitments which might arise in the future in addition to the ones already accounted for, without being in danger of jeopardising the fiscal rules.

Chart A2: The baseline projections

A17 With total current spending (by assumption) remaining constant as a percentage of GDP from 2006-07 onwards, the increase in current consumption as a share of GDP over the period 2000-01 to 2020-21 is due to the declining trend for transfers as a share of GDP. In other words, there is a reallocation of financial resources away from funding transfers to funding current consumption. This is mainly due to the decline in social security spending as a share of GDP but also partly due to a fall in debt interest payments as a share of GDP in the medium term. The marginal drop in current consumption as a percentage of GDP towards the end of the projection period is the result of small increases in transfer and debt interest payments as a percentage of GDP.

A18 With the underlying assumptions remaining more or less unchanged, these illustrative projections produce a broadly similar picture to those presented in previous years. The changes - including the markedly lower net debt level as a percentage of GDP in 2000-01 - are mainly the result of the revised medium-term projections that take into account all existing and announced Government policy initiatives.

A19 The projected changes in net debt emphasise the importance of ensuring sound public finances in the short term to prepare for future developments. On current projections, net debt falls to around 30 per cent of GDP in 2006-07, a rate well below the 40 per cent level defined as consistent with meeting the sustainable investment rule. This downward trend, however, is not projected to continue into the future. Rather, net debt is projected to rise gradually to reach $37^1/_2$ per cent of GDP in 2030-31 given the long-term growth and investment assumptions.

External studies

A20 The general conclusion of the baseline projections has been broadly supported by other studies. Using a set of generational accounts, the National Institute of Economic and Social Research (NIESR), for example, concluded that the UK faced only a modest generational imbalance, suggesting that the public finances will be sustainable in the long run.

AGEING AND PUBLIC PENSION EXPENDITURE

The UK is well placed internationally

A21 In an international context, the UK is well placed compared with other countries, many of whom face marked generational imbalances (NIESR, 1999)[3]. The UK's relatively favourable position derives from a number of factors, including a sound fiscal starting point, less pressing demographic developments and price indexation of universal state pension benefits. This is complemented by substantial and continuing growth in private pensions. The Government is therefore able to target its resources on low and middle income pensioners, helping ensure average pensioner incomes continue to rise faster than average incomes of the rest of the population. The Government has introduced and raised the Minimum Income Guarantee for the poorest pensioners, linking this to earnings and is consulting on extending this further to all low and middle income pensioners through the Pension Credit from 2003. The implications of these initiatives are fiscally sustainable, and the policies being developed are consistent with meeting the fiscal rules. Over the long term net debt is projected to remain below 40 per cent of GDP.

European initiatives

A22 In February 2000, ECOFIN (the Council of EU finance ministers) requested a detailed study of the impact of ageing populations on public sector pension systems. Following the request, the Commission's Economic Policy Committee (EPC) set up a working group, comprising representatives from the EU Member States and the Commission, to prepare an in-depth analysis covering the next 50 years. Future research projects for the working group include the study of the impact of ageing populations on health-care costs and, possibly, on other age-related expenditure such as education. This will help to build up a comprehensive picture of the likely impact of ageing populations on the public finances of the Member States in the first half of this century.

A23 The working group's results on public sector pensions were published in a progress report in December 2000[4]. Member States were requested to provide long-term projections of public pensions expenditure, based on commonly-accepted definitions and demographic and macroeconomic assumptions. Different scenarios were considered, not least to test the robustness of the results. For example, the working group studied the effects of using different demographic projections (which were provided by EUROSTAT) and of different hypotheses on labour market performance, interest rates and productivity.

A24 The two main scenarios, however, were the "current policy" and "Lisbon" cases. In the former, Member States used macroeconomic assumptions, for example on participation and unemployment rates, based on projections provided by the OECD and EUROSTAT. Furthermore, labour productivity growth was assumed to converge towards $1^3/_4$ per cent a year between 2020 and 2030. The real interest rate was set at 4 per cent.

A25 Based on these assumptions - and economic policies already in place or firmly announced - Member States projected the evolution of public pension expenditure as a share of GDP (before tax) over the next 50 years. The main conclusion of the analysis was that the share is predicted to rise sharply in most Member States. In addition to one other Member State, the only exception was the UK where public pension expenditure was projected to decline gradually as a share of GDP from 5.1 per cent in 2000 to 3.9 per cent by 2050.

A26 In the "Lisbon" case, the projections were based on assumptions consistent with the conclusions of the Lisbon European Council in March 2000. These conclusions set ambitious objectives for Member States, including reaching full employment, boosting employment rates by nearly 10 percentage points between now and 2010, and achieving rapid economic growth of around 3 per cent a year in the coming years. Productivity growth rates and levels were assumed to converge towards the respective US rate and level by the end of the projection period.

A27 Despite these more optimistic assumptions, the main finding remained broadly unchanged: with the exception of the UK and a few other Member States, the share of public pension expenditure in GDP was predicted to rise between 2000 and 2050.

Table A2: Change in the share of public pension expenditure between 2000 and 2050

	per cent of GDP, before tax	
	"Current policy"	**"Lisbon"**
UK	–1.2	–1.7
EU[1]	3.2	2.0

[1]*Unweighted average including the UK but excluding Greece and Luxembourg. 2040 for France.*

Source: European Commission (2000).

A28 These results have already made their mark, feeding into a Council and Commission report[5] to be presented to the spring 2001 European Council in Stockholm. The report highlights the challenges that need to be addressed by Member States if the ambitious objectives set out at the 2000 Lisbon Council are to be attained. Sustainability of public finances is seen as necessary to achieve these goals, as well as policies to boost employment rates and reform of public pension systems, the latter to be increasingly supplemented by occupational schemes, in a number of Member States.

A29 While the UK is relatively well placed in all these aspects, and able to afford to target extra support to low and middle income pensioners, there is no scope for complacency. The underlying assumptions used in these long-term projections while reasonable and prudent are nonetheless subject to a number of uncertainties. For example, mortality, fertility or migration trends may well turn out to be different from those generally predicted, having a potentially marked effect on revenue and spending in the future. Furthermore, the demand for, and cost of providing, public services might deviate significantly from those predicted. In the light of these uncertainties, the Government's response is to take the ageing of the population into account in its policy making. Policy initiatives such as raising the retirement age for women from 60 to 65 and programmes to raise productivity and labour market participation all play a major role in guaranteeing the long-term sustainability of the public finances.

ALTERNATIVE SCENARIO

A30 As stated above, the outcome of any set of long-term projections is driven by the underlying assumptions and - given the time horizon involved - a large number of assumptions can be considered to be plausible. It is therefore useful to study different scenarios to gain further insights into the economic and demographic forces at work. In Budget 99 and Budget 2000, the EFSR presented the effects of stronger economic growth and higher investment, and higher labour market participation rates, on the long-term sustainability of the public finances.

A31 Amounting to more than 10 per cent of GDP and around a quarter of total current spending, social security expenditure is one of the key determinants of the long-term sustainability of the public finances. Social security comprises a number of spending items such as pensions, disability benefit, Jobseeker's Allowance and Income Support. With the Government determined to increase employment opportunity for all, it could be that there will be less demand for spending items such as Jobseekers' Allowance and Income Support in the future than assumed in the baseline projection.

A32 The alternative scenario is therefore based on the assumption that social security spending will grow a little more slowly than in the baseline scenario. Specifically, it is assumed that social security spending as a percentage of GDP - at 8.2 per cent by 2030-31 - is 1 percentage point lower than in the baseline scenario by the end of the projection period. As in most other industrialised countries, social security spending as a percentage of GDP increased substantially in the UK between the early 1970s - when it was around 7 per cent - and early 1990s when it peaked at around 12 per cent. This was partly at the cost of the other current spending items. Since then social security's share has gradually fallen, giving the alternative scenario some plausibility.

A33 With all other assumptions the same as in the baseline scenario, the illustrative long-term projections show that current consumption can grow faster in the alternative scenario. Despite the fact that the alternative scenario assumes that social security spending as a percentage of GDP will be only 1 percentage point lower than in the baseline projection by 2030-31, the growth rate of current consumption can average $2^3/_4$ per cent for 30 years without jeopardising the fiscal rules.

CONCLUSIONS

The public finances are sustainable in the long term

A34 The set of long-term projections in this annex indicates that the UK's public finances are broadly sustainable in the long term. The current projections therefore confirm earlier findings. Taking a narrower perspective (focusing on public pensions only), a study by the European Commission's Economic Policy Committee provides further evidence that the Government's fiscal policies are sustainable in the long term. The UK is therefore well placed compared with many other EU Member States to deal with the projected impact of an ageing population on the public finances.

A35 Despite this relatively favourable position, there is no room for complacency, not least because of the high degree of uncertainty involved in producing long-term projections. Even though the demographic and economic assumptions used are reasonable and cautious, a wide range of unforeseeable developments might take place over the projection period. It is for this reason that the Government has put in place policy measures designed to offset the impact of an ageing population on revenue and spending flows. Moreover, the Government will continue to produce long-term projections in the future to ensure that its fiscal policymaking takes into account the latest demographic and economic projections.

[1]For the period to 2005-06, the projections presented in Chapter C of the FSBR are used.

[2]See *Trend Growth: Prospects and Implications for Policy,* HM Treasury, November 1999.

[3]*Generational Accounting Around the World*, edited by Alan Auerbach, Laurence Kotlikoff and Willi Leibfritz, NIESR, 1999.

[4]*Progress Report to the Ecofin Council on the Impact of ageing populations on public pension systems,* EPC, 2000.

[5]Based on *Communication from the Commission to the Council and European Parliament: "The contribution of public finances to growth and employment: improving quality and sustainability*", European Commission, December 2000.

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A
Budget policy decisions

INTRODUCTION

This chapter sets out the measures and other policy decisions in Budget 2001 which affect the Budget arithmatic and includes those announced since Budget 2000. The effects[1] of the Budget decisions on Government revenues are set out in Tables A.11 and A.12 and explained in Appendix A1. Tax measures, national insurance contribution measures and measures which affect Annually Managed Expenditure (AME) are included, as are additions to Departmental Expenditure Limits (DEL). Measures which are financed from existing DEL provisions or other sources, such as the Employment Opportunities Fund, are not included. Changes announced in Budget 2000 or earlier which take effect after this Budget are set out in Appendix A2. Appendix A3 provides estimates of the revenue costs of some of the main tax allowances and reliefs.

PERSONAL TAXES AND SPENDING MEASURES

Income tax 2001–02

Bands, rates and personal allowances

The personal allowance will increase to £4,535 as already announced. The age-related personal allowance and income limit, the basic rate limit, blind person's allowance and, where applicable, the married couple's allowance will all rise in line with statutory indexation.(19, d)[1]

10p starting rate limit

The 10p starting rate limit will be increased from £1,520 to £1,880, an increase of £300 above indexation.(18)

WFTC and DPTC

As announced on 9 November 2000, the Working Families' Tax Credit (WFTC) and Disabled Person's Tax Credit (DPTC) weekly rates and thresholds will rise in line with the Rossi index from 10 April.(e)

The disabled child tax credit in WFTC and DPTC will increase by £7.40 above indexation. (j) New enhanced disability tax credits in WFTC and DPTC will be introduced from 10 April 2001, providing extra amounts of £16 per week for qualifying couples and lone parents and, for DPTC, £11.05 per week for single people. Qualifying children will receive the new credit at a rate of £41.05 per week, including the disabled child tax credit. (i)

From 5 June 2001 the basic tax credits in the WFTC and the DPTC will be increased by a further £5 and the limits on eligible childcare costs paid through the childcare tax credit component of WFTC and DPTC will be increased to £135 a week for the childcare costs of one child and £200 a week for the childcare costs of two or more children.(22, 23)

Children's Tax Credit

The Children's Tax Credit will be increased by £1.50 per week, so that it will be worth up to £10 per week (£520 per year) from its introduction in April 2001.(20)

Individual Savings Accounts (ISA)

As announced in the Pre-Budget Report: the higher ISA overall subscription limit of £7,000 and the £3,000 cash sublimit will be extended for a further five years (l); 16 and 17-year olds will be allowed to take out a cash ISA within the £3,000 sublimit from 2001–02 (*); and the ISA rules on investments, transfers and administrative procedures will be extended to Personal Equity Plans.(*)

The maximum earnings for which pension provision may be made with income tax relief (the "earnings cap") will be increased in line with statutory indexation to £95,400. (*)

Table A.1: Bands of taxable income 2001–021

2000–01	**£**	**2001–02**	**£**
Starting rate 10 per cent	0 – 1,520	Starting rate 10 per cent	0 – 1,880
Basic1, 2 rate 22 per cent	1,521 – 28,400	Basic1, 2 rate 22 per cent	1,881 – 29,400
Higher2 rate 40 per cent	over £28,400	Higher2 rate 40 per cent	over £29,400

1 *The rate of tax applicable to savings income in Section 1A ICTA 1988 remains at 20 per cent for income between the starting and basic rate limits.*

2 *The rates applicable to dividends are 10 per cent for income up to the basic rate limit and 32.5 per cent above that.*

Table A.2: Income tax allowances 2001–02

		£	
	2000–01	2001–02	Increase
Personal allowance			
age under 65	4,385	4,535	150
age 65–74	5,790	5,990	200
age 75 and over	6,050	6,260	210
Married couple's allowance[1]			
age 65 before 6 April 2000	5,185	5,365	180
age 75 and over	5,255	5,435	180
minimum amount[2]	2,000	2,070	70
Children's Tax Credit[1]	–	5,200	5,200
Income limit for age-related allowances	17,000	17,600	600
Blind person's allowance	1,400	1,450	50

1 *Tax relief for these allowances is restricted to 10 per cent.*

2 *This is also the maximum relief for maintenance payments where at least one of the parties is aged 65 before 6 April 2000.*

Table A.3: Working Families' Tax Credit and Disabled Person's Tax Credit

		£ per week	
	2000–01	**2001–02**	**Increase**
Basic tax credit (WFTC)	53.15	59.00[6]	5·85
Basic tax credit (DPTC - lone parent or couple)	84.90	91.25[6]	6.35
Basic tax credit (DPTC - single person)	55.15	61.05[6]	5.90
30-hour tax credit	11.25	11.45	0.20
Child tax credit - under 16	25.60[5]	26.00	0.40

Child tax credit - 16-18[1]	26.35	26.75	0.40
Disabled child tax credit[2]	22.25	30.00	7.75
Enhanced disability tax credit - lone parent or couple	–	16.00	16.00
Enhanced disability tax credit (DPTC - single person)	–	11.05	11.05
Enhanced disability tax credit - child[3]	(22.25)	41.05	18.80
Maximum eligible childcare costs allowed[4] - 1 child	100.00	135.00[7]	35.00
Maximum eligible childcare costs allowed[4] - 2+ children	150.00	200.00[7]	50.00
Income threshold - lone parent or couple	91.45	92.90	1.45
Income threshold - (DPTC - single person)	71·10	72.25	1.15

[1] *The 16–18 rate applies to awards starting from the September following the 16th birthday.*

[2] *Payable in addition to the child tax credit. For WFTC, only for awards starting from October 2000.*

[3] *Payable instead of the disabled child tax credit for relevant awards starting from April 2001.*

[4] *Childcare tax credit covers 70 per cent of eligible childcare costs up to the maximum allowed.*

[5] *For awards starting from June 2000. The rate for awards starting in April and May 2000 was £21.25.*

[6] *For awards starting from June 2001 (an increase of £5.00 on awards starting during April and May 2001).*

[7] *For awards starting from June 2001. The 2000-01 levels apply to awards starting during April and May.*

Income tax 2002–03

Children's Tax Credit

The Children's Tax Credit will be increased to £20 per week, up to £1,000 per year, plus indexation for families in the year of a child's birth for children born from 6 April 2002.(21)

Income tax 2003–04

Age-related allowances

The age-related personal allowances will be raised by £240 above indexation from April 2003.(4)

Effects on the Scottish Parliament's tax varying powers – statement regarding Section 76 of the Scotland Act 1998

A one penny change in the Scottish variable rate in 2001–02 could be worth approximately plus or minus £230 million, broadly unaffected by these changes. In the Treasury's view, an amendment of the Scottish Parliament's tax-varying powers is not required as a result of these changes.

Inheritance tax

Threshold

The threshold will be increased by statutory indexation to £242,000.(33)

Taxes on capital gains

Annual exempt amount

The capital gains tax annual exempt amount will be increased by statutory indexation to £7,500.(-)

Business assets taper

As announced in the Pre-Budget Report, employee shareholdings in non-trading companies will qualify for business assets taper relief. This will apply where the employee does not have a material interest of more than 10 per cent.(a,*)

The rules designed to counter avoidance of capital gains tax through use of offshore companies will be amended to ensure that they work fairly and effectively without hindering genuine overseas trade.(17)

Stamp duty

Urban regeneration

As announced in the Pre-Budget Report, stamp duty will be abolished for all property transactions in the most disadvantaged areas following Royal Assent. This will encourage urban renewal and stimulate property markets.(q)

Individual Pension Accounts

As announced on 11 July 2000, investments in collective investment schemes held within an Individual Pension Account may be adjusted free of stamp duty from 6 April 2001.(*)

National insurance 2001-02

The rate of Class 2 national insurance contributions for the self employed and the special Class 2 rate for share fishermen are frozen at £2 and £2.65 per week respectively. The annual Small Earnings Exemption, the special rate of Class 2 contributions for Volunteer Development Workers and the rate of Class 3 voluntary contributions will all be increased in line with statutory indexation. (f)

Table A.4: National insurance contribution rates 2001–02

Weekly earnings[1]	Employee (primary) NICs rate[2] (per cent)	Employer (secondary) NICs rate[3] (per cent)
£0 to £72 (LEL)	0	0
£72 to £87 (PT/ST)	0[4]	0
£87 to £575 (UEL)	10	11.9
Above £575	0	11.9

[1] The limits are defined as LEL – lower earnings limit; PT – primary threshold; ST – secondary threshold; and UEL – upper earnings limit.

[2] The contracted-out rebate for primary contributions in 2000–01 is 1.6 per cent of earnings between the LEL and UEL for all forms of contracting out: contracted-out salary-related schemes (COSRS), contracted-out money purchase schemes (COMPS) and appropriate personal pensions (APPs).

[3] The contracted-out rebate for secondary contributions is 3 per cent of earnings between the LEL and UEL for contracted-out salary-related schemes. For contracted-out money purchase schemes, the employer's contracted-out rebate varies according to the age of the employee. For appropriate personal pensions, the total rebate (primary and secondary combined) applicable to earnings is, like the rebate for COMPS, related to the age of the employee.

[4] No NICs are actually payable but a notional primary Class 1 NIC will be deemed to have been paid in respect of earnings between LEL and PT to protect benefit entitlement.

Table A.5: Self-employed national insurance contribution rates 2001–02

Annual profits	Self employed NICs	
	Class 2	Class 4
Below £3,955 (SEE)	0[1]	0
£3,955 to £4,535	£2 per week	0
£4,535 to £29,900	0	7

Above £29,900	0	0

[1] The self-employed may apply for exception from paying Class 2 contributions if their earnings are less than, or expected to be less than, the level of the Small Earnings Exception (SEE).

National insurance 2002–03

Table A.6: National insurance contribution rates 2002–03

Weekly earnings[1]	Employee (primary) NICs rate[2] (per cent)	Employer (secondary) NICs rate[3] (per cent)
Below £75 (LEL)	0	0
£75 to £89 (PT/ST)	0[4]	0
£89 to £590 (UEL)	10	11·8
Above £590	0	11·8

[1,2,3,4] See table A.4 subject to note 3 below.
[3] The contracted out rebate for secondary contributions is 3.5 per cent of earnings between the LEL and UEL for contracted out salary rebated schemes.

Benefits 2001–02

Capital limits

As announced in the Pre-Budget Report, the £500 capital limits in the Sure Start Maternity Grant and Funeral Payments will be abolished from October 2001.(k)

Pensioners

As announced in the Pre-Budget Report, the basic state pension will be increased to £72.50 a week for single pensioners and £115.90 for pensioner couples, from April 2001. The minimum income guarantee for pensioners will be aligned at a rate of £92.15 a week for single people and £140.55 for couples. (g)

Disability and carers package

As announced on 9 November 2000, an enhanced disability premium will be introduced into Income Support from April 2001, worth an additional £11.05 a week for singles and £16 a week for couples. The Disabled Child Premium in income-related benefits will be increased by £7.40 over indexation to £30 a week. The Carers Premium in Income Support will be raised by £10.25 a week to £24.40. (h)

Income Support and Jobseeker's Allowance

The child premia within Income Support and Jobseeker's Allowance will be increased by £1.50 per week from October 2001. (24)

Benefits 2002–03

Sure Start Maternity Grant

The Sure Start Maternity Grant will be increased from £300 to £500 from April 2002.(28)

Maternity Allowance and Statutory Maternity Pay

From April 2002, the flat rate of Maternity Allowance and Statutory Maternity Pay will be increased to £75 a week.(25)

The qualifying threshold for Small Employer Relief, which allows small businesses to claim a higher rate of reimbursement for paying Statutory Maternity Pay, will increase to an annual national insurance liability of £40,000 from April 2002.(27)

Pensioners

As announced in the Pre-Budget Report, the basic state pension will be increased to £75.50 a week for single pensioners and £120.70 for pensioner couples, from April 2002.(g)

Benefits 2003–04

Maternity Allowance and Parental Leave

From April 2003, Maternity Allowance and the flat rate of Statutory Maternity Pay will be increased to £100 a week, or 90 per cent of previous earnings if less. The payment period will be extended from 18 to 26 weeks.(25, 26)

Paid paternity and adoption leave

From April 2003, paid paternity leave will be introduced for working fathers. It will be paid for two weeks, at the same rate as Statutory Maternity Pay.(29)

From April 2003 paid adoption leave will be introduced, to allow one adoptive parent to claim paid leave at the same rate, and for the same period, as Statutory Maternity Pay.(30)

BUSINESS TAX AND SPENDING MEASURES

Tax on business profits

Minor improvements will be made to Capital Allowances Act 2001.(-)

Capital allowances

As announced on 7 August 2000, capital allowances will be available for the costs of preparing oil installations for reuse, and removing and mothballing them when their eventual fate is unknown, on the same basis as currently available for demolition. This will apply to abandonment programmes approved from that date.(*)

As announced in the Pre-Budget Report, in addition to the reduced rate of VAT for some residential conversions, property owners and occupiers will be able to claim 100 per cent first year capital allowances for expenditure on the renovation or conversion of vacant or underused space above shops to create flats for residential letting. The relief will apply to expenditure from Royal Assent.(r)

Tax relief on contaminated land

Companies that acquire land in a contaminated state will be able to claim an accelerated repayable tax credit on any additional site preparation cost for cleaning up the land following Royal Assent. The level of the credit has been enhanced to 150 per cent compared with the figure of 100 per cent announced in the Pre-Budget Report.(46,s)

Section 48 film tax relief

The 100 per cent write-off of production and acquisition expenditure, on completion, for British qualifying films with budgets not exceeding £15 million will be extended to cover expenditure incurred to 1 July 2005.(16)

De minimis limits for business gifts

The de minimis limit for business gifts will be increased to £50 for business taxes and VAT. This will come into effect: for self-employed income tax for accounting periods ending after 5 April 2001; for corporation tax for accounting periods commencing from 1 April 2001; and for VAT for gifts made on or after 8 March 2001. (38)

Life insurance

Insurers will be required to give policyholders details of gains on life insurance products with effect from 6 April 2002. The law relating to transfers of shares in such products will be clarified with effect from 2001–02.(39)

Changes to double taxation relief

As announced in the Pre-Budget Report, the formula used to calculate the mixer cap will be simplified for dividends paid to the UK on or after 31 March 2001. Foreign tax arising at more than one level in a chain of companies will be able to count towards the final measure of relief. In addition, the rate of underlying tax paid on dividends from UK subsidiaries of overseas holding companies will be deemed to the current rate of corporation tax and it will be possible to make a partial claim for foreign tax. Double taxation relief for non-residents trading in the UK will apply to chargeable, rather than accounting, periods ending on or after 21 March 2000.(*)

Amendments to group rules

A measure will be introduced to clarify the operation of the amended degrouping charge and notional transfers legislation with effect from 1 April 2000.(*)

Abolition of withholding tax

Existing rules requiring companies to withhold tax on intra-UK payments of interest and royalties made to companies within the charge to corporation tax will be abolished from 1 April 2001, as announced in the Pre-Budget Report. Withholding tax on intra-UK company to company annuities and annual payments will also be lifted from 1 April 2001.(2)

Limited liability partnerships (LLPs)

As announced in the Pre-Budget Report, tax loss through the use of LLPs (including through property investment LLPs) as an alternative to current business arrangments will be prevented. A new measure will clarify the general rules to treat LLPs as partnerships for tax purposes. The measures will apply from 6 April 2001, the date when LLPs will become available.(-)

Value added tax (VAT)

Easing the impact of VAT on SMEs

A package of measures aimed at easing the impact of VAT for small and medium-size enterprises (SMEs) will be introduced as follows:

The VAT registration threshold will be increased broadly in line with inflation from £52,000 to £54,000 from 1 April 2001 and the deregistration threshold will increase from £50,000 to £52,000. (c)

As announced in the Pre-Budget Report, from 1 April 2001 the turnover limit at which businesses can join the cash accounting scheme will be increased from £350,000 to £600,000 and for the annual accounting scheme from £300,000 to £600,000. The turnover limit at which businesses must leave the schemes will be increased to £750,000.(-)

Modernising VAT relief

From 1 April 2001, the scope of the existing zero rate for motor vehicles designed or substantially and permanently adapted for use by people with disabilities will be adjusted to include a wider choice of vehicles.(34)

Following Royal Assent, the rate of VAT on children's car seats will be reduced from 17.5 per cent to 5 per cent.(35)

From 1 April 2001, the zero-rating of young children's clothing and footwear will be simplified and modernised.(36)

A new VAT refund scheme will be introduced by 1 September 2001 for national museums and galleries offering free admission to the public. Eligible bodies which do not currently charge will be able to recover the VAT they incur from 1 April 2001.(37)

The Government will introduce a UK wide grant scheme to help offset the VAT costs of repairs to listed buildings which are used as places of worship. The effect of the grant will be to reduce the VAT costs to 5 per cent for new work undertaken from 1 April 2001.

Incentives for investors, entrepreneurs and employees

Enhancements to EIS, VCT and CVS

From 7 March 2001, the proportion of money raised under the Enterprise Investment Scheme (EIS), Venture Capital Trust (VCT) schemes and Corporate Venturing Scheme (CVS) that has to be employed within 12 months will be reduced. Rules that withdraw EIS reliefs when a company floats on a recognised Stock Exchange will be relaxed and a corresponding change will be made to the rules for loss relief on investments in trading companies. Other technical improvements will also be made to the EIS.(15)

Expansion of EMI

The value of shares over which Enterprise Management Incentive (EMI) options can be granted will be doubled to £3 million per company from Royal Assent and the limit on the number of participating employees will be removed. There will also be other technical improvements.(1)

All-employee share ownership plan (AESOP)

Employees will not pay stamp duty when they buy partnership and dividend shares from an AESOP trust from Royal Assent thereby ending the potential for a double charge to stamp duty when a trust sells shares to an employee. There will also be other technical improvements.(14)

NICs on share options

As announced in the Pre-Budget Report, companies will be able to settle NICs liabilities on the growth in value of some employee share options that were granted to employees between 6 April 1999 and 19 May 2000. This will take effect from Royal Assent of the Social Security Contributions (Share Options) Bill 2001.(b)

Securing the tax base

Direct taxes

As announced on 2 October 2000, legislation will be introduced to counter stock lending avoidance schemes with effect from that date.(-)

A measure will be introduced, with effect from 7 March 2001, to close a loophole in the Controlled Foreign Companies provisions. It affects a small number of companies, predominantly financial traders.(40)

New rules will prevent avoidance of petroleum revenue tax (PRT) arising in connection with the decommissioning of North Sea oil installations. PRT relief for expenditure on decommissioning installations in fields producing gas which is exempt from PRT will be extended to take fairer account of the use of those installations by other fields in return for tariffs which were liable to PRT. The changes will apply from 7 March 2001.(*)

Other measures

Pension schemes in surplus

The special charge on payments to employers out of surplus funds held by tax approved pension schemes will be reduced to 35 per cent. This will apply to all payments made after Royal Assent.(*)

Self assessment legislation

As announced on 10 November 2000, a package of measures will improve and clarify the legislation governing assessments, amendments, appeals and collection under self assessment. (*)

ENVIRONMENTAL TAXES AND SPENDING MEASURES

Climate change levy

Exempt unlicensed electricity suppliers will not be charged climate change levy (to be introduced from 1 April 2001) on the proportion of their input fuel that is ultimately for an excluded or exempt purpose in line with the treatment of autogenerators. (*)

Taxable commodities used in a combined heat and power station by a third party will benefit from the climate change levy exemption.(*)

Transport and the environment

Car fuel scale charges

From 6 April 2001 the VAT car fuel scale charge for private motoring in company cars will be adjusted for the movement in pump prices between Budget 2000 and Budget 2001. The corresponding income tax scale charge as anounced in Budget 98 will be increased by 20 percentage points above this adjustment.(41)

Fuel duties

As announced in the Pre–Budget Report, fuel duties and non-road fuel oil duties will be frozen (o). In addition, with effect from 7 March 2001 the duty rate for ultra low sulphur petrol will be cut by 2 pence per litre (6). As announced on 21 February 2001, the duty rate for unleaded petrol will be cut by 2p per litre from 7 March 2001 to 14 June 2001.(42) The duty rate for ultra-low sulphur diesel will be cut by 3 pence per litre.(7)

The separate duty rate for higher-octane unleaded petrol ('super unleaded' and 'lead replacement petrol') will be abolished with effect from 7 March 2001.(8)

Green fuels

From 7 March 2001 the duty rate on gaseous road fuels will be cut from 15 pence per kilogramme to 9 pence per kilogramme, broadly equivalent to a 3 pence per litre cut. After this reduction, duty on gaseous road fuels will not be increased in real terms until 2004 at the earliest.(9)

Budget 2002 will introduce a new duty rate for biodiesel. This will be set at 20 pence per litre lower than the duty rate on ultra-low sulphur diesel.(10)

From Royal Assent the Government will have the power to allow duty reductions or exemptions for approved pilot projects. This year, the Government plans to launch pilot projects to assess the feasibility and/or environmental benefits of hydrogen, methanol, bioethanol and biogas.(-)

Green travel

As announced in the Pre-Budget Report, VAT will be removed from 1 April 2000 from the purchase of adult cycle helmets and the VAT zero-rating for passenger transport will be extended from vehicles with 11 or more passenger seats to vehicles with 9 or more passenger seats.(*)

From April 2002 the 3 per cent diesel supplement for company cars achieving the Euro-IV emission standard will be removed, discounts for alternatively fuelled company cars will be introduced and the passenger seating threshold on works buses qualifying for tax exemptions will be lowered from 12 to 9.(n)

Authorised mileage rates

As announced in the Pre-Budget Report, the authorised mileage rates for business trips in cars up to 1500cc will be increased from April 2001 to 40 pence for the first 4,000 miles per year and 25 pence for further miles. The rates for the two higher bands will be frozen.

From April 2002 the cycle rate for business trips will be increased to 20 pence per mile.(m) As proposed in the Pre – Budget Report, there will also be a single statutory tax and NICs free rate of 40 pence per mile for the first 10,000 business miles per year for all sizes of car plus 25 pence for additional miles. The passenger rate for business trips will be increased to 5 pence per mile. (5)

Table A.7: Changes to duties on road fuels and other hydrocarbon oils

	Changes in duty (per cent)	Effect of tax[1] on typical item (increase in pence)	Unit

Leaded petrol	–	–	litre
Unleaded petrol[2,3]	–4.10	–2.4	litre
Diesel	–	–	litre
Ultra-low sulphur diesel	–6.15	–3.5	litre
Ultra-low sulphur petrol[3]	–4.18	–2.4	litre
Gas oil	–	–	litre
Fuel oil	–	–	litre
AVGAS	–	–	litre
Road fuel gas	–40	–7.1	kg

[1] *Tax refers to duty plus VAT, except for gas oil and fuel oil, which is shown exclusive of VAT.*
[2] *The reduction in duty on unleaded petrol is from 7 March 2001 until 14 June 2001 after which the duty rate will be 48.82 pence.*
[3] *The differential duty rate for higher octane unleaded petrol (HOUP) will be abolished; regular HOUP will be taxed as unleaded petrol and ultra-low sulphur HOUP will be taxed as ultra-low sulphur petrol and all other HOUP will be taxed as unleaded petrol.*

Table A.8: Bands and rates for the graduated VED system for new cars

		£		
VED band	**CO_2 emission level (grammes per kilometre)**	**Cars using cleaner fuels**	**Petrol car**	**Diesel car**
A	Up to 150g	90	100	110
B	151g/km to 165g/km	110	120	130
C	166g/km to 185g/km	130	140	150
D	186g/km and above	150	155	160

Vehicle Excise Duties

The VED rates for cars, taxis, motorcycles and buses will be frozen in this Budget.(43)

From 1 July 2001 the reduced VED rate for smaller-engined cars will be extended to 1549cc. Owners of qualifying cars who have taken out licences between 1 November 2000 and 30 June 2001 will receive a rebate of up to £55 per licence in July 2001.(11)

From 1 December 2001 the lorry VED rates shown below will replace the transitional lorry VED rates in force since 1 December 2000.(12,p)

Table A.9: Lorry VED rates

Table A.9a: VED rates

Band	Standard VED rate £	RPC VED rate
A	165	160
B	200	160
C	450	210
D	650	280
E	1,200	700
F	1,500	1,000
G	1,850	1,350

Table A.9b: VED bands for rigid lorries

Vehicle	2 axles	3 axles	4 or more axles
not over 7.5t	A	A	A
not over 15t	B	B	B
not over 21t	D	B	B
not over 23t	–	C	B
not over 25t	–	D	C
not over 27t	–	D	D
not over 32t	–	–	E

Table A.9c: VED bands for 2 axle tractive lorries

Vehicle	1 or more axle trailer	2 or more axle trailer	3 or more axle trailer
not over 25t	A	A	A
not over 28t	C	A	A
not over 31t	D	D	A
not over 34t	E	E	C
not over 38t	F	F	E
not over 40t	G	G	G

Table A.9d: VED bands for 3 axle tractive unit articulated lorries

Vehicle	1 or more axle trailer	2 or more axle trailer	3 or more axle trailer
not over 28t	A	A	A
not over 31t	C	A	A
not over 33t	E	C	A
not over 34t	E	D	A
not over 36t	E	D	C
not over 38t	F	E	D
not over 44t	G	G	E

From 1 April 2001 there will be no VED charge for all vehicles in the special concessionary VED class (including tractors and similar agricultural vehicles) and electric motorcycles. The DVLA will automatically reimburse outstanding months on such VED discs in May 2001, backdating the rebates to 1 March 2001.(13)

From 1 December 2001 the VED rate on recovery vehicles will be changed to £165 for recovery vehicles up to 25 tonnes and

£415 for recovery vehicles over 25 tonnes. (*)

From 1 December 2001 the transitional VED rate on special types vehicles in force since 1 December 2000 will be made permanent: £2,585 for special types vehicles without a reduced pollution certificate and £2,085 for special types vehicles with a reduced pollution certificate. (*)

From Royal Assent, mobile concrete and other pumps will be reclassified as mobile cranes and will therefore qualify for the special vehicles VED rate. (*)

From Royal Assent, the link between the payment of VED refunds and the Statutory Off-Road Notification (SORN) system will be abolished. In addition, the Secretary of State for the Environment, Transport and the Regions will have the right to waive the requirement for the VED disc to be surrendered at the time of refund in certain circumstances. (-)

Land use

Urban regeneration

The scope of the reduced rate of VAT for conversions announced in the Pre-Budget Report will be extended to include Houses with Multiple Occupation, residential communal homes and conversions from non-residential properties following Royal Assent.(44)

As announced in the Pre-Budget Report, an adjustment to the zero rate of VAT to provide relief for the sale of renovated houses that have been empty for 10 years or more will be introduced from 1 August 2001. In addition to the capital allowances changes, from Royal Assent the reduced rate of VAT (5 per cent) will be extended to the renovation of dwellings that have been continuously empty for at least three years from Royal Assent.(45, r)

Other indirect taxes

Excise duties

Tobacco duties

The duties on all tobacco products will be increased by 1.8 per cent in line with inflation, typically 5.8 pence on a packet of 20 cigarettes, from 6pm on 7 March 2001.(32)

From 1 July 2001, it will be a criminal offence to transport, sell, offer for sale or allow the use of premises for the sale of tobacco without a 'UK duty paid' pack mark.

Table A.10: Changes to tobacco duties

	Changes in duty (per cent)	Effect of tax[1] on typical item (increase in pence)	Unit
Cigarettes	1.8	5.8	packet of 20
Cigars	1.8	1.9	packet of 5
Hand-rolling tobacco	1.8	5.0	25g
Pipe tobacco	1.8	3.0	25g

[1] *Tax refers to duty plus VAT.*

Alcohol duties

Alcohol duties will be frozen in this Budget.(31)

Dilution of cider

From Royal Assent, the Government will introduce legislation to prohibit the tax avoidance practice of diluting cider after the duty point.(-)

Betting and gaming duties

By 1 January 2002, general betting duty will be replaced with a gross profits tax, calculated using a rate of 15 per cent applied to gross margins, except for spread betting where rates of 3 per cent on financial and 10 per cent on other spread bets will be used.(3)

Additionally, bets placed with brokers or with agents holding bookmakers' permits (except for agents acting on behalf of the TOTE) will be brought within the scope of the new duty system. The on-course exemption for betting at racecourses and greyhound tracks will be retained. The Government will be consulting on whether to retain the on-course exemption for betting at other sports venues or to bring betting at those venues within the scope of the new system.

The gaming duty bands will be uprated on 1 April 2001 in line with inflation.(-)

Modernising indirect taxes

A statutory provision to pay compensatory interest on excise duty that has been wrongly levied or where there is undue delay in the repayment of excise duties will be introduced from a date to be appointed. It will also provide for excise duty to be repaid to persons or businesses incorrectly refused the authority or approval to obtain goods relieved of duty.(-)

The VAT reduced rate legislation (Schedule A1 to the Value Added Tax Act 1994) will be simplified, making it clearer and more consistent with other legislation on VAT reliefs.(-)

Appointment of tax representatives

From 1 January 2002 the power of the UK to require the appointment of a tax representative for Non Established Taxable Person (NETPs) from the EU or other countries with which the UK has similar mutual assistance arrangements to those existing in the EU will be removed.(-)

ADDITIONAL SPENDING DECISIONS

Additions to Departmental Expenditure Limits (DEL)

This Budget provides £2$^1/_3$ billion over the next three years to Departmental Expenditure Limits (DEL) for key public services. These are:

- £1 billion for education, including, in England, £600 million over three years direct funding to head teachers to modernise buildings and equipment and improve pupil attainment and a £200 million fund over three years for recruitment and retention incentives for teachers;
- £1 billion for health including, in England, £450 million over three years for front line hospital investment and a new fund for recruitment and retention incentives for key health service staff;
- £330 million to help tackle drugs, including, in England and Wales, £220 million over three years for Crime and Disorder Partnerships to drive out drug related crime in local communities and resources to support voluntary action against drugs by leaders of the business and sport world; and
- an addition of £60 million to the Capital Modernisation Fund in 2001-02.

AME Margin

This Budget sets the Annually Managed Expenditure (AME) margin to £1 billion in 2001-02, £2 billion in 2002-03 and £3 billion in 2003-04, a reduction of £1.7 billion, £1.6 billion and £1.6 billion respectively since the Pre-Budget Report.

Table A.11: Budget 2001 policy decisions

		(+ve is an Exchequer yield) £ million			
		2001–02 indexed	**2002–03 indexed**	**2003–04 indexed**	**2001–02 non–indexed**
	PBR CONSULTATION MEASURES				
1	Enterprise Management Incentives: expansion	–10	–15	–20	–10

2	Abolition of withholding tax on intra–UK corporate interest	–250	–25	*	–250
3	General betting duty: reform by January 2002	–45	–145	–100	–45
4	Over index aged income allowances by £240 from April 2003	0	0	–120	0
5	Authorised mileage rates	0	–5	–5	0
Fuel duty					
6	Ultra–low sulphur petrol: cut duty by 2p	–445	–470	–465	–445
7	Ultra–low sulphur diesel: cut duty by 3p	–610	–620	–625	–610
8	Abolition of higher rate on higher octane unleaded petrol (including lead replacement petrol)	–85	–80	–65	–85
9	Road fuel gases: cut duty by 6p per kg	*	–5	–5	*
10	Biodiesel: cut duty by 20p from Royal Assent 2002	0	–10	–15	0
Vehicle Excise Duty					
11	Increase threshold for reduced VED rates for private and light goods vehicles tax class to 1549cc from November 2000	–430	–270	–250	–430
12	Introduction of reformed VED system for lorries	–105	–310	–310	–105
13	Abolition of VED for tractors	–15	–15	–15	–15
Total: PBR consultation measures (tax and AME)		**–1,995**	**–1,970**	**–1,995**	**–1,995**
NEW BUDGET MEASURES					
MEETING THE PRODUCTIVITY CHALLENGE					
14	All–employee share ownership plan: stamp duty exemption on purchase of shares from trust	*	*	–5	*
15	EIS/VCTs/CVS: enhancement	–5	–5	–5	–5
16	Films: extension of 100 per cent write–off for production costs	0	*	–50	0
17	Improved flexibility of close company foreign capital gains rules	*	–10	–10	*
INCREASING EMPLOYMENT OPPORTUNITY FOR ALL					
18	Income Tax: over-indexation of starting rate band by £300 from £1,520 to £1,880	–750	–950	–950	–900
19	Income Tax: indexation of basic rate limit	0	0	0	–400
FAIRNESS FOR FAMILIES AND COMMUNITIES					
Supporting families with children					
20	Increase Children's Tax Credit by £1.50 to £10 from April 2001	–230	–310	–310	–230
21	Increase Children's Tax Credit by a further £10 for families in the year of a child's	0	–170	–250	0

birth from April 2002				
22 Increase Working Families' Tax Credit (WFTC) basic credit by £5 from June 2001	–165	–300	–315	–165
23 Increase WFTC childcare tax credit limit from June 2001 to £135 for child care costs for one child and £200 for two or more	–5	–15	–15	–5
24 Increase Income Support and Jobseeker's Allowance child premia by £1.50 from October 2001	–120	–245	–250	–120
Maternity package				
25 Raise flat rate Statutory Maternity Pay and Maternity Allowance to £75 from April 2002 and £100 from April 2003	0	–45	–205	0
26 Extend Statutory Maternity Pay and Maternity Allowance from 18 to 26 weeks from April 2003	0	0	–160	0
27 Small Employer Relief: expand eligibility from April 2002	0	–30	–30	0
28 Increase Sure Start Maternity Grant by £200 from April 2002	0	–40	–40	0
29 Introduce two weeks paid paternity leave from April 2003	0	0	–50	0
30 Introduce paid adoption leave for one parent from April 2003	0	0	–5	0

	(+ve is an Exchequer yield) £ million			
	2001–02 indexed	**2002–03 indexed**	**2003–04 indexed**	**2001–02 non–indexed**
Duties and other tax changes				
31 Alcohol: freeze duties	–90	–90	–90	0
32 Tobacco: revalorise duties	0	0	0	+125
33 Inheritance tax: index threshold	0	0	0	–40
34 VAT: modernising relief on vehicles adapted for people with disabilities	–10	–10	–10	–10
35 VAT: reduced rate on children's car seats	–5	–5	–5	–5
36 VAT: modernising relief for young children's clothing and footwear	–20	–20	–20	–20
37 VAT: refund scheme for national museums and galleries	–10	–15	–15	–10
38 Increase in de minimis limit for business gifts for business taxes and VAT	–15	–15	–15	–15
39 Life insurance policies: policyholder information	*	*	+10	*
40 Controlled foreign companies	0	+20	+20	0
PROTECTING THE ENVIRONMENT				
41 VAT: revalorisation of fuel scale charges	0	0	0	–15
42 Unleaded petrol: cut duty by 2p from 7 March 2001 to 14 June 2001	–15	0	0	–15
Vehicle Excise Duty				
43 Freeze car VED for one year	–85	–85	–85	0
Urban regeneration				
44 VAT: extend scope of reduced rate on conversion of residential dwellings	–25	–35	–35	–25
45 VAT: reduced rate on renovations of homes for 3 or more years	–5	–5	–5	–5
46 Enhanced tax relief for cleaning contaminated sites	–15	–35	–40	–15
Total: new Budget measures (tax and AME)	**–1,570**	**–2,415**	**–2,940**	**–1,875**
Total: Budget measures (tax and AME)	**–3,565**	**–4,385**	**–4,935**	**–3,870**
ADDITIONAL BUDGET POLICY DECISIONS				
Additions to DEL				
Education	–290	–330	–380	
Health	–360	–355	–290	
Fighting crime and drugs	–70	–110	–155	

Carrying forward of DEL underspend	–1,000	0	0
Additions to Capital Modernisation Fund	–60	0	0
Change to AME margin	+1,730	+1,580	+1,610
TOTAL: BUDGET POLICY DECISIONS	**–3,615**	**–3,600**	**–4,150**

* *Negligible*

Table A.12: Other measures announced since Budget 2000

(+ve is an Exchequer yield) £ million

		2001–02 indexed	2002–03 indexed	2003–04 indexed	2001–02 non–indexed
	MEETING THE PRODUCTIVITY CHALLENGE				
a	Extend CGT business asset definition	–5	–5	–10	–5
b	Unapproved share options	+200	–230	–80	+200
c	VAT: indexation of registration and deregistration thresholds	0	0	0	–10
	INCREASING EMPLOYMENT OPPORTUNITY FOR ALL				
d	Income tax: indexation of aged income limit and most allowances	0	0	0	–1,150
E	Indexation of Working Families' Tax Credit (WFTC) and Disabled Person's Tax Credit (DPTC) rates and thresholds	0	0	0	–100
f	Indexation of national insurance limits and freeze of Class 2 rates	–5	–5	–5	–430
	FAIRNESS FOR FAMILIES AND COMMUNITIES				
g	Pensioners' package	–1,610	–2,440	–2,580	–1,790
h	Disability and carers package	–195	–210	–220	–195
i	WFTC and DPTC: enhanced disability credits	–15	–20	–20	–15
j	WFTC and DPTC: increase in disabled child credit	–5	–10	–10	–5
k	Abolition of capital limits for Sure Start Maternity Grant and Funeral Payments	–10	–15	–15	–10
l	Extending £7,000 ISA limit for 5 years to April 2006	–20	–80	–140	–20
	PROTECTING THE ENVIRONMENT				
m	Reform of authorised mileage rates	–40	–40	–40	–40
n	Green travel package	–5	–10	–10	–5
o	One year nominal freeze for all fuel duties from April 2001	–395	–405	–415	0
p	Rebate of lorry VED	–160	0	0	–170
	Urban regeneration package				
q	Stamp duty: exemption for property within disadvantaged communities	–60	–100	–100	–60
r	Tax relief for residential conversions	–50	–80	–80	–50
s	Tax relief for cleaning contaminated sites	–35	–50	–35	–35
	TOTAL	**–2,410**	**–3,700**	**–3,760**	**–3,890**

Note: As required by the Code for Fiscal Stability, the November 2000 Pre–Budget Report economic and fiscal projections were based on and included the impact of all Government decisions and all other circumstances where the impact of these decisions and circumstances could be quantified with reasonable accuracy by the day the projections were finalised.

A
Appendices

APPENDIX A1 : EXPLAINING THE COSTINGS

This appendix explains how the Exchequer effects of the Budget measures are calculated. In the context of these calculations, the net Exchequer effects for measures may include amounts for taxes, national insurance contributions, social security benefits and other charges to the Exchequer and, for Customs and Excise, penalties.

The general approach

The net Exchequer effect of a Budget measure is generally calculated as the difference between applying the pre 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 revenue 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 petrol includes 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 implementation of others, the measures are generally costed in the order in which they appear in Table A.11 and A.12.

The non-indexed base columns in Tables A.11 and A.12 show the revenue effect of changes in allowances, thresholds and rates of duty (including the effect of any measures, such as the increases in the standard rate of landfill tax, previously announced but not yet implemented) from their pre-Budget level. 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 future Budgets.

Where the Government has a pre-announced policy, such as the increases in the standard rate of landfill tax previously announced but not yet implemented, this is also stripped out of the indexed numbers. Measures announced in this Budget are assumed to be indexed in the same way for future Budgets.

The indexed base has been calculated on the assumption that each year fuel, tobacco and alcohol duties and allowances and thresholds, other than VAT, gaming duties and tax credits, rise in line with the projected increase in the RPI over 12 months to the September following the Budget, assuming implementation dates of March for fuel and tobacco and April for alcohol. Tax credits are assumed to rise in line with the Rossi index. The VAT thresholds and all other duties are assumed to rise in line with the RPI increase over the year to the previous December (2.9 per cent in the year to December 2000). Increases in VAT, gaming duty bands and landfill tax are assumed to be implemented in April, amusement machine licence duty in August and air passenger duty in November.

These costings are shown on a National Accounts basis. The National Accounts basis aims to recognise tax when the tax liability accrues irrespective of when the tax is received by the Exchequer. However, some taxes are scored on a receipts basis, principally due to the difficulty in assessing the period to which the tax liability relates. Examples of such taxes are corporation tax, self assessment income tax, inheritance tax and capital gains tax. This approach is consistent with other Government publications.

Notes on Individual Budget Measures

Anti-avoidance measures

The yields represent the estimated direct effect of the measures with the existing level of activity. Without these measures, there could be a significant future loss of revenue currently included in the baseline.

Working Families' Tax Credit

The revenue effects include the consequential changes to the basic credit and childcare tax credit limits within the Disabled Person's Tax Credit. (22,23)

ISA subscription limits

The cost will rise to £275 million by 2006-07. (l)

Income tax bands and allowances

The full year cost of increasing age related allowances is £150 million in 2003-4. (4)

Capital gains business assets taper relief

The cost will rise to £15 million from 2004-05. (a)

Pensioners' package

These costings include the consequential change to income tax and national insurance rebates. (g)

Tax relief for residential conversions

The estimated costs combine the effects of the adjustment to the zero rate of VAT to provide relief for the sale of renovated houses that have been empty for 10 years or more and the introduction of 100 per cent first year capital allowances for creating flats above shops for residential letting. (r)

Films: extension of 100 per cent write off for production costs

The cost is expected to rise to £90 million in 2004-05 and then decline in 2005-06. After that, some companies may pay higher tax because their expenditure will have been relieved in earlier years. (16)

Life insurance: policyholder information

Following this change, policyholders will receive more information on life policy gains, facilitating completion of their tax returns. The estimated yield relates to the consequential improvement in compliance. (40)

VAT relief for national museums and galleries

The £10-15 million cost represents the cost of refunding the VAT currently incurred by those national museums and galleries who offer free admission to the public, together with the lost VAT on the admission charges of those national museums and galleries who move to free admission. (38)

Ultra-low sulphur petrol

This assumes that the announced duty cut encourages the take-up of ultra-low sulphur petrol as a substitute for standard unleaded petrol. (6)

General betting duty

This assumes that the announced reform encourages repatriation of the largest UK bookmakers and expansion of the domestic market. (3)

APPENDIX A2 : TAX CHANGES ANNOUNCED IN BUDGET 2000 OR EARLIER

This appendix sets out a number of tax, national insurance contribution, social security benefit and other changes to the Exchequer which were announced before the Budget, the effects of which are taken into account in the forecasts.

Table A2.1: Measures announced in Budget 2000 or earlier which take effect after this Budget

(+ve is an Exchequer yield) £ million

	2001–02	2002–03	2003–04	2001–02

		indexed	indexed	indexed	non-indexed
	INLAND REVENUE TAXES				
1	Abolition of withholding tax on international bonds and foreign dividends	–400	0	+25	–400
2	Reduction of employer NICs rates by 0.3 percentage points from April 2001	–1,050	–1,100	–1,150	–1,050
3	Reduction of employer NICs rates by 0.1 percentage points from April 2002	0	–370	–380	+0
Employee NICs:					
4	Align lower earnings threshhold with income tax personal allowance in April 2001	–850	–950	–950	–1,200
5	Increase upper earnings limit to £575 in April 2001	+260	+270	+280	+560
6	Introduction of Children's Tax Credit of £8.50 per week from April 2001	–1,300	–1,750	–1.750	–1,300
7	Stakeholder pensions	–600	–1,650	–2,150	–600
8	Extension of WFTC to those receiving maternity pay from April 2001	–40	–70	–90	–40
9	Double taxation relief	+5	+5	–15	+5
10	Car fuel scale charge	+50	+150	+150	+50
11	Enhanced capital allowances for energy saving technologies	–70	–130	–110	–70
12	Company car taxation	0	*	–25	+0
CUSTOMS AND EXCISE TAXES					
13	Climate change levy	+1,000	+1,030	+1,055	+1,000
14	Aggregates levy	0	+380	+385	+0
15	£1 per tonne increase in landfill tax each year	+30	+55	+75	+35
16	Air passenger duty: restructuring	–80	–90	–100	–80
TOTAL		**–3,045**	**–4,220**	**–4,750**	**–2,090**

* Negligible

Inland Revenue taxes

Withholding tax rules for Paying and Collecting Agents of international bonds and foreign dividends will be abolished from April 2001 and instead the Inland Revenue will collect routine information about the savings income of all individuals. (1)

The rate of employer national insurance contributions will be reduced by 0.3 percentage points from April 2001. This will help to ensure that all the revenues from the climate change levy are recycled to business. The revenues from the aggregates levy will be recycled through a further reduction of 0.1 percentage points from April 2002. (2,3)

The level of earnings above which people will pay national insurance contributions will be aligned with the income tax personal allowance. The level of earnings above which employees will pay no further national insurance contributions (the upper earnings limit) will also increase to maintain the earnings base upon which national insurance contributions are paid. (4,5)

A new Children's Tax Credit will be introduced from 6 April 2001 for families with children. A credit of up to £8.50 per week, tapered away from families where one or both of the parties is a higher rate taxpayer was announced in Budget 2000. The increases announced in this Budget are included in Table A.11. (6)

The costs of stakeholder pensions include:

- Income tax relief on contributions to stakeholder pensions including those made by qualifying employees in occupational pension schemes;
- national insurance rebates to stakeholder pensions and tax relief associated with the employees' part of those rebates;
- additional costs from aligning the tax regime for personal pensions with that for stakeholder pensions;
- higher NIC rebates from appropriate personal pensions and stakeholder pensions following the change from SERPS to State Second Pension in April 2002;

The annual cost is expected to reach around £5 billion by 2050 after taking account of the savings on SERPs and contracting out deductions.(7)

Two administrative reforms to the WFTC and DPTC from April 2001 will allow a new claim to be made immediately on the birth of a child to reflect the family's change of circumstances and will enable any mother who works 16 hours or more prior to the birth of a child and who is in receipt of Statutory Maternity Pay or Maternity Allowance to meet the work criteria for WFTC and DPTC. (8)

The revenue effects shown on this table for double taxation changes relate to those changes which come into effect from 31 March 2001.(9)

The Chancellor announced in Budget 98 that scale charges for fuel provided for private motoring in company cars would increase by 20 per cent above revalorisation from 6 April 1998 in each of the following four years. (10)

Businesses will qualify for 100 per cent first year capital allowances on expenditure on designated energy saving technologies following the publication of the 'Energy Technology List' to be issued on 1 April 2001 by the Department of the Environment Transport and the Regions. This change will partially offset the cost to business of the climate change levy. (11)

From April 2002, the tax and Class 1A NICs charge for company cars will be linked to the CO^2 exhaust emissions. The cost of this measure will rise to £75 million in 2004-05. (12)

Customs and Excise taxes

As announced in Budget 99, the Government is to introduce a climate change levy on energy use by business with effect from 1 April 2001. The products subject to the levy are electricity (0.43p/kWh), gas (0.15p/kWh), liquified petroleum gas (0.96p/kg) and solid fuels (1.17p/kg). (13)

A levy on the commercial exploitation of aggregates in the UK will be introduced on 1 April 2002. The levy will be charged at a rate of £1.60 per tonne. (14)

The standard rate of landfill tax will be increased from £11 per tonne to £12 per tonne with effect from 1 April 2001, in line with the Government's commitment to increase the rate by
£1 per tonne each year until at least April 2004. (15)

As announced in Budget 2000, from 1 April 2001, the duty on economy flights within the European Economic Area (EEA) will be reduced from £10 to £5. In addition, all flights to the Scottish Highlands and Islands will be exempt from duty. The duty on economy flights and other destinations will remain at £20. The rate for club and first class fares for destinations in the EEA will remain at £10, but will rise from £20 to £40 for other destinations. The return leg exemption for flights within the UK will be abolished from April 2001. (16)

APPENDIX A3: TAX ALLOWANCES AND RELIEFS

This appendix provides estimates of the revenue cost of some of the main tax allowances and reliefs.

Tax reliefs can serve a number of purposes. In some cases they may be used to assist or encourage particular individuals, activities or products. They may thus be an alternative to public expenditure. In this case they are often termed "tax expenditures". There may, for instance, be a choice between giving tax relief as an allowance or deduction against tax, or by an offsetting cash payment.

Many allowances and reliefs can reasonably be regarded (or partly regarded) as an integral part of the tax structure - called "structural reliefs". Some do no more than recognise the expense incurred in obtaining income. Others reflect a more general concept of "taxable capacity": the personal allowances are a good example. To the extent that income tax is based on ability to pay, it does not seek to collect tax from those with the smallest incomes. But even with structural reliefs of the latter kind, the Government has some discretion about the level at which they are set.

Many other reliefs combine both structural and discretionary components. Capital allowances, for example, provide relief for depreciation at a commercial rate as well as an element of accelerated relief. It is the latter element which represents additional help provided to business by the Government and is a "tax expenditure".

The loss of revenue associated with tax reliefs and allowances cannot be directly observed, and estimates have to be made. This involves calculating the amount of tax that individuals or firms would have had to pay if there were no exemptions or deductions for certain categories of income or expenditure, and comparing it with the actual amount of tax due. The Government regularly publishes estimates of tax expenditures and reliefs for both Customs and Excise and Inland Revenue taxes. Largely because of the difficulties of estimation, the published tables are not comprehensive but do cover the major reliefs and allowances.

The estimates in Table A3.1 below show the total cost of each relief. The classification of reliefs as tax expenditures, structural reliefs and those elements combining both is broad brush and the distinction between the expenditures and structural reliefs is not always straightforward. In many cases the estimated costs are extremely tentative and based on simplifying assumptions. The figures make no allowance for the fact that changes in tax reliefs may cause people to change their behaviour. This means that figures in table A3.1 are not directly comparable with those of the main Budget measures.

Estimation of behavioural effects is notoriously difficult. The sizes of behavioural change will obviously depend on the measure examined and possible alternative behaviours. For example, removing the tax privileges of one form of saving may just lead people to switch to another tax privileged form of saving.

Table A3.1 also gives details of reliefs relating to VAT, which is collected by Customs and Excise. It shows the estimated yield forgone by not applying the standard rate of VAT
(17.5 per cent) to goods and services which are currently zero-rated, reduced-rated, exempt or outside the scope of VAT. Estimates of the scale of structural reliefs for local authorities and equivalent bodies are also shown. Again, the figures are estimates and must be treated with caution. In line with the treatment of Inland Revenue taxes, they make no allowance for changes in behaviour.

The estimated costs of reliefs and allowances given in Table A3.1 cannot be added up to give a meaningful total. The combined yield of withdrawing two related allowances could differ significantly from the sum of individual costs. Similarly the sum of the costs of component parts of reliefs may differ from the total shown.

More details on individual allowances and reliefs can be found in the HM Treasury publication "*Tax Ready Reckoner and Tax Reliefs*", November 2000.

Table A3.1: Estimated costs of principal tax expenditure and structural reliefs

<u>TAX EXPENDITURES</u>

	£ million	
	Estimated cost for	
	1999–00	**2000–01**
Income Tax		
Relief for:		
Approved pension schemes	11,500	12,400
Approved profit sharing schemes	190	200
New all-employee share ownership plan	0	80
Approved discretionary share option schemes	100	60
Approved savings-related share option schemes	420	410
Personal Equity Plans	1,000	950
Individual Savings Accounts	120	450
Venture Capital Trusts	100	190
Enterprise Investment Scheme	110	130
Profit related pay	900	130

Vocational training	55	50
Exemption of:		
First £30,000 of payments on terminatin of employment	1,100	1,100
Interest on National Savings Certificates including index-linked certificates	180	200
Tax Exempt Special Savings Account interest	375	400
Premium Bond prizes	90	130
SAYE	90	60
Income of charities	925	950
Foreign service allowance paid to Crown servants abroad	100	100
First £8,000 of reimbursed relocation packages provided by employers	300	300
Tax Credits:		
Life assurance premiums (for contracts made prior to 14 March 1984)	110	100
Mortgage interest and life annuities interest	1,600	70
Working Families' Tax Credit	1,010	4,600
Disabled Person's Tax Credit	20	100
Capital gains tax		
Exemption of gains arising on disposal of only or main residence	3,100	3,400
Retirement relief	210	170
Inheritance tax		
Relief for:		
Agricultural property	90	90
Business property	110	110
Exemption of transfers to charities on death	310	320
Value Added Tax		
Zero-rating of:		
Food	8,200	8,150
Construction of new dwellings (includes refunds to DIY builders)	2,700	2,900
Domestic passenger transport	1,550	1,600

Table A3.1: Estimated costs of principal tax expenditure and structural reliefs

	£ million	
	Estimated cost for	
	1999–2000	**2000–2001**
International passenger transport	200	200
Books, newpapers and magazines	1,450	1,500
Children's clothing	1,000	1,050
Water and sewerage services	1,000	1,000
Drugs and supplies on prescription	600	650
Supplies to charities	150	200
Ships and aircraft above a certain size	350	400
Vehicles and other supplies to disabled people	250	250
Lower rate on domestic fuel and power	1,600	1,550

<u>**STRUCTURAL RELIEFS**</u>

Income tax

Personal allowance	32,500	32,100
Income tax and corporation tax		
Double taxation relief	6,000	6,000
Corporation tax		
Reduced rate of corporation tax on policy holders' fraction of profit	450	400
National insurance contributions		
Contracted-out rebates occupational schemes:		
Occupational schemes deducted from national insurance contributions received	5,890	6,310
Occupational schemes (COMPS) paid by the Contributions Agency direct to scheme	110	120
Personal pensions	2,390	2,570
Value Added Tax		
Refunds to:		
Local authorities and Northern Ireland government of VAT incurred on non-business purchases	3,700	3,900
The BBC and ITN of VAT incurred on non-business purchases	250	250
Central Government, Health Authorities and NHS Trusts on contracted-out services and projects under private finance initiative	1,850	1,950

RELIEFS WITH TAX EXPENDITURE AND STRUCTURAL COMPONENTS

Income Tax		
Married couple's allowance	1,900	0
Age-related allowances	1,400	1,700
Additional personal allowance	160	0
Relief for maintenance payments	70	5
Exemption of:		
British government securities where owner not ordinarily resident in the United Kingdom	850	850
Child benefit (including one parent benefit)	830	880
Long-term incapacity benefit	200	140
Industrial disablement benefits	80	80
Attendance allowance	220	220
Disability living allowance	390	410
War disablement benefits	90	80
War widow's pension	60	60
Income tax and corporation tax		
Capital allowance of which:	17,900	18,700

Table A3.1: Estimated costs of principal tax expenditure and structural reliefs

	£ million	
	Estimated cost for	
	1999–2000	**2000–2001**
Temporary first year allowances for SMEs	300	170
B>Corporation tax		
Small companies' reduced corporation tax rate	1,700	1,800

Starting rate of corporation tax	0	150
Capital gains tax		
Indexation allowance and rebasing to March 1982	500	400
Taper relief	130	320
Exemption of:		
Annual exempt amount (half of the individual's exemption for trustees)	2,000	1,500
Gains accrued but unrealised at death	1,100	1,100
Petroleum revenue tax		
Uplift on qualifying expenditure	200	300
Relief for exploration and appraisal expenditure	30	50
Oil allowance	300	600
Safeguard: a protection for return on capital cost	300	250
Tariff receipts allowance	70	100
Exemption for gas sold to British Gas under pre-July 1975 contracts	140	170
Inheritance tax		
Nil rate band for chargeable transfers not exceeding the threshold	5,600	5,900
Exemption of transfers on death to surviving spouses	1,100	1,200
Stamp Duties		
Exemption of transfers of land and property where the considerations do not exceed the threshold	240	200
National insurance contributions		
Reduced contributions for self-employed not attributable to reduced benefit eligibility	2,400	2,300
Value Added Tax		
Exemption of:		
Rent on domestic dwellings	2,850	3,000
Rent payable by exempt businesses on commercial property	450	500
Private education	350	350
Health services	500	500
Postal services	400	400
Burial and cremation	100	100
Finance and insurance	100	100
Betting and gaming and lottery	750	750
Small traders	100	100

[1] The contents of the brackets after each measure in this chapter refer to the line in Tables A.11 and A.12 where its yield or cost is shown. The symbol "–" means that the proposal has no Exchequer effect. "*" means that the effect is negligible, amounting to less than £3 million a year.

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B

The Economy

The Government's pursuit of economic stability has delivered the most favourable combination of low interest rates, low inflation and low unemployment since the 1960s. The challenge ahead lies in securing further progress towards full employment and closing the productivity gap, leading to stronger sustained growth in living standards for all:

* **The Government's policy frameworks helped to secure continued strong economic performance in 2000. GDP growth rose to 3 per cent, RPIX inflation averaged just over 2 per cent and unemployment fell to its lowest levels since the 1970s.**
* **GDP growth is still expected to ease back to its assumed trend rate of $2\frac{1}{4}$ to $2\frac{3}{4}$ per cent in 2001 and later years. The impact of weaker than previously expected global demand is likely to be offset by stronger momentum in domestic spending in the shorter term.**
* **But with economic stability and strong employment gains already secured, the UK economy is now well placed to achieve a much stronger productivity performance. This would lay the foundation for GDP growth at or beyond the upper ends of the Budget forecast ranges.**
* **The UK economy is now enjoying its longest period of sustained low inflation since the 1960s, helping to keep interest rates at historically low levels. RPIX inflation is forecast to rise gradually back to $2\frac{1}{2}$ per cent by spring 2002.**
* **The economic outlook has become more uncertain since the Pre-Budget Report, in particular reflecting risks to US growth. But with sound public finances and low inflation, policy is well placed to respond to adverse news.**

Introduction[1,2]

B1 This chapter sets out the economic background to Budget 2001, providing updated forecasts for the UK and world economies over the next three years. The overview section provides a summary of the UK outlook in the light of developments since the November 2000 Pre-Budget Report, and in particular the recent slowdown in the US economy. Global prospects are summarised at the end of this chapter, preceded by a more detailed discussion of UK forecast issues and risks.

UK ECONOMY OVERVIEW

Table B1: Summary of forecast

		Forecast		
	2000	**2001**	**2002**	**2003**
GDP growth (per cent)	3	$2^1/_4$ to $2^3/_4$	$2^1/_4$ to $2^3/_4$	$2^1/_4$ to $2^3/_4$
RPIX inflation (per cent, Q4)	2	2	$2^1/_2$	$2^1/_2$

Recent developments

B2 2000 was a successful year for the UK economy. GDP growth increased to 3 per cent, in line with the Government's forecasts, and significantly above its post-war average of around $2^1/_2$ per cent. Strong growth in domestic demand more than accounted for the expansion, driven by a 3.6 per cent rise in household consumption, still well above trend rates. As had been expected, business investment decelerated significantly in 2000 following rapid growth over previous years, though it gathered pace in the second half. Whole economy fixed capital formation was supported by an estimated 5 per cent increase in general government investment.

B3 Buoyant external demand lifted total export volume growth to nearly $7^1/_2$ per cent in 2000, and goods volumes rose at their fastest rate since 1973. Manufacturing output growth of 1.6 per cent therefore was the highest since 1994, albeit still lagging the stronger expansion in services, but variation in performance within the sector remains marked. This contributed to a better net trade performance compared to the previous two years, though still robust growth in import volumes meant that net exports reduced GDP growth by 0.9 percentrage points in 2000. The current account deficit overall showed signs of stabilising at around $1^1/_2$ per cent of GDP.

B4 Further gains in the employment rate have driven unemployment to its lowest level since the 1970s, ending 2000 at 5.3 per cent on the International Labour Organisation (ILO) measure and just 3.5 per cent on a claimant count basis. Nevertheless, productivity growth rose to an estimated $2^1/_4$ per cent for the year as a whole, a considerable improvement over previous years. Despite labour market tightening and evidence of skills shortages, growth in average earnings and unit wage costs remain within sustainable limits. RPIX inflation was just 2.1 per cent in 2000, the lowest annual average since 1963, notwithstanding the sharp rise in oil prices during the course of the year.

B5 The main news since the Pre-Budget Report has been the significant slacking in global economic growth during the second half of 2000. This was driven by a sharper than anticipated slowdown in the US, with growth falling from 1.4 per cent in the second quarter of 2000 to just 0.3 per cent in the fourth quarter. Consumer and business sentiment weakened sharply, financial conditions tightened and the manufacturing sector began to contract. In response, the Federal Reserve cut interest rates by 100 basis points in January. Growth in Europe has eased far more modestly, with consumer demand remaining firm. The mild recovery in Japan appears to be losing momentum, and countries in emerging Asia have slowed markedly.

B6 UK growth also slowed during the second half of 2000, though the latest GDP growth estimate probably understates the continued underlying strength of demand in the UK goods and labour markets. GDP rose by just 0.3 per cent in the fourth quarter of 2000, down from 1.0 per cent and 0.8 per cent in the second and third quarters respectively. However, an erratic fall in oil and gas output had a significant impact, reducing fourth quarter GDP growth by 0.2 percentage points. Poor autumn weather and disruption to the rail network may also have affected the growth profile.

B7Excluding oil and gas output, GDP growth was much closer to trend in the fourth quarter of 2000, in line with the Pre-Budget Report forecast. This was also reflected in still buoyant growth in final domestic demand, which rose by 0.7 per cent. Household consumption growth eased to 0.7 per cent though, following revisions to earlier quarters, it now shows little sign of an underlying slowing during the course of 2000. Strong growth in retail sales volumes and a recovery in car registrations during the fourth quarter tell a similar story. Consumer confidence remains at high levels and the saving ratio has declined further.

B8Still buoyant growth in household spending was reinforced by growth in general government consumption during the second half of 2000. Total business investment growth also picked up significantly, driven by services, but with manufacturing investment remaining subdued, despite improved sentiment recorded in business surveys. Goods export volume growth has remained robust, despite slacker external demand, but services volumes fell markedly in the fourth quarter. Import volume growth has been rather weaker than expected, surprisingly so from EU countries, with net trade making a modest positive contribution to growth in the fourth quarter.

The labour market

B9Latest official data indicate that the working-age employment rate has recently flattened out at a historically high level, having stayed close to 74.6 per cent since last spring. But with population rising strongly, Labour Force Survey (LFS) employment increased by a further 225 thousand during the course of 2000, contributing to a total rise of more than one million since spring 1997[3]. Modest falls in employment recorded in the autumn probably reflected temporary factors. Severe weather and transport disruption may have led to one-off dislocations in labour supply: fewer temporary employees more than accounted for the dip in total employment, and LFS employment in the fourth quarter was little changed on its third quarter record high.

Chart B1: LFS employment, unemployment and participation

B10 Moreover, business surveys provide little evidence of any stalling in employment growth. The Chartered Institute of Purchasing and Supply (CIPS) whole economy employment index has remained close to levels last seen in mid-1998. This mainly reflects buoyant service sector readings, though the manufacturing index has edged up close to the level consistent with employment bottoming out. Forward-looking survey measures of employment intentions also signal buoyant labour demand, backed by still high levels of new notified vacancies and record readings for the Recruitment and Employment Confederation index of press recruitment advertising. Ratios of new and total unfilled vacancies to unemployment remain close to record highs, and survey evidence of recruitment difficulties is still widespread.

B11ILO unemployment has flattened somewhat since summer 2000, and currently stands at just over $1^1/_2$ million, or 5.3 per cent. Labour market turning points are typically signalled by an increased rate of job loss. However, at around seven people in every thousand in autumn 2000, the redundancy rate remained at a low level and is little changed on a year earlier. This compares to a peak of well over ten per thousand in the early 1990s. Similarly, the flattening in claimant unemployment last autumn largely reflected a decline in people leaving the count, with inflows into unemployment showing a gradual downward trend in 2000. Subsequent substantial falls in claimant unemployment in December and January have driven the rate to just 3.5 per cent, its lowest since 1975.

B12 Wage pressures have increased moderately since the Pre-Budget Report. Headline earnings growth was 4.4 per cent in the three months to December, around $^1/_2$ percentage point above its trough in summer 2000, though still well down on its 6 per cent millennium peak. Monthly data show that overall earnings growth in December was boosted by renewed positive contributions from bonus payments. But underlying earnings (excluding bonuses) growth has also moved just above $4^1/_2$ per cent, and settlements have been edging up too. Nevertheless, with the step up in productivity growth to well over 2 per cent since late 1999, unit wage cost growth has come down. It is estimated to have remained below $2^1/_2$ per cent in the fourth quarter of 2000, despite the erratic dip in output growth. Manufacturing productivity growth picked up to 4.8 per cent in the fourth quarter, and unit wage cost growth turned negative again after a year of modest growth.

B13 The National Minimum Wage (NMW) of £3.60 per hour for employees aged 22 years and over was introduced in April 1999, and increased to £3.70 in October 2000. Before introducing a NMW the Government carefully considered its wider impact, and ensured that it was set at a prudent and sensible level. To date there is little or no evidence of any adverse effects on employment or inflationary pressures. The Government has announced that the adult rate will be increased to £4.10 from October 2001, and £4.20 from October 2002. Compared with the introductory adult NMW of £3.60, the increase to £4.10 might boost total wage costs by under $^1/_4$ per cent, and the further increase in October 2002 is in line with expected inflation.

Trend output growth

B14 Sustainable output growth in the late 1990s has been driven by a substantial rise in the employment rate to just below the 75 per cent figure recorded in 1990. But then it reflected a strong cyclical peak in the output cycle, and labour cost pressures rose significantly. By contrast, wage and price inflation have remained relatively subdued in recent years, signalling improved underlying labour market performance. This has taken most commentators by surprise, and consensus forecasts for employment and unemployment have typically proved too pessimistic. Box B1 looks at the unexpected strength of employment growth in more detail.

Box B1: Why has employment growth been so strong?

Between spring 1997 and the fourth quarter of 2000 ILO unemployment has fallen by 520 thousand, with the rate down from 7.2 per cent to 5.3 per cent. Moreover, as set out in the Pre-Budget Report, this fall is judged to have been mainly structural rather than cyclical, given the surprisingly subdued trend in wage inflation. In other words, the sustainable or non-accelerating inflation rate of unemployment (NAIRU) has come down sharply, providing an important supply-side boost for the UK economy by raising available labour supply, despite the relatively weak upward trend in aggregate labour market participation.

Among various factors contributing to a lower NAIRU, significant reductions in long-term unemployment are thought to have played a key role. More effective job search has helped to contain pay pressures at lower aggregate levels of unemployment. Numbers unemployed for more than 12 months (ILO basis) have nearly halved since spring 1997, a fall of 380 thousand in total, compared to a 11 per cent reduction in shorter-term unemployment. This is likely to reflect the culmination of a succession of labour market programmes, including the impact of the New Deal. Enhanced product market competition and greater economic stability, by anchoring inflation expectations, are also likely to have helped to moderate wage pressures.

Box B1: LFS employment and total hours worked

Labour market adjustment to supply-side changes is typically fairly sluggish, meaning that actual unemployment can deviate from its sustainable level for long periods. This reflects costs of adjustment for both firms and workers. However, LFS employment has risen by well over a million since spring 1997, and the working-age employment rate has risen from 72.9 per cent to 74.6 per cent, and across all age groups. This rapid absorption of increased labour supply into employment suggests that employer demand-side factors have also been more conducive to employment growth in recent years.

An examination of trends in heads and hours-based measures of labour provides part of the explanation. LFS total hours worked have risen at an annual average 0.7 per cent since the second quarter of 1997, compared to 1.1 per cent a year growth in numbers employed. Hence falling average hours appear to have boosted demand for workers, accounting for around one third of the increase in LFS employment. The modestly rising share of part-time employment within the total accounts for only a small part of the reduction in average hours overall. Rather, a fall in full-time average hours has been the main driver, and this is likely to have been a trend rather than cyclical effect.

Greater economic stability provides one possible explanation for relatively rapid growth in heads-based measures of labour demand. Uncertainty about prospects encourages firms to increase labour demand through rising hours and temporary employment. Conversely, economic stability lowers firms' perceived risk of incurring hiring and firing costs and so encourages them to take on permanent employees and reduce overtime. Indeed, the proportion of temporary employees within total employment has fallen markedly against a previously rising trend, from 6.7 per cent in spring 1997 to 6 per cent currently. By contrast, the share of temporary employees increased significantly in the earlier 1990s, accounting for around one third of employment gains between spring 1993 and spring 1997. At the same time, overtime hours and involuntary part-time working have also declined in recent years, and increased job security has probably been a key factor supporting high levels of consumer confidence.

Thus against the background of fundamental supply-side improvements pushing down the NAIRU, the impact of greater economic stability in boosting demand for workers may be another important factor in explaining the buoyancy of employment growth since 1997.

B15 A formal analysis of trend output growth was set out in the Pre-Budget Report[4]. The non-accelerating inflation rate of unemployment (NAIRU) appears to have fallen broadly in line with actual unemployment over recent years, to around $5^1/_2$ per cent on the ILO definition. This has underpinned estimated trend output growth of just over $2^1/_2$ per cent a year since the first half of 1997. Rising employment probably also largely explains temporarily subdued productivity growth over the same period, given the evidence that those entering work tend to have lower than average productivity levels. Underlying productivity performance is estimated to have been only just below the long-run average growth rate of around 2 per cent a year.

B16 Looking ahead, the mid-points of the Budget 2001 forecast ranges are again anchored on the neutral assumption of $2^1/_2$ per cent a year trend output growth, whereas projections for the public finances (Chapter C) continue to be based on the deliberately cautious $2^1/_4$ per cent assumption. However, a number of respected independent organisations explicitly adopt a more favourable central view. In particular, it is argued that the UK is now well placed to achieve a significantly stronger productivity performance than the neutral 2 per cent assumption underlying the economic forecast. This might partly reflect a period of 'catch-up', with businesses striving to secure further productivity improvements in order to restore profitability, and also to avoid excess wage pressures in a tight labour market. Such factors would encourage a gradual rebalancing from employment to productivity-led growth, as seen over the past year.

B17 Moreover, there are good grounds for anticipating a more fundamental improvement in productivity. There has been growing support for the view that 'capital deepening' through Information and communications technologies (ICT) investment and related diffusion of know-how has contributed to the acceleration in US trend productivity since the mid-1990s. The UK's ICT spending record appears broadly comparable to the US, with investment estimated to have risen by around 30 per cent a year in real terms in the late 1990s[5]. Moreover, a Department of Trade and Industry study[6] shows that the UK fares well internationally in terms of firms' computer usage, internet access, and provision of ICT training. But while the evidence suggests that UK firms are well placed at least partly to emulate US performance, the Budget 2001 forecast makes only a small allowance for upside productivity potential within the upper limits of the forecast ranges.

B18 The upper ends of the forecast ranges also make only a very modest allowance for the possibility of further employment rate increases, beyond the modest 0.1 per cent a year figure built in to the neutral trend growth assumption. Here the scope for doing better is highlighted by continued dispersion in regional and local labour market performance, despite the significant narrowing already achieved. As set out in chapters 2, 3 and 4 of the EFSR, Government policies to extend employment opportunity and close the productivity gap, backed by the continued delivery of economic stability, will play their part in raising the trend rate of growth.

Output and demand

B19 There are no compelling reasons to change the judgement that the economy is currently operating just above potential. Assuming trend growth of just over 2$^1/_2$ per cent through to end-2000, latest data imply an output gap of just over $^1/_2$ per cent in the fourth quarter of 2000, much as expected in the Pre-Budget Report. Although underlying earnings growth has edged up slightly, most measures of domestic inflation remain subdued and some survey indicators of capacity utilisation have recently eased. Thus there is a case for a slightly stronger estimate of trend growth since 1997, and hence a somewhat smaller estimate of the current output gap. However, a longer run of supporting evidence would be needed fully to justify such a judgement.

Chart B2: The output gap

B20 While overall growth prospects are little changed since the Pre-Budget Report, recent developments suggest that the short-run composition of demand is likely to be different. US import growth dried up late in 2000 and the short-term outlook for US growth has deteriorated significantly (see Box B3). With the US market accounting for less than one fifth of UK exports, direct impacts on UK growth are unlikely to be very large. However, taking account of implications for third countries, UK export market growth is now forecast to slow more sharply than previously expected during the course of 2001, falling to 6 per cent for the year as a whole, down from 11$^1/_4$ per cent in 2000.

B21 Though improved business survey indicators signalled robust export demand early in 2001, weaker world demand is now expected to drive a significant slowing in export volume growth during the course of the year. The full impact is likely to be only partly offset by sterling's depreciation: the exchange rate index has fallen by around 5 per cent since its peak in October 2000. Export volumes are now forecast to grow by 5$^1/_2$ to 5$^3/_4$ per cent in 2001 and 4$^3/_4$ to 5$^1/_4$ per cent in 2002, though this masks an expected pick-up in both export markets and sales during the course of 2002. Net exports are now expected to subtract 1 percentage point from GDP growth in 2001 and 2002, both $^1/_2$ percentage point weaker than the Pre-Budget Report forecast.

B22 The weaker global outlook may also impact on domestic spending. Company earnings on the UK's substantial equity and direct investments in the US are likely to fall, and prospects for future output growth have become more uncertain. Such factors could restrain business investment growth in the UK, though underlying profitability has improved and survey investment intentions are generally buoyant. Moreover, domestic confidence has shown little reaction to US developments. The Confederation of British Industry (CBI) business optimism indicator rose to long-run levels in January and consumer confidence, particularly in their own financial situation, remains historically high. Sentiment should be buoyed by the Monetary Policy Committee's (MPC) pre-emptive cut in interest rates in February.

Chart B3: Gross Domestic Product (GDP)

B23 Indeed continued momentum in domestic demand is expected fully to offset weaker trade prospects. Consumer spending in particular has continued to exceed expectations, rising at an annualised rate of over 3$^1/_2$ per cent in the second half of 2000. It is now forecast to grow by 3$^1/_4$ to 3$^1/_2$ per cent in 2001, easing only modestly from 2000, and about 1 percentage point stronger than expected in November. Buoyant consumer demand is expected to be reinforced by the planned increase in government spending and some pick-up in business investment. Rapid growth in final demand may be partly met by de-stocking given strong inventory accumulation in mid-2000. Domestic demand overall is therefore forecast to rise by 3$^1/_4$ to 3$^1/_2$ per cent this year, $^1/_2$ percentage point above the Pre-Budget Report forecast, underpinning an unchanged GDP growth forecast of 2$^1/_4$ to 2$^3/_4$ per cent in 2001.

B24 Increased indebtedness is expected to encourage households to rebuild saving beyond 2001, and so the unexplained element in recent consumer spending strength is assumed to dissipate. Household consumption growth is therefore forecast to fall back to $2^1/_4$ to $2^3/_4$ per cent by 2003, bringing it much closer into line with key determinants, including an easing in real income growth back to longer-run rates in 2002 and diminished wealth effects. Growth in government spending is also planned to ease beyond 2001–02, and so domestic demand growth overall is forecast to fall back gradually to $2^3/_4$ to $3^1/_4$ per cent in 2002 and $2^1/_4$ to $2^3/_4$ per cent in 2003. The contribution of net trade to GDP growth is forecast to strengthen gradually over the same period, as import volume growth eases to trend rates and export demand recovers. GDP growth overall therefore is expected to remain around its estimated trend rate of $2^1/_4$ to $2^3/_4$ per cent in 2002 and 2003.

B25 Downside risks to the outlook have clearly sharpened since November, mainly reflecting the possibility of a harder landing for the US economy. This would imply further weakening in demand for UK exports, though possibly partly offset by adjustments in world exchange rates. Adverse global news might also temporarily depress UK business and consumer confidence. Nevertheless, private sector financial imbalances remain moderate both compared to the past, and to current US experience. Overall balance sheet health also suggests that adjustment in private demand should be fairly gradual, and provides some cushion against adverse external events (see Box B2). But private sector financial health is clearly susceptible to further falls in share prices, despite the substantial adjustment in high technology stocks that has already occurred.

B26 The economic forecast makes no allowance for the economic effects of the current outbreak of Foot and Mouth Disease. Whereas this has potentially serious implications for the livestock farming and related sectors of the economy, on any reasonable assumptions about the duration and direct and knock-on effects of the outbreak, there is unlikely to be a discernible impact on aggregate GDP growth.

Inflation

B27 The UK economy is witnessing the longest period of sustained low inflation since the 1960s and, on the HICP measure, UK inflation since the end of 1999 has been the lowest in the EU. RPIX inflation modestly undershot the Government's inflation target throughout 2000, averaging just over 2 per cent for the year as a whole. Direct upward pressures on petrol pump prices as a result of dearer oil were more than offset by further deflation in other goods sectors and, within services, significant cuts in utility prices in the spring. With oil prices falling from their autumn 2000 peak, RPIX inflation has edged down since the Pre-Budget Report, reaching just 1.8 per cent in January. This is lower than expected in November, though sharp changes in petrol prices have contributed to volatility in the monthly outturns.

B28 The rise in oil prices to more than \$30 per barrel in September 2000 provided the main inflationary impulse last year. Direct impacts on petrol and domestic heating prices added around 0.6 per cent to RPIX inflation during the year, and headline producer input and output price inflation also trended higher until the autumn. However, core output price inflation was much more subdued, remaining at around 1 per cent for much of the year. With non-oil import prices also rising gradually during 2000, this indicates a further compression of producer margins helping to contain domestic inflationary pressures.

B29 The significant deceleration in unit wage costs provides the clearest evidence that domestic price pressures have moderated. Unit wage cost growth fell below 2 per cent from mid-2000, reflecting both the slowing in average earnings growth since spring and also the significant pick-up in productivity growth. While shorter-term movements in productivity can be misleading, the recent trend in domestic cost growth suggests that still buoyant expansion in domestic demand can be accommodated for a period. Against this, beyond a sharp fall in insurance price inflation, there has been only very tentative evidence of a more general moderation in core services inflation.

B30 This highlights the protracted, but uneven, impact of sterling's strength on margins across the various sectors of the UK economy. RPIX goods inflation outturns have benefited not only from a further compression of producer margins, but also a continued squeeze at the retail level. Inflation in some sectors, including household goods and clothing and footwear, has reached 40-year lows. By contrast, the service sector is relatively sheltered from competitive forces associated with the level of sterling, and profitability is likely to have risen as headline earnings growth fell back. Latest evidence suggests that the underlying pace of retail goods deflation may be easing, helped by the recent recovery of the euro. An increasing balance of retailers expect to raise prices in the period ahead, according to the CBI Distributive Trades Survey.

Chart B4: RPIX

B31 As in November, oil prices are assumed to remain around the mid-point of the OPEC target range of \$22-\$28 a barrel, implying that their direct contribution to inflation will turn negative from spring 2001. Nevertheless, RPIX inflation is expected to rise gradually back to its $2^1/_2$ per cent target by spring 2002, reflecting upward pressure from non-oil import prices and a declining negative contribution from changes in margins. Wage inflation has edged up recently, and domestic costs may exert further upward pressure on inflation before the output gap closes. Compared to the Pre-Budget Report forecast, the more prolonged expected undershoot of the Government's inflation target mainly reflects both a lower starting point for the projection and a smaller contribution from indirect taxes. Budget 2001 excise duty measures, compared to revalorisation of rates, are expected to lower RPIX inflation by around 0.3 percentage points between July 2001 and March 2002, and by marginally less up to July.

B32GDP deflator inflation averaged 1.8 per cent in 2000, down from 2.3 per cent in 1999. The fall reflected a smaller positive contribution from the terms of trade coupled with a sharp drop in consumers' expenditure deflator (CED) inflation to its lowest level since 1959. CED inflation is now more than 1 percentage point below RPIX inflation, mainly reflecting coverage differences. CED inflation is expected to move gradually back in line with RPIX inflation through 2001, pushing up overall GDP deflator inflation to 2$^1/_4$ per cent in 2001 and 2$^1/_2$ per cent thereafter.

Independent forecasts

B33 The independent consensus for GDP growth in both 2001 and 2002 is 2.6 per cent, little changed since autumn, and very close to the mid-points of the Budget 2001 forecast ranges. New independent forecasts for GDP growth released in February were slightly weaker on average, possibly reflecting the latest global developments, though moderate UK growth in the fourth quarter of 2000 will have been a factor. Independent forecasts show the balance of payments current account deficit stabilizing at around 1$^3/_4$ per cent of GDP in 2001 and 2002. These deficits are smaller than in the Budget 2001 forecast though, as always, there exists a very wide range of views around the independent average.

Table B2: Budget and independent[1] forecasts

Percentage changes on a year earlier unless otherwise stated

	2001			2002		
		Independent			Independent	
	March Budget	**Average**	**Range**	**March Budget**	**Average**	**Range**
Gross domestic product	2$^1/_4$ to 2$^3/_4$	2.6	1.5 to 3.2	2$^1/_4$ to 2$^3/_4$	2.6	0.7 to 3.6
RPIX (Q4)	2	2.2	1.3 to 2.6	2$^1/_2$	2.4	1.4 to 3.2
Current account (£ billion)	–21$^3/_4$	–17.7	–26.0 to –4.9	–25$^1/_4$	–17.6	–37.9 to –8.0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts', February 2001.*

UK FORECAST IN DETAIL

The household sector

B35 With revised data now showing annualised growth in household consumption stuck at 3$^1/_2$ to 4 per cent during much of 2000, clear signs of a slowing to more sustainable rates are now hard to discern. Available evidence suggests that the 0.7 per cent expansion in consumption in the fourth quarter of 2000 was driven by further robust services and retail goods spending. However, much more rapid growth in the durables category is also notable, particularly given the temporary weakness in spending on vehicles. Durables are typically the most cyclical element of household consumption, and so any deceleration in spending might have been expected to show most clearly in this area. Consistent with this, housing market indicators have shown some firming in prices and expected turnover since the Pre-Budget Report.

Box B2: Private sector financial position

Households and private non-financial companies (PNFCs) have both moved into overall financial deficit in recent years (chart a), driven mainly by lower household saving and increased PNFC capital spending. The desire to contain net borrowing has clearly helped to restrain company spending recently, and business investment has decelerated significantly despite buoyant output growth and signs of improved profitability. A key feature of the Budget 2001 forecast is that household spending behaviour follows suit, with a gradual recovery in the saving ratio helping to

return consumption growth to sustainable rates by 2002.

There is, however, a risk of sharper or deeper adjustment in domestic spending. In the shorter term, events in the US could act as the catalyst given direct financial market and investment linkages, as well as the possibility of a more general loss of confidence. Past experience suggests that this risk may hinge on several factors. Not surprisingly, the overall scale of financial imbalances is crucial. However, the speed of any adjustment is also likely to depend on the private sector's overall balance sheet position. Monetary policy may also be important.

Despite the deterioration over recent years, the UK private sector and current account deficits remain modest by US standards, and still well below late 1980s levels. Relatively restrained investment in housing assets in particular has helped to contain household net borrowing, despite the sharp fall in the saving ratio. Company investment has been stronger, but saving has held up, keeping PNFC net borrowing well below its end-1980s' peak.

Most important, the burden of interest payments is now decisively lower (chart b). Because the economy is fairly close to trend, there seems little prospect of higher interest rates driving income gearing to the levels that caused severe financial distress in the early 1990s. It also implies greater scope for monetary policy manoeuvre in the event of any general weakening in prospects.

Although the household sector debt-income ratio has risen to record levels in recent years, this has been more than matched, and probably encouraged, by rapid gains in wealth (chart c). Strong growth in financial wealth in particular has pushed the ratio of total household wealth to income to record levels, though such gains are likely to have been skewed towards the top end of the income distribution. Similarly, company worth has risen sharply, meaning that PNFC capital gearing (the ratio of debt to share capital) at market valuations is relatively benign (chart d), despite large increases in debt. This may also mask significant distributional variation; debt burdens and capital gearing is likely to be much higher within sectors undergoing rapid technological change, notably telecommunications.

Private balance sheet strength seems likely to encourage a gradual, as opposed to sharp, reduction in future borrowing and also provides some cushion against adverse news. But any failure of demand to adjust would raise the risk of a more serious retrenchment in the medium term. Moreover, with private debt at high levels, overall financial health remains susceptible to asset valuations, notwithstanding the recent modest decline in share prices. In the event of a much sharper fall in equities, households and firms would probably want to reduce their debt burden. So particularly in the company sector, where debt as a proportion of the capital stock at purchasers' prices is now very high, any re-assessment of future income prospects could have a significant impact on spending and therefore the short-term economic outlook.

Box B2: Chart 1

Box B2: Chart 2

Box B2: Chart 3

Box B2: Chart 4

B36 It is difficult to account for the pace of consumption growth over recent years in terms of long-run determinants such as real incomes, wealth and interest rates. A significant slowing in household consumption might have been expected during the course of 2000, as earlier monetary policy tightening took effect and support to spending from past gains in household wealth dissipated. Continued robust spending could reflect a range of factors. For example, Bank of England analysis shows that only a small part of the increase in official interest rates during the second half of 1999 was passed on to consumers. Increased job security resulting from reductions in involuntary part-time and temporary working may also have played a part in boosting consumer confidence (Box B1). However, the failure of economic models to account for the strength of the recent consumer cycle is not unusual in an historical context. In particular, the timing of turning points in consumer borrowing is very hard to predict.

B37 Unexpected strength in consumer spending has been mirrored in a significant decline in the household saving ratio. Greater job security and low inflation may have permanently reduced longer-term precautionary motives for saving, and net household borrowing is estimated to be around $1^1/_2$ per cent of GDP in 2000. However, the Budget 2001 forecast assumes that households will wish to curtail borrowing beyond 2001, notwithstanding the recent reduction in official interest rates. Household consumption growth therefore is expected to fall back from $3^1/_4$ to $3^1/_2$ per cent in 2001 to $2^1/_4$ to $2^3/_4$ per cent by 2003, more clearly in line with key determinants, including slower real income growth and more moderate gains in wealth. Any further significant deterioration in household financial balances would heighten the risk of a sharper adjustment in spending in later years (Box B2).

Table B3: Household sector[1] expenditure and income

	Percentage changes on previous year			
		Forecast		
	2000	2001	2002	2003
Household consumption[2]	3 3/4	3 1/4 to 3 1/2	2 1/2 to 3	2 1/4 to 2 3/4
Real household disposable income	2 1/4	4 1/4 to 4 1/2	2 1/2 to 3	2 1/2 to 3
Saving ratio (level, per cent)	3 3/4	4 3/4	5	5 1/4

[1] *Including non-profit institutions serving households.*

[2] *At constant prices.*

Companies and investment

B38 Business investment growth fell back to 2.1 per cent in 2000, closely in line with the Budget 2000 and Pre-Budget Report forecasts. The ratio of business investment to GDP at constant prices ended the year at 14.5 per cent, a new record high, buoyed by continued falls in the price of ICT capital goods. This has contributed to a marked increase in PNFC borrowing since the mid-1990s, reaching 2 per cent of GDP in 1999 though easing somewhat in 2000. Although historically low average interest rates have kept income gearing at low levels, a desire to contain the deterioration in company finances probably goes a long way towards explaining the recent slowing in investment growth. Moreover, the underlying trend may have been exaggerated by a bunching of expenditures in the run-up to the millennium. The profile of business investment during 2000 supports this, with quarterly growth rising above 3 per cent in the fourth quarter following a much weaker first half of the year.

Chart B5: Business and non-residential investment ratios

B39 Increased corporate indebtedness is expected to prevent further rapid growth in business investment in the period ahead, notwithstanding evidence of improved company profitability. The PNFC gross operating surplus stepped up markedly in 2000, though buoyed by the sharp improvement in North-Sea profits. Underlying pressures also look to have eased as still robust output growth drove a significant upturn in productivity, and export prices began to rise, now assisted by the stronger euro. The British Chambers of Commerce (BCC) measures of profit expectations have risen above their long-run averages, and manufacturing investment intentions have recovered well above the levels that foreshadowed weak spending since 1999. Still buoyant service sector intentions are harder to interpret. The BCC measure failed to pick up the earlier deceleration in services investment, perhaps reflecting a significantly uneven distribution of spending within the sector.

Table B4: Gross fixed capital formation

	Percentage changes on previous year			
		Forecast		
	2000	2001	2002	2003
Whole economy[1]	2 1/4	5 1/2 to 5 3/4	3 to 3 1/2	3 1/2 to 4
of which:				
Business[2,3]	2	2 1/2 to 3	2 1/4 to 2 3/4	2 1/2 to 3
Private dwellings[3]	2 3/4	1/4 to 3/4	2 to 2 1/2	2 to 2 1/2
General government[3,4]	5	43 1/2	8 1/2	11 3/4

[1] *Includes costs associated with the transfer of ownership of land and existing buildings.*

[2] *Private sector and public corporations' (except National Health Service Trusts) non-residential investment. Includes*

investment under the Private Finance Initiative.

[3] *Excludes purchases less sales of land and existing buildings*.

[4] *Includes National Health Service Trusts*.

B40 Business investment growth is forecast to rise to $2\frac{1}{2}$ to 3 per cent in 2001, remaining around this rate in later years. Business investment as a proportion of GDP is therefore expected to remain very close to its recent record high, leading to persistent, though narrowing, company financial deficits. Overall company balance sheet health suggests that these deficits should be readily financeable, preventing any sharp retrenchment in capital spending (Box B2). However, PNFC net worth and capital gearing remain susceptible to market valuations of company assets, notwithstanding recent falls in equity prices. So private investment spending is vulnerable to downward revisions to earnings expectations, particularly in the more highly geared technology sectors, which have spent heavily in recent years. Total fixed investment will be boosted by much sharper increases in general government investment, averaging around 20 per cent a year over the next three years.

Trade and the balance of payments

B41 The trade in goods and services deficit in 2000 rose much more modestly than in the previous two years, to 2 per cent of GDP. Greater stability in the trade deficit mainly reflected much stronger growth in export volumes. Rapid growth in UK export markets lifted growth in non-oil goods volumes to 11 per cent - the strongest since 1973 – but services export volumes fell by 2 per cent, probably partly reflecting weaker financial markets. Import volumes were slightly weaker than expected in the second half of 2000, but rose by nearly 9 per cent during the year as a whole. The resulting significant deterioration in the real trade balance was partly offset by an improvement in the terms of trade. The current account deficit is now estimated at 1.5 per cent of GDP in 2000, as expected in the Pre-Budget Report.

B42 Movements in the overall trade deficit have masked divergent trends against European Union (EU) and non-EU countries. Trade with the EU moved close to balance during the second half of 2000, contrasting with a continued widening of the deficit with non-EU countries. The UK's position as a net oil exporter to the EU has benefited from relatively high spot prices, boosting oil revenues from the EU by more than £3 billion in 2000. But rising oil prices have the opposite effect on non-EU trade, where the UK typically runs a deficit on oil. Moreover, while total export volumes to both areas have grown strongly, there have been stark differences in import trends: imports from non-EU countries rose more than three times faster than imports from the EU in 2000.

Chart B6: Balance of payments current account

B43 Weaker than expected global demand is expected to drive a renewed widening in the trade deficit over the next two years. Export volume growth is forecast to fall back more sharply than anticipated in November, troughing at $4\frac{3}{4}$ to $5\frac{1}{4}$ per cent in 2002, in line with lower expected export market growth. Exporters' share in UK export markets is assumed to remain broadly constant. This more than explains the larger trade in goods and services deficit, now forecast at $3\frac{1}{4}$ per cent of GDP in 2002. Import volume growth is now expected to ease more gradually to trend, given stronger than previously anticipated domestic demand. But the trade balance effect is offset by lower import price inflation in 2001, partly reflecting the impact of weaker global demand on commodity prices. The current account deficit is expected to rise to $2\frac{1}{2}$ per cent of GDP in 2002, $\frac{3}{4}$ percentage point larger than forecast in November, partly reflecting a slightly weaker investment income surplus. But the UK's net overseas asset position is strong, and so investment income should pick up with stronger global growth, particularly in the US, helping the current account deficit to narrow in 2003.

Table B5: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices[1]			
	Exports	**Imports**	**Exports**	**Imports**	**Terms of trade[2]**	**Goods and services balance**
2000	$7\frac{1}{2}$	$8\frac{3}{4}$	$1\frac{1}{2}$	1	$\frac{1}{2}$	$-18\frac{1}{2}$
Forecast						

2001	$5\frac{1}{2}$ to $5\frac{3}{4}$	$7\frac{1}{2}$ to $7\frac{3}{4}$	$1\frac{1}{4}$	$1\frac{3}{4}$	$-\frac{1}{2}$	$-26\frac{3}{4}$
2002	$4\frac{3}{4}$ to $5\frac{1}{4}$	$6\frac{1}{4}$ to $6\frac{3}{4}$	$3\frac{3}{4}$	$3\frac{3}{4}$	0	$-33\frac{3}{4}$
2003	$5\frac{1}{2}$ to 6	$5\frac{1}{2}$ to 6	3	3	0	$-36\frac{3}{4}$

[1] *Average value indices.*

[2] *Ratio of export to import prices.*

B44 Risks to US and global growth mean that overall trade prospects are very uncertain. The US accounts directly for over 15 per cent of UK exports, with booming US import growth in 2000 contributing to the first bilateral goods surplus since 1988. While this implies a small direct weight in UK GDP, third country impacts, including global equity price and confidence effects, will tend to magnify the overall impact on UK demand. Moreover, the UK's significant direct and equity investment in the US generates substantial overseas earnings. Reciprocal flows from the US provide an important support to UK business, though any weakening might be partly offset by other foreign investors diverting funds to more attractive non-US markets. As discussed in Box B3, a 1 percentage point reduction in US growth is estimated to lower growth in UK export markets by 1 percentage point or more, equivalent to a drag on UK GDP growth of more than $\frac{1}{4}$ percentage point.

Table B6: Summary of economic prospects[1]

	Percentage changes on a year earlier unless otherwise stated					
	Forecast[2]				Average errors from past forecasts[3]	
	2000	**2001**	**2002**	**2003**	**2001**	**2002**
Output at constant market prices						
Gross domestic product (GDP)	3	$2\frac{1}{4}$ to $2\frac{3}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$\frac{1}{2}$	$\frac{3}{4}$
Manufacturing output	$1\frac{1}{2}$	$1\frac{3}{4}$ to 2	$1\frac{1}{2}$ to 2	$1\frac{1}{2}$ to 2	$\frac{3}{4}$	$2\frac{1}{4}$
Expenditure components of GDP at constant market prices[4]						
Domestic demand	$3\frac{3}{4}$	$3\frac{1}{4}$ to $3\frac{1}{2}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$\frac{1}{2}$	$1\frac{1}{4}$
Household consumption[5]	$3\frac{3}{4}$	$3\frac{1}{4}$ to $3\frac{1}{2}$	$2\frac{1}{2}$ to 3	$2\frac{1}{4}$ to $2\frac{3}{4}$	$\frac{1}{2}$	$1\frac{1}{4}$
General government consumption	$2\frac{1}{2}$	$4\frac{1}{4}$	$3\frac{1}{4}$	3	1	$1\frac{1}{4}$
Fixed investment	$2\frac{1}{4}$	$5\frac{1}{2}$ to $5\frac{3}{4}$	3 to $3\frac{1}{2}$	$3\frac{1}{2}$ to 4	$1\frac{1}{2}$	$2\frac{1}{4}$
Change in inventories[6]	$\frac{1}{2}$	$-\frac{1}{2}$	$\frac{1}{4}$	$-\frac{1}{4}$	$\frac{1}{4}$	$\frac{1}{2}$
Export of goods and services	$7\frac{1}{2}$	$5\frac{1}{2}$ to $5\frac{3}{4}$	$4\frac{3}{4}$ to $5\frac{1}{4}$	$5\frac{1}{2}$ to 6	$1\frac{3}{4}$	$2\frac{1}{2}$
Imports of goods and services	$8\frac{3}{4}$	$7\frac{1}{2}$ to $7\frac{3}{4}$	$6\frac{1}{4}$ to $6\frac{3}{4}$	$5\frac{1}{2}$ to 6	2	3
Balance of payments current account						
£ billion	–14	$-21\frac{3}{4}$	$-25\frac{1}{4}$	–25	7	9
per cent of GDP	$-1\frac{1}{2}$	$-2\frac{1}{4}$	$-2\frac{1}{2}$	$-2\frac{1}{4}$	$\frac{3}{4}$	$\frac{3}{4}$
Inflation						

RPIX (Q4)	2	2	2½	2½	½	½
Producer output prices (Q4)[7]	1¾	1¾	2	2	½	1¾
GDP deflator at market prices	1¾	2¼	2½	2½	¾	1
Money GDP at market prices						
£ billion	935	978 to 982	1025 to 1033	1073 to 1086	8	12
percentage change	5	4¾ to 5	4¾ to 5¼	4¾ to 5¼	¾	1¼

[1] *The forecast is consistent with output, income and expenditure data to the fourth quarter of 2000, released by the Office for National Statistics on 23rd February 2001. See also footnote 1 on the first page of this chapter.*

[2] *The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

[3] *Average absolute errors for year-ahead projections made in spring forecasts over the past ten years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2001 and 2002.*

[4] *Further detail on the expenditure components of GDP is given in Table B7.*

[5] *Includes households and non-profit institutions serving households.*

[6] *Contribution to GDP growth, percentage points.*

[7] *Excluding excise duties.*

Table B7: Gross domestic product and its components

THE WORLD ECONOMY

Overview

B45 After a year of rapid expansion in 2000, global activity looks set to ease this year, led by a sharp slowdown in the US economy and renewed weakness in Japan. Inflation concerns should fade and world trade growth is likely to fall back quite sharply. G7 growth is slowing more rapidly than expected at the time of the Pre-Budget Report, which will depress activity in other regions. Emerging Asia is already experiencing a significant slowdown, exacerbated by the global weakness in electronics markets. Oil exporters face moderating prices, and countries with close trade links with the US will see weaker exports. Europe could prove relatively insulated, as trade links are comparatively modest and domestic demand remains robust.

Table B8: The world economy

		Percentage change on a year earlier		
		Forecast		
	2000[1]	2001	2002	2003
Major 7 countries[2]				
Real GDP	4	2	2 1/2	2 1/2
Consumer price inflation[3]	2 1/2	2 1/4	2 1/4	2 1/4
World trade in goods and services	11 3/4	6 3/4	6 1/2	6 3/4
UK export markets[4]	11 1/4	6	5 1/4	5 3/4

[1] *Estimates, except consumer price inflation.*

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

[3] *Final quarter of each period. For UK, RPIX.*

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

G7 activity

B46G7 growth has been weaker than expected since the Pre-Budget Report, reflecting the marked US slowdown in the fourth quarter of 2000 and downward revisions to GDP estimates in Japan. This weakness looks set to persist into the first half of 2001. G7 GDP growth for the year as a whole is now forecast at 2 per cent, revised down from 3 per cent in November. However, the European economies should continue to grow at healthy rates and the US slowdown is expected to be short-lived. So, even though Japan's prospects for a self-sustaining recovery have faded, G7 growth is projected to pick up to 2 1/2 per cent in 2002 and 2003.

B47 Falling stock prices, higher energy prices, tightening conditions in private credit markets, and declining confidence have all contributed to slower US growth. The Federal Reserve responded quickly, cutting the Federal Funds rate by 100 basis points in January. But the economy will remain weak in the first half of 2001 and unemployment is likely to rise. After that, there is great uncertainty about the outlook. Most analysts expect the economy to recover in the second half of 2001 as monetary policy loosening, improving confidence, moderating oil prices and prospective fiscal easing take effect. However, there are clear risks of a much sharper adjustment in private spending (see Box B3). The Budget forecast assumes that US GDP growth returns gradually to its potential rate by 2003.

Box B3: The US economy - outlook and risks

Since 1997 the US economy has expanded at over 4 per cent a year, and labour productivity growth has accelerated, helped by a surge in the capital equipment and software available for each worker. But demand has increased even more quickly than the economy's ability to supply goods and services. The rapid pace of expansion needed to slacken and, as expected, the economy began to slow last summer. However, falling exports and weak business investment contributed to a much sharper than anticipated slowdown in the final quarter of last year, with growth falling to just 1.1 per cent at an annualised rate. Recent data point to near zero growth in the first quarter of this year.

In response to the rapid slowdown, the US Federal Reserve cut official interest rates by a total of 100 basis points during January, and financial markets expect further cuts in the near future. Since then, investor and consumer confidence has weakened further, raising fears of a more prolonged downturn. The outlook is uncertain. Most analysts expect the economy to recover in the second half of this year, as looser monetary policy, moderating oil prices and continuing strong underlying productivity growth combine to boost activity. The economy is expected to return to healthy growth in 2002.

There are, however, significant downside risks that could increase both the depth and the duration of the downturn.

The large imbalances in the economy, including a current account deficit of around 4 1/2 per cent of GDP, a negative personal savings ratio and a record level of household debt as a share of disposable income, could unwind rapidly, reinforcing the slowdown that is already in place.

The decline in corporate profits has already led to a sharp cutback in investment. However, consumption has continued to grow, and provided ongoing stimulus to the economy. The risk is that consumer confidence will continue to fall, prompting an abrupt decline in consumption. In addition, consumers may rein in their spending, as wealth gains no longer offset the negative savings ratio. With lower growth prospects, investors may be unwilling to finance the current account deficit, leading to a sharp correction in the dollar. On the supply side, if much of the recent productivity gains prove to be cyclical this could lead to heightened inflationary pressures, which would require a more prolonged period of lower growth to bring the economy back to its potential output level.

A deeper and more prolonged downturn in the US would affect the rest of the world through trade and financial market links, and spillovers to confidence. It is difficult to quantify the effects of a US slowdown on the rest of the world, because they depend on how policy and financial markets would respond. Nevertheless, estimates informed by world macroeconomic model simulations suggest that a temporary reduction in US growth of 1 percentage point, assuming a moderate fall in equity prices, might reduce UK export market growth by the order of 1 percentage point or more.

B48 In Japan, near-term economic prospects have deteriorated. Business confidence has peaked, and equity prices have fallen further from low levels, causing renewed strains in the banking sector. Private consumption remains weak and industrial production is depressed by the downturn in the global electronics market. With ongoing restructuring and a weaker external environment, it now seems that Japan's economy will slow in 2001, and the outlook remains uncertain.

B49 As expected in the Pre-Budget Report, growth in the euro area remains healthy. Firm consumer and business confidence, some fiscal stimulus and weaker oil prices are all expected to support economic growth in 2001. Together with strong growth in Canada, this should provide support to the world economy during 2001. However, in both areas the weaker external environment is likely to dampen activity somewhat beyond 2001, and economic growth is expected to fall back towards trend in later years.

The developing countries

B50 After a robust performance during much of 2000, growth in developing countries has begun to moderate. The Asian economies are slowing markedly. Equity prices have fallen significantly over the past year, and market confidence remains weak. The slow pace of corporate and financial restructuring is undercutting recovery in several countries. However, with the exception of Indonesia and the Philippines, the region is now much less vulnerable to financing crises.

B51 Growth in Latin America should moderate this year, as countries dependent on either the US or oil begin to slow. Large current account deficits and refinancing needs make the region vulnerable to a pronounced global slowdown and any increase in investor risk aversion. However, global monetary easing should provide scope to lower interest rates and reduce debt-servicing costs for countries such as Argentina. Prospects in Eastern Europe remain good, as healthy growth continues in the euro area and Russia continues to benefit from buoyant oil prices.

Chart B7: G7 GDP and world trade

World trade

B52 World trade grew by $11^3/_4$ per cent in 2000. This partly reflected cyclical strength in world economic activity but also the surge in industrial production in the 1997–98 crisis-hit economies, as inventories were rebuilt. World trade growth is expected to fall back significantly, due to weaker global activity, and in particular a sharp slowing in US import volume growth from $13^3/_4$ per cent in 2000. World trade growth is expected to slow sharply to $6^3/_4$ per cent in 2001, and $6^1/_2$ per cent in 2002.

B53UK export markets grew by $11^1/_4$ per cent in 2000, driven by buoyant US and European imports. These effects are expected to fade, as the US slows significantly and the European expansion eases. Weaker import growth in emerging Asia will also play a part, so that the UK's export market growth is expected to fall back to 6 per cent this year and $5^1/_4$ per cent in 2002.

G7 inflation

B54 High oil prices lifted headline inflation in 2000 in the major economies other than Japan, and there was some acceleration in the rate of growth of the prices of intermediate inputs. However, core inflation – which excludes energy and food prices – remained low. Concerns about inflationary pressures in 2001 have faded as growth prospects have weakened, world oil prices have eased, and wage growth has remained moderate. The US cut short-term interest rates by 100 basis points in January, and interest rate expectations in the US and the euro area have declined. G7 inflation is expected to fall from $2^1/_2$ per cent in 2000, to $2^1/_4$ per cent in 2001 and 2002.

Chart B8: G7 consumer price inflation (CPI) and oil prices

Oil and commodity prices

B55 Commodity prices pose little risk to global inflation in 2001. Oil prices have fallen back from their autumn peaks, and non-oil commodity prices remain subdued. Increasing supply and high stock levels are projected to keep agricultural prices in check, while metals and minerals prices are expected to grow moderately in line with global economic growth.

[1] The forecast is consistent with output, income and expenditure data to the fourth quarter of 2000 released by the Office for National Statistics (ONS) on 23 February 2001. This release also contained revisions to earlier quarters of 2000 which the Treasury has carried through to certain other national accounts series that the ONS has not yet revised, in particular sectoral saving and net borrowing. A fully consistent national accounts dataset for 2000 will be published by ONS on 26 March. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk), and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

[2] The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

[3] The LFS has not yet been re-grossed to new (higher) population estimates post-1998, and the published LFS data quoted in this chapter will in due course be subject to revision.

[4]See Annex A of the ***Pre-Budget Report***, HM Treasury, November 2000 and especially Table A2, page 147. This table decomposes trend output growth during the 1990s into estimated contributions from growth in trend labour productivity and the employment rate. It also set out the Government's $2^1/^2$ per cent a year neutral assessment of the outlook for trend output growth.

[5]Treasury estimate based on input-output tables for the period 1995–98.

[6]***Business in the Information Age: International Benchmarking Study 2000***, UK Online for Business, Department of Trade and Industry, October 2000.

C

The Public Finances

The latest projections of the public finances show that the underlying position remains strong. Recent fiscal outturns have been better than expected, largely reflecting non-discretionary, structural changes, which feed through into future years. This enables substantial new resources to be released to the Government's priority areas, while still locking in the tough fiscal stance set out in Budget 2000 and the Pre-Budget Report. As a result of a continuing commitment to stability and prudence, the Government remains on track to meet its fiscal rules:

* **the current budget surplus is estimated to be £23 billion (nearly 21/2 per cent of GDP) in 2000–01. The surplus is projected to be around 13/4 per cent of GDP in 2001–02, 11/2 per cent of GDP in 2002–03 and about 3/4 per cent of GDP thereafter. In each year the current surplus is at least as high as in the Pre-Budget Report.**
* **public sector net debt, which was 44 per cent of GDP at the end of 1996–97, is projected to fall to 31.8 per cent of GDP by the end of 2000-01, and to fall further to under 30 per cent in 2002–03 and to remain at around 30 per cent of GDP after March 2003. Net debt in every year is lower than in the Pre-Budget Report projections, by about 1/2 per cent of GDP.**

Cyclically-adjusted public sector net borrowing is estimated to be a repayment of 1.4 per cent of GDP in 2000–01. A repayment of 0.3 per cent of GDP is projected for 2001–02. Modest deficits are projected from 2002–03, reflecting the rapid growth in public investment. These deficits are at the same levels as in the Pre-Budget Report and are consistent with the sustainable investment rule.

INTRODUCTION

C1Chapter 2 describes the Government's fiscal framework, including the two strict fiscal rules, and shows how the projections of the public finances are consistent with meeting these rules. This chapter explains in more detail the Government's performance against the fiscal rules. It includes:

- five year ahead projections of the current budget surplus and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule respectively;
- projections of public sector net borrowing, the fiscal aggregate relevant to assessing the impact of fiscal policy on the economy;
- consistent projections of the cyclically-adjusted fiscal balances; and
- detailed analyses of the outlook for government receipts and expenditure.

MEETING THE FISCAL RULES

C2The Government remains firmly on track to meet the fiscal rules throughout the next five years. Table C1 compares the latest estimates for the current year and projections up to 2005–06 of the main fiscal balances with those in the Pre-Budget Report and Budget 2000. The projected current budget surplus has increased by a further £6$^{.5}$ billion since the Pre-Budget Report in 2000–01, and by £1 billion in 2001–02. There have been similar improvements to public sector net borrowing in 2000–01 and 2001–02, and the latest projections for both the current surplus and net borrowing are the same or better in the subsequent four years as they were in the Pre-Budget Report. The fiscal stance including Budget measures is at least as tight as set out in the Pre-Budget Report, which was itself at least as tight as in Budget 2000.

Table C1: Fiscal balances comparison with Budget 2000 and PBR 2000[1]

	Outturn[2]	Estimate[3]	Projections				
	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06
Fiscal balances (£ billion)							
Surplus on current budget							
Budget 2000	17.1	14	16	13	8	8	
PBR 2000	19.4	16.6	16	14	8	8	8
Budget 2001	**19.2**	**23.1**	**17**	**15**	**8**	**9**	**9**
Net borrowing							
Budget 2000	–11.9	–6	–5	3	11	13	
PBR 2000	–16.4	–10.1	–6	1	10	12	13
Budget 2001	**–16.0**	**–16.4**	**–6**	**1**	**10**	**11**	**12**
Cyclically-adjusted budget balances (per cent of GDP)							
Surplus on current budget – Budget 2000	1.8	1.3	1.3	1.0	0.7	0.7	
Surplus on current budget – PBR 2000	1.9	1.5	1.4	1.1	0.6	0.7	0.7
Surplus on current budget – Budget 2001	**1.9**	**2.1**	**1.4**	**1.1**	**0.6**	**0.7**	**0.7**
Net borrowing – Budget 2000	–1.2	–0.5	–0.3	0.5	1.1	1.1	
Net borrowing – PBR 2000	–1.6	–0.8	–0.3	0.3	1.1	1.1	1.1
Net borrowing – Budget 2001	**–1.6**	**–1.4**	**–0.3**	**0.3**	**1.1**	**1.1**	**1.1**

1 *Excluding windfall tax receipts and associated spending*.

2 *The 1999–2000 figures were estimates in Budget 2000*.

3 *The 2000–01 figures were projections in Budget 2000 and PBR 2000*.

C3Table C2 shows the latest outturns for the key fiscal aggregates and other important measures of the public finances, including net borrowing and net worth, together with estimates for the current year and projections up to 2005–06.

C4The current budget balance has improved from a deficit of 3 per cent of GDP in 1996–97 to a surplus of over 2 per cent of GDP in 1999–2000. The surplus is estimated to have risen further to nearly $2\frac{1}{2}$ per cent of GDP in 2000–01. Current budget surpluses of around $1\frac{1}{2}$ to $1\frac{3}{4}$ per cent of GDP are projected over the next two years. Thereafter, surpluses are projected to fall to around $\frac{3}{4}$ per cent of GDP from 2003–04. Consistent with the need to maintain a cautious approach, this profile shows that the Government is well on track to meet the golden rule over the projection period, with the average surplus on the current budget from 1999–2000 projected to be at least $1\frac{1}{2}$ per cent of GDP throughout the next five years.

C5Net borrowing is equal to net investment minus the surplus on the current budget. Public sector net investment is projected to be a little under $\frac{3}{4}$ per cent of GDP in 2000–01, implying a surplus on net borrowing of around $1\frac{3}{4}$ per cent of GDP. The ratio of net investment to GDP is projected to more than double to $1\frac{3}{4}$ per cent of GDP by 2003–04. The rapid growth of net investment results in declining surpluses of net borrowing over the next two years and, in conjunction with the effect of slower economic growth and the measures announced in the Pre-Budget Report and in this Budget, modest deficits over the remainder of the period.

Table C2: Summary of public sector finances1

	Per cent of GDP							
	Outturns	**Estimate**				**Projections**		
	1998–99	**1999–00**	**2000–01**	**2001–02**	**2002–03**	**2003–04**	**2004–05**	**2005–06**
Fairness and prudence								
Surplus on current budget	0.8	2.1	2.4	1.7	1.4	0.8	0.8	0.8
Average surplus since 1999–2000		2.1	2.3	2.1	1.9	1.7	1.5	1.4
Cyclically-adjusted surplus on current budget	0.5	1.9	2.1	1.4	1.1	0.6	0.7	0.7
Long-term sustainability								
Public sector net debt[2]	39.7	36.8	31.8	30.3	29.6	29.7	29.9	30.0
Net worth[2]	12.2	17.4	18.8	21.3	21.6	21.4	21.0	20.4
Primary balance	3.3	4.2	4.0	2.5	1.7	0.8	0.7	0.6
Economic impact								
Net investment[2]	0.5	0.4	0.8	1.1	1.5	1.7	1.8	1.8

Public sector net borrowing (PSNB)	–0.3	–1.8	–1.7	–0.6	0.1	0.9	1.0	1.0
Cyclically-adjusted PSNB	0.0	–1.6	–1.4	–0.3	0.3	1.1	1.1	1.1
Financing								
Central government net cash requirement[2]	–0.5	–1.0	–3.5	0.0	0.5	1.5	1.4	1.4
European commitments								
Treaty deficit[3]	–0.7	–1.7	–1.7	–0.5	0.1	0.9	0.9	1.0
Treaty debt ratio[4]	46.8	43.7	40.6	37.6	36.1	35.7	35.6	35.6
Memo: Output gap	0.4	0.2	0.6	0.5	0.3	0.2	0.1	0.0

[1] *Excluding windfall tax receipts and associated spending.*

[2] *Including windfall tax receipts and associated spending.*

[3] *General government net borrowing. The Treaty definition includes windfall tax receipts and associated spending.*

[4] *General government gross debt.*

C6Updated estimates of the cyclically-adjusted current budget and net borrowing as a per cent of GDP are also shown in Table C2. These allow underlying, or structural trends in the indicators to be seen more clearly, after the estimated effects of the economic cycle are removed.

C7The cyclically-adjusted current balance has moved from a deficit of over 2 per cent of GDP in 1996–97 to a similar sized surplus in 2000–01. With the economy projected to be slightly above trend, the cyclically-adjusted current budget surpluses are a little smaller than the unadjusted projections.

C8There has been a corresponding improvement in cyclically-adjusted net borrowing, which is used to measure the fiscal stance. From a deficit of 3 per cent of GDP in 1996–97, cyclically-adjusted net borrowing is estimated to have moved into balance in 1998–99, and to a surplus of around $1^1/_2$ per cent of GDP in 1999–2000 and 2000–01. Modest deficits are projected from 2002–03 onwards, as the share of public sector net investment in GDP rises.

C9The primary balance is equal to net borrowing excluding net debt interest payments – thus abstracting from the implications of past fiscal deficits. If real interest rates exceed trend GDP growth, a primary surplus is required to stabilise the net debt ratio. The primary balance has swung from a deficit of $^1/_2$ per cent of GDP in 1996–97 to an estimated surplus of 4 per cent of GDP in 2000–01. Although the surplus is projected to decline to $^1/_2$ per cent of GDP in 2005–06 it remains positive throughout the projection period. The continued surplus provides further evidence that, even though there are modest deficits in net borrowing from 2003–04 attributable to increases in net investment, the sustainable investment rule is not at risk.

C10 The central government net cash requirement was a repayment of 1 per cent of GDP in 1999–2000. The repayment in 2000–01 is expected to be $3^1/_2$ per cent of GDP, largely reflecting the receipts from the auction of licences to access the electromagnetic spectrum. The net cash requirement moves into deficit from 2001–02 onwards, reflecting the profile of public sector net borrowing.

Chart C1: Public sector net debt and net worth

C11 The approximate stock counterpart to the net cash requirement is public sector net debt, the key indicator for assessing performance against the sustainable investment rule. The large net cash repayment estimated for 2000–01 leads to a substantial fall in the debt – GDP ratio, from 36.8 per cent in March 2000 to 31.8 per cent in March 2001. Even though the net cash requirement moves into deficit from 2001–02, the deficits are small and the debt – GDP ratio continues to fall slightly before flattening out in 2003–04, at around 30 per cent of GDP. The latest projections of the net debt ratio are about $^1/_2$ per cent of GDP lower than those in the Pre-Budget Report throughout the projection period.

C12 The approximate stock counterpart to the current budget balance is public sector net worth. Current budget surpluses of over 2 per cent of GDP a year have begun to raise net worth since 1998. This follows a prolonged period in which the poor state of the public finances led to it falling to around 12 per cent of GDP. At present, net worth is not used as a key indicator of the public finances due mainly to the difficulties in measuring accurately many government assets and liabilities.

Chart C2: Cyclically-adjusted surplus on current budget

Forecast errors and risks

C13 The fiscal balances, which represent the difference between two large aggregates of spending and receipts, are inevitably subject to wide margins of forecast error. Over the past five years, the average absolute error (ie: the average error irrespective of whether the errors have been positive or negative) for one-year ahead forecasts of net borrowing has been 1 per cent of GDP, or plus or minus £9$^1/_2$ billion at 2000–01 prices. The error tends to grow as the forecast horizon lengthens. About half of this error arises from errors in the forecasts of GDP.

C14 Short-term forecasts of the public finances are critically dependent on the path of the economy, as most tax revenues and some public expenditure (notably social security) vary directly with the economic cycle. If GDP growth were 1 per cent higher or lower than assumed from 2003–04 onwards, net borrowing might be lower or higher by 0.5 per cent of GDP in the first year (equivalent to about £5 billion) and lower or higher by a further 0.2 per cent (£2 billion) in the second year. The estimates for years prior to 2003–04 are slightly different as they are affected by recent changes to the corporation tax payment system, which are being phased in over a number of years. Under the previous tax regime the first year estimate was 0.4 and the second year estimate 0.3 per cent of GDP.

C15 Errors in short-term growth forecasts may have only a *temporary* effect on the public finances. For a given path of trend output, higher or lower growth in the short-term will be followed by lower or higher growth later on, and the public finances may be little affected on average over the cycle. However, errors in estimating the cyclical position of the economy in relation to its trend – the output gap – will have a *permanent* effect.

C16 It is for this reason that even though the fiscal projections are based on prudent and cautious assumptions (see paragraphs C17 to C19), Chart C2 shows a still more cautious case to illustrate the effect of uncertainty over the cyclical position of the economy. This cautious case assumes a larger output gap such that the level of trend output is assumed to be 1 per cent lower than in the central projection above. This scenario would imply that a greater proportion of the projected surplus on current budget was due to cyclical strength of the economy: a 1 per cent larger output gap reduces the structural surplus on current budget by about $^3/_4$ per cent of GDP a year. Nonetheless, even under this scenario, the cyclically-adjusted current budget is projected to be comfortably in surplus in 2000–01 and 2001–02 and broadly in balance or in surplus thereafter. Even on this more cautious basis the Government remains on track to meet the golden rule over the economic cycle.

ASSUMPTIONS

C17 The fiscal projections assume:

- the economy follows the path described in Chapter B. In the interests of caution, the fiscal projections continue to be based on the deliberately prudent and cautious assumption of trend growth of 2$^1/_4$ per cent a year, the lower end of the GDP growth ranges in Chapter B. The main economic assumptions are summarised in Table C3;
- firm Departmental Expenditure Limits as set out in Spending Review 2000 and the Pre-Budget Report but adjusted for subsequent changes (see paragraph
C54);
- prior to firm spending plans being set in the 2002 Spending Review, current expenditure in 2004–05 and 2005–06,

after the end of the 2000 Spending Review period, is projected to grow by $2^{1}/_{2}$ per cent a year in real terms for current expenditure included in departmental expenditure limits, in line with the neutral view of trend, and by $1^{3}/_{4}$ per cent a year in real terms for other current expenditure in line with trends in AME;

- a more than doubling in net investment by the end of the projection period to 1.8 per cent of GDP, which makes a significant contribution to tackling the legacy of under-investment while remaining consistent with the sustainable investment rule; and
- there are no tax changes beyond those already announced in or before this Budget and the indexation of rates and allowances.

Table C3: Economic assumptions for public finance projections

	Percentage changes on previous year						
	1999–00	**2000–01**	**2001–02**	**2002–03**	**2003–04**	**2004–05**	**2005–06**
Output (GDP)	23/4	3	21/4	21/4	21/4	21/4	21/4
Prices							
RPIX	21/4	2	2	21/2	21/2	21/2	21/2
GDP deflator	21/2	13/4	21/2	21/2	21/2	21/2	21/2
RPI[1] (September)	11/4	31/4	13/4	23/4	21/2	21/2	21/2
Rossi[2] (September)	13/4	11/2	11/2	21/4	21/4	21/4	21/4
Money GDP[3] (£ billion)	907	946	990	1036	1085	1136	1189

1 *Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year.*

2 *RPI excluding housing costs, used for uprating certain social security benefits in the following year.*

3 *Not seasonally adjusted.*

C18 The key assumptions underlying the fiscal projections are audited by the National Audit Office. All these assumptions are now reviewed on a three year rolling basis. For this Budget, the NAO have reviewed the assumptions on the composition of GDP and funding. In both cases the review concluded that the assumptions adopted three years ago were reasonable. The NAO also commented that it was reasonable to continue using these assumptions.

C19 As a result of these reviews the key assumptions and conventions used for the Budget public finance projections are unchanged. Details are given in Box C1. In line with the assumption endorsed by NAO, the projections reflect the fact that the average level of claimant count unemployment published by independent forecasters for the last quarter of 2002 is slightly higher than the recent actual levels. This does not represent the Government's view of the prospects for unemployment. It is instead a deliberately cautious approach for the purposes of these fiscal projections.

Box C1: Key assumptions audited by the NAO

*	**Privatisation proceeds[1,6]**	**Credit is taken only for proceeds from sales that have been announced.**
*	**Trend GDP growth[1,6]**	**$2^{1}/_{4}$ per cent a year.**
*	**UK claimant unemployment[1,4,7]**	**Rising slowly to 1.06 million in 2003–04, from recent levels of 1.03 million, consistent with the average of independent forecasts.**

*	**Interest rates[1,6,7]**	**3 month market rates change in line with market expectations (as of February 28).**
*	**Equity prices[2,7]**	**FT-All share index rises from 2902 in line with money GDP.**
*	**VAT[2,7]**	**Ratio of VAT to consumption falls by 0.05 percentage points a year.**
*	**GDP deflator and RPI[2,7]**	**Projections of price indices used to plan public expenditure are consistent with RPIX.**
*	**Composition of GDP[3,8]**	**Shares of labour income and profits in national income are broadly constant in the medium term.**
*	**Funding[3,8]**	**Funding assumptions used to project debt interest are consistent with the forecast level of goverment borrowing and with financing policy.**
*	**Oil prices[5]**	**$24.40 a barrel in 2001, the average of independent forecasts, and then constant in real terms.**
*	**Anti-tobacco smuggling measures[6]**	**Only direct effects, including deterrent effects of fiscal marks, are allowed for.**

[1]Audit of Assumptions for the July 1997 Budget Projections, 19 June 1997 (HC3693)

[2]Audit of Assumptions for the Pre-Budget Report, 25 November 1997 (HC361)

[3]Audit of Assumptions for the Budget, 19 March 1998 (HC616)

[4]Audit of the Unemployment Assumption for the March 1999 Budget Projections, 9 March 1999 (HC294)

[5]Audit of the Oil Price Assumption for the Pre-Budget Report, November 1999 (HC873)

[6]Audit of Assumptions for the March 2000 Budget, 21 March 2000 (HC348)

[7]Audit of Assumptions for the Pre-Budget Report 2000 Report, 8 November 2000 (HC959)

[8]Audit of Assumptions for the March 2001 Budget, 7 March 2001 (HC304)

FISCAL AGGREGATES

C20 Tables C4 and C5 provide more detail on the projections of the current and capital budgets, in £ billion and as a per cent of GDP respectively. The tables show the current surplus and net borrowing, both including and excluding windfall tax receipts and associated spending. The latter gives a clearer picture of underlying trends. Latest estimates of windfall tax associated spending are given in Table 4.1a.

Table C4: Current and capital budgets

	£ billion						
	Outturn	**Estimate**			**Projections**		
	1999–00	**2000–01**	**2001–02**	**2002–03**	**2003–04**	**2004–05**	**2005–06**
Current budget							
Current receipts	358.7	383.2	398	416	432	453	473
Current expenditure	325.3	346.0	367	386	407	426	446
Depreciation	14.6	14.9	15	16	17	17	18
Surplus on current budget (including WTAS[1])	18.7	22.3	16	14	8	9	9
Surplus on current budget2	**19.2**	**23.1**	**17**	**15**	**8**	**9**	**9**
Capital budget							
Gross investment	23.0	26.3	30	35	39	41	43
less asset sales	–4.8	–4.1	–4	–4	–4	–4	–4
less depreciation	–14.6	–14.9	–15	–16	–17	–17	–18
Net investment	3.5	7.4	11	15	19	20	21
Net borrowing (including WTAS[1])	–15.2	–15.0	–5	2	10	11	12
Net borrowing2	**–16.0**	**–16.4**	**–6**	**1**	**10**	**11**	**12**
Public sector net debt – end year	340.1	307.5	307	314	330	347	365
Memos:							
General government net borrowing3	–15.8	–15.6	–5	1	10	11	12
General government gross debt[3]	396.7	383.7	372	375	388	405	423

1 *Windfall tax receipts and associated spending*.

2 *Excluding windfall tax receipts and associated spending*.

3 *Treaty measures of the government deficit and debt*.

C21 The current budget surplus in 2000–01 is estimated to be £23.1 billion. Net investment is estimated to be £7.4 billion, of which £0.6 billion is windfall tax associated spending. The estimated repayment of net borrowing is £16.4 billion.

C22 The current budget surplus is projected to decline to £17 billion in 2001–02, to £15 billion in 2002–03, and then to fall further to about £8–9 billion from 2003–04 onwards. This profile of a modest decline in the current budget surplus from 2001–02 reflects the planned real increase in current expenditure of $2^1/_2$ per cent a year and Pre-Budget Report and Budget spending and tax measures, together with receipts projections that are based on a cautious projection of trend real GDP growth of $2^1/_4$ per cent a year.

C23 Net investment is projected to rise to £11 billion in 2001–02, reducing the repayment of net borrowing to £6 billion. The ratio of net investment to GDP continues to rise, resulting in a projection of net borrowing of around 1 per cent of GDP in 2003–04.

C24 The profile of significant repayments of net borrowing up to 2001–02 results in a declining net debt-GDP ratio. Public sector net debt falls from 36.8 per cent of GDP in 1999–2000, to 31.8 per cent by the end of 2000–01, and to 29.6 per cent of GDP in 2002–03. Although the modest levels of borrowing in subsequent years lead to small increases in the level of net debt, the debt-GDP ratio remains fairly constant at around 30 per cent of GDP for the remainder of the projection period.

C25 Table C5 also shows the Treaty measures of the deficit and debt used in the Excessive Deficits Procedure, as a per cent of GDP. The reference levels of 3 per cent of GDP for the deficit and 60 per cent of GDP for debt are achieved comfortably throughout the projection period.

Table C5: Current and capital budgets

	Per cent of GDP						
	Outturn	**Estimate**			**Projections**		
	1999–00	**2000–01**	**2001–02**	**2002–03**	**2003–04**	**2004–05**	**2005-06**
Current budget							
Current receipts	39.6	40.5	40.2	40.1	39.8	39.9	39.8
Current expenditure	35.9	36.6	37.1	37.3	37.5	37.5	37.5
Depreciation	1.6	1.6	1.6	1.5	1.5	1.5	1.5
Surplus on current budget (including WTAS1)	2.1	2.4	1.6	1.3	0.8	0.8	0.8
Surplus on current budget2	**2.1**	**2.4**	**1.7**	**1.4**	**0.8**	**0.8**	**0.8**
Capital budget							
Gross investment	2.5	2.8	3.1	3.4	3.6	3.6	3.6
less asset sales	–0.5	–0.4	–0.4	–0.4	–0.3	–0.3	–0.3
less depreciation	–1.6	–1.6	–1.6	–1.5	–1.5	–1.5	–1.5
Net investment	0.4	0.8	1.1	1.5	1.7	1.8	1.8
Net borrowing (including WTAS1)	–1.7	–1.6	–0.5	0.2	0.9	1.0	1.0
Net borrowing2	**–1.8**	**–1.7**	**–0.6**	**0.1**	**0.9**	**1.0**	**1.0**
Public sector net debt – end year	**36.8**	**31.8**	**30.3**	**29.6**	**29.7**	**29.9**	**30.0**
Memos:							
General government net borrowing3	–1.7	–1.7	–0.5	0.1	0.9	0.9	1.0
General government gross debt[3]	43.7	40.6	37.6	36.1	35.7	35.6	35.6

1 *Windfall tax receipts and associated spending*.

2 *Excluding windfall tax receipts and associated spending*.

3 *Treaty measures of the government deficit and debt*.

C26 Table C6 provides a detailed analysis of the changes to the projections of the main fiscal aggregates since Budget 2000 and the Pre-Budget Report, distinguishing between discretionary changes to receipts and spending in Spending Review 2000, the Pre-Budget Report and this Budget, and non-discretionary changes made as a result of data revisions and forecasting changes.

Table C6: Fiscal balances comparison with Budget 2000 and PBR 2000[1]

	Outturn	Estimate				Projections	
	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05	2005–0
Fiscal balances (£ billion)							
Surplus on current budget[1]							
Budget 2000	**17.1**	**14**	**16**	**13**	**8**	**8**	
Effects on receipts of:							
Revisions and forecasting changes	0.6	4.7	4.9	5.1	5.3	5.8	
PBR policy measures	–	0.0	–0.6	–1.1	–1.1	–1.1	
Effects on spending of:							
Revisions and forecasting changes[2]	1.7	–2.0	–0.9	–0.2	–1.6	–1.2	
SR2000 and PBR policy measures	–	–0.3	–2.8	–2.8	–2.9	–2.9	
PBR 2000	**19.4**	**16.6**	**16**	**14**	**8**	**8**	**8**
Effects on receipts of:							
Revisions and forecasting changes	1.3	2.9	2.2	3.5	4.0	4.3	4.1
Budget 2001 policy measures	–	–	–3.3	–3.8	–3.9	–3.9	–4.0
of which:							
PBR consultation measures	–	–	*–2.0*	*–2.0*	*–2.0*	*–2.0*	*–2.0*
New tax measures	–	–	*–1.3*	*–1.8*	*–1.9*	*–2.0*	*–2.0*
Effects on spending of:							
Revisions and forecasting changes	–1.4	3.6	1.1	0.7	0.3	0.2	0.8
Budget 2001 policy measures	–	–	0.6	0.5	0.1	0.1	0.1
of which:							
Changes to AME margin	–	–	*1.7*	*1.6*	*1.6*	*1.7*	*1.7*

New DEL and AME measures	–	–	*–1.1*	*–1.0*	*–1.5*	*–1.6*	*–1.6*
Budget 2001	**19.2**	**23.1**	**17**	**15**	**8**	**9**	**9**
Net borrowing[1]							
Budget 2000	**–11.9**	**–6**	**–5**	**3**	**11**	**13**	
Effects on receipts of:							
Revisions and forecasting changes	–0.6	–4.7	–4.9	–5.1	–5.3	–5.8	
PBR policy measures	–	0.0	0.6	1.1	1.1	1.1	
Effects on spending of:							
Revisions and forecasting changes[2]		–3.9	0.3	0.5	–0.8	0.3	0.8
SR2000 and PBR policy measures		0.8	2.8	2.8	2.9	2.9	
PBR 2000	**–16.4**	**–10.1**	**–6**	**1**	**10**	**12**	**13**
Effects on receipts of:							
Revisions and forecasting changes	–1.3	–2.9	–2.2	–3.5	–4.0	–4.3	–4.1
Budget 2001 policy measures			3.3	3.8	3.9	3.9	4.0
of which:							
PBR consultation measures	–	–	*2.0*	*2.0*	*2.0*	*2.0*	*2.0*
New tax measures	–	–	*1.3*	*1.8*	*1.9*	*2.0*	*2.0*
Effects on spending of:							
Revisions and forecasting changes	1.7	–3.4	–1.6	–0.4	–0.2	–0.3	–0.9
Budget 2001 policy measures	–	–	0.3	–0.1	0.3	–0.1	–0.1
of which:							
Changes to AME margin			*–1.7*	*–1.6*	*–1.6*	*–1.7*	*–1.7*
New DEL and AME measures			*2.1*	*1.4*	*1.9*	*1.6*	*1.6*

Budget 2001	**–16.0**	**–16.4**	**–6**	**1**	**10**	**11**	**12**

1 *Excluding windfall tax receipts and associated spending.*

2 *Including changes to AME margin.*

C27 Following the announcement of the spending envelope in Budget 2000, the only effect of Spending Review 2000 on changes to overall spending was the decision to carry forward just £$^3/_4$ billion of the £2 billion underspend in 1999–2000 into 2000–01 and £$^3/_4$ billion into 2001–02. In this Budget it has been decided to carry forward the £1 billion underspend assumed for 2000–01 into 2001–02, and there have also been further additions to departmental expenditure limits (see paragraph C54). Of the amount carried forward into 2001–02, £$^1/_2$ billion is capital expenditure. Details of these changes and the effects of tax and annually managed expenditure policy measures in this Budget and the Pre-Budget Report are shown in Table A11.

C28 The table shows that the projected current budget surplus and repayment of net borrowing in 2000–01 increased by £2.4 billion and £3.6 billion respectively between Budget 2000 and the Pre-Budget Report. Much of this increase reflected stronger than expected receipts. There has been a further increase of £3 billion in receipts since the Pre-Budget Report, and lower spending has led to even larger increases in both the current surplus and the repayment of net borrowing. Lower spending reflects in part the assumption of a £1 billion underspend against departmental expenditure limits in 2000–01, but mostly lower annually managed expenditure.

C29 The forecasting changes for receipts from 2001–02 onwards carry forward the extra receipts in 2000–01, but in addition reflect changes to the profile of North Sea tax receipts (see paragraph C46). There are no forecasting changes to overall departmental expenditure limits, although there are some changes in the split between current and capital spending which affect the current surplus. The reductions in total annually managed expenditure are lower after 2001–02 than in 2000–01. Details of the forecasting changes are given in the following sections on receipts and public expenditure.

C30 Between Budget 2000 and the Pre-Budget Report the overall forecast changes outweighed the effects of policy measures, and net borrowing in the Pre-Budget Report projections was £1–2 billion a year less than in the Budget 2000 forecast. The forecasting changes since the Pre-Budget Report have been largely balanced by tax and spending policy changes. As a result, net borrowing is a little lower in 2001–02 and 2002–03, and unchanged thereafter. The current surplus is about £1 billion a year higher in most years than in the Pre-Budget Report.

RECEIPTS

C31 Table C7 gives detailed projections of receipts in £ billion to 2001–02. Changes in the receipts projections since the Pre-Budget Report and Budget 2000 are shown in Table C8. Projections of receipts as a percentage of GDP to 2005–06 are shown in Table C9. Table C10 sets out the projections of the tax-GDP ratio.

C32 Total receipts are estimated to rise by 6 $^3/_4$ per cent in 2000–01, similar growth to the previous year. The strength of receipts contrasts with money GDP which has been growing by under 5 per cent, reflecting low increases in the GDP deflator. As a result, the receipts-GDP ratio has increased, to a projected 40.5 per cent in 2000–01.

C33 The increases in the receipts-GDP ratio partly reflect changes to the aggregate ratio of wages and salaries, company profits and consumer spending to GDP. This ratio has increased fairly steadily since 1996–97, in part reflecting the strength of the economy over this period. (This tends to be correlated with the output gap, see *Fiscal Policy: public finances and the cycle*, HM Treasury March 1999.) In addition, while inflation is currently at very low levels, oil and gas prices are relatively high, which is increasing the profits share of GDP of North Sea companies.

C34 Even after allowing for the changes in this ratio, the increase in the ratio of net taxes and social security contributions (and in the ratio of total receipts) to GDP in the two years to 2000–01 has been significantly greater than could have been expected by the Treasury's published ready reckoners for the effects of the economic cycle on the public finances – and after allowing for the doubling of oil prices over this period (see Tables C9 and C10). This is reflected in fairly large forecast errors for receipts in 2000–01 in both the Budget 2000 and Pre-Budget Report forecasts (see Table C8). Most of these errors relate to the forecasts of income tax and social security contributions (see paragraphs C37 – C41 and C51).

Table C7: Public sector current receipts

£ billion	Outturn	Estimate	Projection
	1999–00	2000–01	2001–02
Inland Revenue			
Income tax (gross of tax credits)	95.7	106.7	111.5
Corporation tax1	34.4	32.1	37.8
Tax credits	–3.2	–4.9	–7.4
Petroleum revenue tax	0.9	1.9	1.6
Capital gains tax	2.1	2.9	2.5
Inheritance tax	2.0	2.2	2.3
Stamp duties	6.9	8.2	8.0
Total Inland Revenue taxes (net of tax credits)	**138.8**	**149.1**	**156.4**
Customs and Excise			
Value added tax	56.4	59.0	61.3
Fuel duties	22.5	23.0	22.5
Tobacco duties	5.7	7.5	7.6
Spirits duties	1.8	1.8	1.8
Wine duties	1.7	1.8	1.9
Beer and cider duties	3.0	3.0	3.0
Betting and gaming duties	1.5	1.5	1.5
Air passenger duty	0.9	1.0	1.0
Insurance premium tax	1.4	1.7	1.8
Landfill tax	0.4	0.5	0.5
Climate change levy			0.8
Customs duties and levies	2.0	2.1	2.1
Total Customs and Excise	**97.3**	**102.8**	**105.9**
Vehicle excise duties	4.8	4.5	4.5
Oil royalties	0.4	0.6	0.6
Business rates2	15.8	17.2	17.5
Social security contributions	56.4	60.1	62.6
Council Tax	13.0	13.9	14.7
Other taxes and royalties3	8.4	8.9	9.5
Net taxes and social security contributions4	**334.9**	**357.0**	**371.6**
Accrual adjustments on taxes	4.8	3.1	1.7
less VAT and own resources contribution to EU budget	–5.6	–6.3	–5.9
less PC corporation tax payments	–0.3	–0.2	–0.2
Tax credits5	3.2	4.9	5.8

Interest and dividends	3.8	5.3	4.8
Other receipts	17.9	19.4	20.5
Current receipts	**358.7**	**383.2**	**398.4**
Memo:			
North Sea revenues6	2.5	4.8	5.9

1 Includes advance corporation tax (net of repayments): 1.7 –0.4 0.0

Also includes North Sea corporation tax after ACT set off, and corporation tax on gains. Gross of R&D tax credit and tax credit for cleaning contaminated sites (zero in 2000–2001, £0.1 billion in 2001–02) which are scored within the Tax credits line.

2 *Includes district council rates in Northern Ireland.*

3 *Includes money paid into the National Lottery Distribution Fund.*

4 *Includes VAT and 'traditional own resources' contributions to EU budget. Net of income tax credits. Cash basis.*

5 *Excludes Children's Tax Credit, which scores as a tax repayment in the national accounts.*

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

Table C8: Changes in current receipts since Budget 2000 and PBR 2000

£ billion

	2000–01		**2001–02**	
	Budget 2000	**PBR 2000**	**Budget 2000**	**PBR 2000**
Income tax (gross of tax credits)	5.7	2.9	4.3	1.9
Income tax credits	0.2	0.0	0.1	–0.4
Non-North Sea corporation tax	–1.3	0.4	–0.7	0.1
North Sea revenues	0.4	–0.6	0.4	–1.4
Capital taxes[1]	–0.5	–0.2	–1.4	–0.3
Stamp duty	1.0	–0.1	0.5	–0.1
Value added tax	–0.6	–0.2	–0.7	–0.2
Excise duties[2]	–0.3	0.0	–2.0	–1.1
Social security contributions	1.3	0.3	1.4	0.4
Other taxes and royalties[3]	1.7	–0.2	0.7	–0.5
Net taxes and social security contributions	7.6	2.3	2.6	–1.7
Other receipts and accounting adjustments	0.0	0.6	0.7	0.7
Current receipts	**7.6**	**2.9**	**3.3**	**–1.1**

1 *Capital gains tax and inheritance tax.*

2 *Fuel, alcohol and tobacco duties.*

3 *Includes Council Tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*

C35 The ratio of net taxes and social security contributions as a percentage of GDP is projected to fall steadily over the next three years. In addition to the tax cuts in this Budget and the Pre-Budget Report, the decline reflects slightly weaker projections of GDP growth, consistent with the cautious assumptions for trend GDP; the fall in corporation tax receipts as a per cent of GDP, once the transitional period for the new system of instalment payments comes to an end; and projected lower levels of North Sea production (the profits from which are taxed at higher rates than in the non-North Sea sector). Receipts in 2001–02 are lower than expected in the Pre-Budget Report as the effect of Budget measures on receipts outweighs the effect of forecasting changes.

C36 Total tax receipts in 2001–02 are about £$1\frac{1}{2}$ billion lower than projected in the Pre-Budget Report because the effect of Budget tax measures outweighs the effects of forecasting changes (see Table C6). However, money GDP is slightly lower reflecting a lower GDP deflator and the tax-GDP ratio is unchanged. In subsequent years, the effects of tax measures are balanced by forecasting changes, but the slightly lower levels of money GDP mean that the receipts-GDP ratio is slightly higher in some years than previously projected. The direct tax burden on a typical family with two children will fall in 2001–02 to its lowest level since 1972.

Table C9: Current receipts

	Per cent of GDP						
		Outturn	Estimate			Projections	
	1999–00	**2000–01**	**2001–02**	**2002–03**	**2003–04**	**2004–05**	**2005–06**
Income tax (gross of tax credits)	10.6	11.3	11.3	11.4	11.5	11.6	11.7
Non-North Sea corporation tax	3.6	3.2	3.4	3.4	3.2	3.3	3.3
Tax credits[1]	–0.3	–0.5	–0.7	–0.8	–0.8	–0.8	–0.8
of which:							
Working Families' Tax Credit[2]	–0.1	–0.5	–0.5	–0.5	–0.5	–0.5	–0.5
North Sea revenues[3]	0.3	0.5	0.6	0.6	0.5	0.5	0.4
Value added tax	6.2	6.2	6.2	6.2	6.1	6.1	6.1
Excise duties[4]	3.8	3.9	3.7	3.7	3.6	3.5	3.4
Social security contributions	6.2	6.4	6.3	6.2	6.2	6.2	6.3
Other taxes and royalties[5]	6.5	6.8	6.7	6.7	6.7	6.7	6.7
Net taxes and social security contributions[6]	36.9	37.7	37.5	37.3	37.0	37.0	37.0
Accruals adjustments on taxes	0.5	0.3	0.2	0.2	0.2	0.2	0.2
less EU transfers	–0.6	–0.7	–0.6	–0.5	–0.4	–0.4	–0.4
Income tax credits[7]	0.3	0.5	0.6	0.6	0.6	0.5	0.5
Other receipts	2.4	2.6	2.5	2.6	2.5	2.5	2.4
Current receipts[8]	39.6	40.5	40.2	40.1	39.8	39.9	39.8
Memo:							
Current receipts (£billion)	358.7	383.2	398	416	432	453	473

1 *Mainly MIRAS and tax reliefs under the Working Families' Tax Credit and Children's Tax Credit schemes.*

2 *The Working Families' Tax Credit will, subject to legislative constraints, be replaced in 2003 by a new integrated system of support for children and an employment tax credit*

3 *Includes oil royalties, petroleum revenue tax and North Sea corporation tax (after ACT set-off).*

4 *Fuel, alcohol and tobacco duties.*

5 *Includes Council Tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*

6 *Includes VAT and 'own resources' contributions to EU budget. Net of income tax credits. Cash basis.*

7 *Excludes Children's Tax Credit, which scores as a tax repayment in the national accounts.*

8 *Accruals basis.*

Chart C3: Tax-GDP ratio

Table C10: Net taxes and social security contributions[1]

	Per cent of GDP						
	Outturn	Estimate			Projections		
	1999–00	**2000–01**	**2001–02**	**2002–03**	**2003–04**	**2004–05**	**2005–06**
Budget 2000	37.0	36.9	37.3	37.1	36.7	36.6	
PBR 2000	36.9	37.3	37.5	37.3	36.9	36.9	36.8
Budget 2001	**36.9**	**37.7**	**37.5**	**37.3**	**37.0**	**37.0**	**37.0**

1 *Net of income tax credits; cash basis.*

Income tax

C37 Income tax receipts (net of tax credits) in 2000–01 are expected to be about £102 billion, £3 billion higher than forecast in the Pre-Budget Report and up £6 billion on the Budget 2000 forecast. These upward revisions are despite the fact that overall levels of wages and salaries are estimated to grow by slightly less in 2000–01 than in either of the two previous forecasts. About half the increase since the Pre-Budget Report reflects higher than expected Self Assessment receipts, which mainly reflect the tax due for the 1999–2000 tax year on self-employment earnings and other income not subject to PAYE. Most of the rest of the increase reflects higher than expected PAYE receipts, probably from bonus payments.

C38PAYE receipts have grown by about 12 per cent in 2000–01. This increase is higher than previously forecast and above what would be expected from current estimates of the growth of wages and salaries, even taking account of fiscal drag. It also comes on top of a larger than expected increase in 1999–2000. Recent Budget measures have had little effect overall on the growth of PAYE receipts in 2000–01. However, earlier Budget measures, mainly the November 1996 phasing out of tax relief on profit-related pay and extending PAYE to cover tax due when certain share options are exercised, have increased PAYE growth in 2000–01. Nonetheless, even after allowing for past Budget measures and fiscal drag, there is still a significant amount of the increase in PAYE to be explained.

C39 One possible explanation for these forecast errors is that the earnings distribution has changed unexpectedly over the last few years, with above average increases at higher earnings levels. Another possibility is that the national accounts are under-recording the growth of wages and salaries; however, the income account currently includes a small negative statistical discrepancy for 2000, implying incomes are being slightly over-recorded relative to money GDP. Also, the introduction of Self Assessment, which was originally thought to have just led to a one-off improvement in taxpayer compliance, may have had a delayed effect on PAYE receipts. One reason is that about half of all taxpayers subject to Self Assessment pay some of their tax through PAYE. As long as any extra tax due under Self Assessment is less than £1000, they can opt to have it collected in subsequent years through adjustments to PAYE codes.

C40 Any of these explanations would suggest that, other things equal, the unexpected increase in income tax receipts is unlikely to be unwound in future, and the forecasts carry them forward. However, as in past forecasts, the stronger than expected rate of growth of receipts has not been reflected in upward revisions to forecast growth rates of income tax for given economic determinants.

C41 As a result of the recent increases in PAYE and Self Assessment receipts income tax receipts (net of tax credits) are expected to rise to 10.8 per cent of GDP in 2000–01 from 10.3 per cent in 1999–2000. Mainly as a result of Budget measures, in particular the introduction of the Children's Tax Credit and the increase in the starting rate limit, the income tax to GDP ratio is projected to fall to 10.5 per cent in 2001–02, but then increase by about 0.1 per cent a year as a result of fiscal drag.

Non-North Sea corporation tax

C42 Receipts of non-North Sea corporation tax in 2000–01 are expected to be nearly £30 billion, about £$^{1}/_{2}$ billion above the Pre-Budget Report forecast and £1 billion below the Budget 2000 forecast. Receipts are £3 billion less than in 1999–2000 mainly as a result of the tax reforms introduced in 1999, which cut the rates of tax, abolished advance corporation tax and introduced a four year transition to quarterly instalment payments for large companies, but also because of a decline in taxable profits of onshore industrial and commercial companies in 1999.

C43 Since the March 2000 Budget, total payments by onshore large companies under the instalment regime have been lower than forecast. The specified profile of payments for the first year was four instalments of 15 per cent of liability and a balancing payment of 40 per cent. In the event, the first three instalments were slightly higher, while the balancing payments were less than the expected 40 per cent. Since the Pre-Budget Report, payments on profits in 1999 have been above forecast while payments on profits in 2000 have been lower. Repayments of tax on earlier accounting periods and of ACT on foreign income dividends have been higher than forecast. Also, when group instalment payments by large oil companies have been attributed to each group member, some payments initially treated as North Sea payments have been switched to onshore companies.

C44 Receipts are forecast to increase to £34 billion in 2001–02 as a result of higher profits and the effect of the third year of the transition to instalments. In 2002–03 they are projected to rise by a further £1$^{1}/_{2}$ billion, but then fall by nearly £$^{3}/_{4}$ billion in 2003–04 as the extra tax paid during the four year transition to instalments ends. The yield is expected to increase steadily with increasing profits thereafter.

C45 The ratio of onshore corporation tax receipts to GDP was about 3.5 per cent in the period 1996-97 and 1998-99 and would normally be expected to stay at much the same level each year in the absence of changes to the tax regime or changes in the company profits share of GDP. However the transition to the new instalment system changes the ratio from year to year over the period from 1998-99 to 2002-03. Once the transition is complete, the ratio stabilises at around 3.3 per cent, a lower level than before mainly because of reductions in the rates announced in the 1997 and 1998 Budgets.

North Sea revenues

C46 Receipts from companies engaged in North Sea oil and gas extraction are estimated to be £43/4 billion in 2000–01 compared with £21/2 billion in 1999–2000. The increased payments derive directly from the effects of higher oil prices. Receipts in 2000–01 are £1/2 billion below the Pre-Budget Report forecast and £1/2 billion higher than the Budget 2000 forecast. The increase since March last year reflects higher than expected oil prices throughout 2000 while the reduction since the Pre-Budget Report is due to lower than expected instalment payments of North Sea corporation tax, slightly lower oil prices in the last quarter of 2000, and the attribution of some corporation tax received under group payments to onshore companies. Receipts are projected to rise to nearly £6 billion in 2001–02 when the full effect of higher oil prices in 2000 feeds through to receipts of corporation tax. From 2002–03 receipts decline slowly as production levels are forecast to fall. The higher oil price leads to increases in the ratio of North Sea revenues to GDP in both 2000–01 and 2001–02, but the ratio then falls as production declines.

C47 Capital gains tax receipts are expected to be £2.9 billion in 2000–01, falling back to £2.5 billion the following year as the Budget 2000 taper reform begins to affect receipts. These forecasts are slightly below those in the Pre-Budget Report, and about £$^{1}/_{2}$ billion lower than expected in the Budget 2000 forecast. The revision since the last Budget takes account of the lower 1999–2000 outturn and the latest information on the pattern of asset disposals. The change since the Pre-Budget Report mainly reflects changes to equity prices as governed by the audited assumption (see Box C1). Inheritance tax receipts are little changed compared with either the Pre-Budget Report or Budget 2000 forecast, at £2.2 billion in 2000–01 and £2.3 billion in 2001–02.

Stamp duty

C48 Stamp duty receipts are forecast to increase from £6.9 billion in 1999–2000 to £8.2 billion in 2000–01 reflecting the impact of the Budget 2000 rate increases on land and property receipts, the strength of the equity markets, particularly in the first part of the year, and a high level of receipts from mergers and acquisitions. An expected return to more normal levels of stock market activity in 2001–02 reduces receipts to £8.0 billion. This is slightly down on the Pre-Budget Report, reflecting lower share prices offset by slightly higher forecasts for the property market.

VAT receipts

C49VAT receipts in 2000–01 are expected to be £59.0 billion, £0.2 billion below the Pre-Budget Report forecast. However, the ratio of VAT receipts to consumer spending is projected to be slightly higher than expected in 2000-01, and unchanged from the previous year. In future years, the forecast uses the National Audit Office audited assumption that, after allowing for the effects of Budget measures, the ratio of VAT receipts to consumer spending declines gradually, by 0.05 percentage points a year from its level in 2000–01. Compared with the Pre-Budget Report forecast, the net effect of the revised consumer spending projections and the Budget 2001 measures is to increase VAT receipts by nearly £$^1/_2$ billion a year from 2002-03 onwards.

Excise duties

C50 The estimate of excise duties in 2000-01 is broadly unchanged from the Pre-Budget Report forecast. In future years, excise duties are forecast to be some £1$^1/_2$ billion a year lower than in the Pre-Budget Report, reflecting the Budget cuts in road fuel duties. The forecast of alcohol and tobacco receipts is broadly unchanged. The ratio of excise duty to GDP is expected to decline over the forecast period, reflecting the assumption that consumption of goods subject to excise duties grows by less than GDP.

Social security contributions

C51 Social security (national insurance) contributions are projected to be £60.1 billion in 2000–01, an increase of 6$^1/_2$ per cent. As with income tax, the much stronger growth of social security contributions compared with wages and salaries has resulted in outcomes above those forecast in Budget 2000 and the Pre-Budget Report. While the employee upper earnings limit reduces the amount of fiscal drag in the social security contributions regime, nonetheless it seems likely that the unexpected buoyancy of social security contributions and PAYE receipts in 2000–01 are related. The ratio of social security contributions to GDP is projected to fall slightly over the next five years, reflecting assumed higher rates of contracting out of the state pension scheme, as individuals increasingly make use of stakeholder pensions.

PUBLIC EXPENDITURE

C52 Table C11 shows projections for public expenditure for the current year and the three years covered by Spending Review 2000. The projections cover the whole public sector using the aggregate Total Managed Expenditure (TME). TME is split into Departmental Expenditure Limits (DEL), firm three year limits for departments' programme spending, and Annually Managed Expenditure (AME), spending that is not easily subject to firm multi-year limits.

Table C11: Total Managed Expenditure 1999-2000 to 2003-2004

			£ billion		
	Outturn	Estimate		Projections	
	1999–00	**2000–01**	**2001–02**	**2002–03**	**2003–04**
Departmental Expenditure Limits					
Resource Budget	159.9	172.3	187.0	199.1	210.7
Capital Budget	19.4	21.9	25.3	29.4	34.4
Total Departmental Expenditure Limits	**179.3**	**194.2**	**212.3**	**228.5**	**245.1**
Annually Managed Expenditure					
Departmental AME:					
Social Security Benefits	97.2	99.1	104.9	108.6	113.5
Housing Revenue Account subsidies	3.4	3.2	4.6	4.3	4.1
Common Agricultural Policy	2.9	2.8	2.6	2.6	2.7
Export Credits Guarantee Department	0.9	1.1	0.8	0.4	0.4
Self-financing public corporations capital expenditure	1.4	1.4	1.0	1.2	0.9
Net public service pensions	5.2	5.4	5.6	5.6	5.9
National Lottery	1.9	2.0	2.3	2.2	1.8

Other programme expenditure	0.2	–0.1	0.0	–0.1	–0.3
Non-cash items:					
Depreciation	7.8	7.8	8.3	8.9	9.7
Cost of capital charges	13.6	13.8	13.5	14.4	14.8
Provisions and other charges	2.3	1.0	–0.6	0.6	1.0
Total departmental AME[1]	**136.7**	**137.5**	**143.0**	**148.8**	**154.5**
Other AME:					
Net payments to EC institutions2	2.9	3.5	2.7	2.6	2.9
Locally financed expenditure	17.2	18.0	19.1	20.1	21.0
Central Government gross debt interest	25.3	26.6	23.1	24.2	24.0
Accounting and other adjustments	–18.0	–11.5	–7.5	–8.4	–8.0
Total other AME	**27.4**	**36.6**	**37.4**	**38.4**	**40.0**
AME Margin	0.0	0.0	1.0	2.0	3.0
Annually Managed Expenditure	**164.1**	**174.0**	**181.4**	**189.2**	**197.5**
Total Managed Expenditure	**343.5**	**368.3**	**393.7**	**417.8**	**442.6**
of which:					
Public sector current expenditure	325.3	346.0	367.0	386.4	407.3
Public sector net investment	3.5	7.4	11.2	15.3	18.7
Public sector depreciation	14.6	14.9	15.5	16.0	16.6

1 *Including non-cash items.*
2 *Net payments to EC institutions exclude the UK's contribution to the cost of EC aid to non-member states (which is attributed to the aid programme). Net payments therefore differ from the UK's net contribution to the EC budget, latest estimates for which are (in £ billion):*

1999–00	*2000–01*	*2001–02*	*2002–03*	*2003–04*
3.3	*4.1*	*3.4*	*3.5*	*3.8*

The trended forecast for 2000-01 is £3.4 billion

C53 Spending Review 2000 was the first to be conducted on a resource basis. The introduction of resource budgeting moves public spending onto an accruals basis scoring spending as and when resources are consumed. This is a move away from cash budgeting, as shown in Budget 2000, where budgets score cash payments when they are made. The move to resource budgeting does not affect TME but does lead to changes within DEL and AME. The details of these changes were set out in the Pre-Budget Report.

Chart C4: Total Managed Expenditure

C54 Table C12 shows changes to DEL and AME since the Pre-Budget Report on the new resource basis. DEL was underspent by £2 billion in 1999-2000 and as part of Spending Review 2000 £$^{3}/_{4}$ billion was carried forward into 2000–01, and £$^{3}/_{4}$ billion into 2001–02. It is now provisionally estimated that the revised DEL total for 2000–01 will be underspent by £1 billion. This underspend will be carried forward into 2001–02. There will also be further additions to DEL of £2.4 billion over the next three years, comprising an extra £1 billion for education, £1 billion for health, £$^{1}/_{3}$ billion for fighting drugs and drug crime, and £0.1 billion for the Capital Modernisation Fund. Table C13 shows the Departmental Expenditure Limits in terms of the resource and capital budgets. It has been updated since the Pre-Budget Report to reflect transfers between departments and programmes, and additions to and allocations from the DEL reserve.

C55 Forecasts of individual AME programmes were reviewed in the Pre-Budget Report, but after excluding the additional spending on measures announced in the Pre-Budget Report from 2001–02 onwards and a DEL/AME classification switch, total AME was left unchanged from the Spending Review by offsetting savings in AME programmes in the AME margin. Total AME for 2000–01 was unchanged as the costs of the measures are to be met from the AME margin. The AME forecasts have now been reviewed again and the AME margin has been reset to £1 billion in the first year (2001–02), £2 billion in the second year and £3 billion in the third. It is expected that the costs of statutory compensation for the curent outbreak of Foot and Mouth disease will be met from within announced public spending totals for Annually Managed Expenditure.

C56 The main economic assumptions underpinning the AME projections are set out in Table C3. As explained in C19, the projections are based on the latest audited assumption for UK claimant unemployment which is in line with the average of independent forecasters (see Box C1).

Table C12: Changes in Total Managed Expenditure since PBR2000

			£ billion		
	Outturn	Estimate		Projections	
	1999–00	**2000–01**	**2001–02**	**2002–03**	**2003–04**
Departmental Expenditure Limits					
Resource Budget	**1.1**	**–0.5**	**1.9**	**1.8**	**1.6**
Capital Budget	**1.5**	**–0.5**	**–0.1**	**–1.0**	**–0.8**
Total Departmental Expenditure Limits	**2.5**	**–1.0**	**1.8**	**0.8**	**0.8**
Annually Managed Expenditure					
Social Security Benefits	0.0	0.1	–0.1	–0.1	0.7
Housing Revenue Account subsidies	0.1	0.0	0.0	0.0	0.0
Common Agricultural Policy	0.2	0.1	–0.2	–0.1	–0.1
Export Credits Guarantee Department	0.0	0.0	0.5	0.2	0.4
Self-financing public corporations					
capital expenditure	0.4	0.0	–0.5	0.0	–0.1
Net public service pensions	–0.1	–0.1	0.1	–0.2	–0.1
National Lottery	0.0	–0.2	0.1	0.1	–0.3
Other programme expenditure	0.3	–0.1	0.0	–0.1	–0.3
Non-cash items:					
Depreciation	0.5	0.9	0.9	0.5	0.7
Cost of capital charges	0.6	1.0	0.7	2.4	2.5
Provisions and other charges	1.7	1.0	–0.6	0.5	0.7
Total departmental AME[1]	**3.8**	**2.5**	**1.1**	**3.4**	**4.2**
Other AME:					
Net payments to EC institutions	0.0	0.7	0.1	0.1	0.1
Locally financed expenditure	0.0	–0.4	–0.1	–0.1	0.0
Central Government gross debt interest	–0.2	–0.4	–1.5	–0.6	–0.4
Accounting and other adjustments	–4.2	–2.2	–0.8	–2.4	–3.0
Total other AME	**–4.3**	**–2.3**	**–2.3**	**–3.1**	**–3.3**
AME Margin	0.0	–2.6	–1.7	–1.6	–1.6
Annually Managed Expenditure	**–0.6**	**–2.4**	**–3.0**	**–1.3**	**–0.7**
Total Managed Expenditure	**1.9**	**–3.4**	**–1.2**	**–0.5**	**0.1**
of which:					
Public sector current expenditure	1.4	–3.6	–1.7	–1.3	–0.5
Public sector net investment	0.3	0.3	0.5	0.8	0.5
Public sector depreciation	0.2	–0.1	0.0	0.1	0.1

1 *Including non cash items.*

C57AME for 2000–01 is £2.4 billion lower than in the Pre-Budget Report, almost entirely because of the AME margin. Net payments to EC institutions scoring as AME were higher than expected because of a substantial shortfall in the expected level of receipts compared to what was expected at the time of the Pre-Budget Report. This was offset by lower than expected spending on other AME programmes.

Table C13: Departmental Expenditure Limits – resource and capital budgets

			£ billion		
	Outturn	**Estimate**		**Plans**	
	1999–00	**2000–01**	**2001–02**	**2002–03**	**2003–04**
Resource Budget					
Education and Employment	14.2	17.0	18.9	20.6	22.0
Health	40.0	44.0	47.7	52.4	56.6
of which: NHS	*39.4*	*43.2*	*46.7*	*50.5*	*54.5*
Environment, Transport and Regions	4.0	4.7	5.1	5.7	5.8
Local Government	33.9	35.3	36.9	39.0	41.6
Home Office	7.1	8.2	8.7	9.2	9.7
Legal Departments	2.7	3.0	3.1	3.2	3.2
Defence	18.2	18.1	18.3	18.5	18.7
Foreign and Commonwealth Office	1.0	1.1	1.2	1.1	1.1
International Development	2.2	2.6	2.7	2.9	3.2
Trade and Industry[1]	2.8	3.2	4.0	3.6	3.3
Agriculture, Fisheries and Food[2]	1.0	1.1	1.1	1.1	1.1
Culture, Media and Sport	0.9	1.0	1.0	1.1	1.2
Social Security (administration)	3.2	3.6	3.8	4.2	4.2
Scotland[3]	12.0	12.7	13.7	14.5	15.3
Wales[3]	6.2	6.9	7.6	8.0	8.5
Northern Ireland Executive[3]	4.3	4.8	5.0	5.3	5.7
Northern Ireland Office[3]	1.0	1.1	1.0	1.1	1.0
Chancellor's Departments	3.5	3.8	3.9	4.0	4.0
Cabinet Office	1.2	1.2	1.3	1.3	1.3
Employment Opportunities Fund[4]	0.5	0.7	0.9	0.9	1.4
Invest to Save Budget	0.0	0.0	0.0	0.0	0.1
Capital Modernisation Fund	0.0	0.0	0.0	0.0	0.0
Policy Innovation Fund	0.0	0.0	0.0	0.0	0.0
Reserve	0.0	0.0	1.2	1.4	1.7
Allowance for shortfall	0.0	–2.0	0.0	0.0	0.0
Total Resource Budget DEL	**159.9**	**172.3**	**187.0**	**199.1**	**210.7**
Capital budget					
Education and Employment	1.1	1.5	2.6	3.1	3.9
Health	0.9	1.6	2.1	2.4	2.7
of which: NHS	*0.9*	*1.5*	*2.0*	*2.3*	*2.6*
Environment, Transport and Regions	5.9	6.3	6.4	8.4	10.7
Local Government	0.3	0.1	0.1	0.3	0.3
Home Office	0.5	0.7	1.0	1.0	0.9

Legal Departments	0.1	0.1	0.1	0.1	0.1
Defence	5.9	5.5	5.5	5.7	6.2
Foreign and Commonwealth Office	0.1	0.1	0.1	0.2	0.2
International Development	0.3	0.3	0.4	0.4	0.4
Trade and Industry[1]	0.2	0.4	0.7	0.7	1.0
Agriculture, Fisheries and Food[2]	0.2	0.2	0.2	0.3	0.3
Culture, Media and Sport	0.1	0.0	0.1	0.1	0.1
Social Security (administration)	0.0	0.1	0.1	0.1	0.0
Scotland[3]	1.7	2.3	2.7	3.0	3.3
Wales[3]	0.9	0.9	0.9	1.2	1.3
Northern Ireland Executive[3]	0.6	0.7	0.8	0.8	0.7
Northern Ireland Office[3]	0.0	0.0	0.1	0.1	0.0
Chancellor's Departments	0.1	0.1	0.2	0.2	0.2
Cabinet Office	0.2	0.2	0.2	0.2	0.2
Employment Opportunities Fund[4]	0.2	0.7	0.0	0.0	0.0
Invest to Save Budget	0.0	0.0	0.0	0.0	0.0
Capital Modernisation Fund	0.0	0.0	0.5	0.9	1.2
Policy Innovation Fund	0.0	0.0	0.0	0.0	0.0
Reserve	0.0	0.0	0.6	0.4	0.5
Allowance for shortfall	0.0	0.0	0.0	0.0	0.0
Total Capital Budget DEL	**19.4**	**21.9**	**25.3**	**29.4**	**34.4**
Total Departmental Expenditure Limits	**179.3**	**194.2**	**212.3**	**228.5**	**245.1**
Total education spending	40.6	46.0	49.7	53.7	58.1

1 *Includes the capital expenditure of the Export Credits Guarantee Department*
2 *Includes spending on BSE related programmes*
3 *For Scotland and Wales, the split between current and capital budgets is decided by the respective Executives. For Northern Ireland, during any period when the Assembly ceases to operate, this is a matter for the Secretary of State.*
4 *Formerly Welfare to Work expenditure financed by the Windfall Tax.*

C58AME in 2001–02 is £3 billion lower than in the Pre-Budget Report. About £1$^3/_4$ billion of this is due to the AME margin but debt interest payments are now expected to be about £1$^1/_2$ billion lower because of lower forecast RPI inflation leading to lower accrued uplift on index-linked gilts and lower market expectations for short term interest rates.

C59 The reduction in AME is lower in both 2002–03 (down £1$^1/_4$ billion from the Pre-Budget Report) and 2003–04 (down £$^3/_4$ billion). Forecasts for debt interest are lower in both years by around £$^1/_2$ billion due mainly to lower short-term interest rate expectations. Social security spending is expected to be about £$^3/_4$ billion higher in 2003–04 than in the Pre-Budget Report, partly because of the increases in Income Support and Jobseekers' Allowance child premiums and the maternity package measures announced in this Budget, and partly because of higher take up of Disablility Living Allowance and Attendance Allowance. The reduction in AME for 2003–04 is also lower than in earlier years because upward changes in the accounting adjustments are no longer off set by changes in other AME programmes. Details of the main accounting adjustments, which comprise those items within TME but outside DEL and AME main programmes, are shown in Table C14. The main reasons for the increase since the Pre-Budget Report are changes to the adjustments on VAT refunded on general government expenditure (which have no effect on the fiscal position because they are offset by changes to receipts) and the changes announced in this Budget to Working Families' Tax Credit.

Table C14: Accounting and other adjustments

		Outturn	Estimate	Projections		
		1999–00	2000–01	2001–02	2002–03	2003–04
1	Non-trading capital consumption	7.9	8.1	8.4	8.8	9.2
2	VAT refunded on general government expenditure	5.9	6.3	6.7	7.3	7.8
3	EC Contributions	–5.6	–6.3	–5.9	–5.4	–4.7
4	Income tax credits*of which Working Families' Tax Credit and*	3.0	4.9	5.8	6.1	6.1
	Disabled Person's Tax Credit:[1]	*1.0*	*4.5*	*5.3*	*5.6*	*5.7*
5	Adjustments for public corporations	3.7	4.1	4.1	4.2	4.5
6	Intra general government debt interest	–3.4	–2.9	–2.9	–3.1	–2.8
7	Financial transactions in departmental budgets	–1.8	–2.3	–2.0	–1.8	–2.0
8	Adjustments for expenditure financed by receipts	0.1	0.1	0.2	0.2	0.2
9	Other accounting adjustments less	–3.8	–0.6	–0.5	–0.5	–0.5
	non-cash items in DEL	0.2	0.2	0.2	0.2	0.2
	non-cash items in AME	23.7	22.6	21.1	23.9	25.5
Total accounting and other adjustments		**–18.0**	**–11.5**	**–7.5**	**–8.4**	**–8.0**

£ billion

[1] *The Working Families' Tax Credit will, subject to legislative constraints, be replaced in 2003 by a new integrated system of support for children and an employment tax credit.*

C60 As both DEL and AME are lower than in the Pre-Budget Report, TME is now expected to be around £3 1/2 billion lower in 2000–01. In 2001–02 and 2002–03 the reductions in AME outweigh the increases in DEL leaving TME lower than at the Pre-Budget Report by £1 1/4 billion and £1 1/2 billion respectively. In 2003–2004 the increase in DEL outweighs the reduction in AME leaving TME marginally higher. Chart C4 shows the ratio of TME to GDP. The ratio rises over the next few years, reflecting the higher levels of public investment.

C61 Table C15 gives a breakdown of public sector capital expenditure.

Table C15: Public sector capital expenditure

£ billion

	Outturn	Estimate	Projections		
	1999–00	2000–01	2001–02	2002–03	2003–04
CG spending and LA support in DEL	10.3	15.2	17.4	21.9	26.1
Locally-financed spending	0.9	0.5	2.1	2.0	1.8
National Lottery	1.7	1.2	1.4	1.3	1.1
Public corporations1	4.4	4.2	3.9	4.4	4.3
Other capital spending in AME	0.9	1.1	1.2	1.4	1.5
Allocation of reserve and AME margin	0.0	0.0	0.6	0.4	0.5
Public sector gross investment2	**18.2**	**22.3**	**26.7**	**31.3**	**35.3**
Less depreciation	–14.6	–14.9	–15.5	–16.0	–16.6
Public sector net investment2	**3.5**	**7.4**	**11.2**	**15.3**	**18.7**
Proceeds from the sale of fixed assets3	4.8	4.1	3.8	3.8	3.8

1 *Public corporations' capital expenditure is partly within DEL and partly within AME.*

2 *This and previous lines are all net of sales of fixed assets.*

3 *Projections of total receipts from the sale of fixed assets by public sector. These receipts are taken into account in arriving at public sector gross and net investment, which are net of sales of fixed assets.*

PRIVATE FINANCE INITIATIVE

C62 Under the Private Finance Initiative (PFI) the public sector purchases services from a private sector partner. In addition to requiring capital investment to be undertaken by the private sector, the ability of the private sector partner to be innovative and manage risks appropriately allocated to it can result in a specified level of service at a price that represents value for money.

C63 The PFI has now become an established method of delivering many public services which require significant investment in capital assets. Projects with a combined capital value of over £14 billion have been signed since May 1997 in such diverse areas as schools, colleges, hospitals, local authorities, defence IT, and property management. Approval of a PFI scheme depends on a thorough assessment of the lifetime costs of both providing and maintaining the underlying asset and the running costs of delivering the required service. The PFI provides considerable opportunities for the private sector; in return the contractual relationship with the public sector ensures the ongoing delivery of cost effective and quality services.

C64 The Government is committed to developing PFI and other partnerships arrangements with the private sector to further enhance the delivery of public services and to ensure the delivery of a higher sustainable level of public sector investment. The Government wants to exploit all commercial potential and spare capacity in public sector assets through a sensible balance of risk and reward.

C65 Table C16 shows a breakdown by department of the estimated public sector investment resulting from signed contracts and Table C17 those expected to reach preferred bidder stage within the next three years. From 2000–01 to 2003–04, some £13 billion of new investment is expected as a result of PFI.

Table C16: Departmental estimate of capital spending by the private sector (signed deals):

		£ million		
	Estimate	**Projections**		
	2000–01	**2001–02**	**2002–03**	**2003–04**
Defence	121	147	200	100
Foreign and Commonwealth Office and International Development	7	7	6	7
Agriculture, Fisheries and Food[1]	0	0	0	0
Trade and Industry	36	61	24	26
Environment, Transport and Regions[2,3]	619	639	855	1015
Education and Employment[4]	15	28	9	0
Home Office	160	136	297	0
Legal Departments	37	36	13	6
Culture, Media and Sport	0	0	0	0
Health	491	501	235	67
Social Security	42	17	67	14
Scotland	540	289	78	20
Wales	160	11	0	0
Northern Ireland	39	26	4	0
Chancellor's Departments	104	87	19	19
Cabinet Office	155	159	42	6
Local authorities[5,6]	1352	1404	1215	1150

Total	3878	3548	3064	2430

[1] Includes Forestry Commission

[2] Includes the private sector capital investment in Channel Tunnel Rail Link.

[3] In addition, substantial private investment is levered in through housing, urban regeneration and other programmes.

[4] Excludes private finance activity in education institutions classified to the private sector. Estimated total values for these are £80m in 2000–01 and £226m in 2001–02. Includes projects in Voluntary Aided schools only; Schools projects funded through Revenue Support Grant are included in the Local Authority figures.

[5] Figures represent spending on projects supported by central government through Revenue Support Grant.

[6] PFI activity in Local Authority schools is included in the Local Authorities line.

C66 Under PFI, the public sector contracts for services not assets, and capital investment is only one of the activities undertaken by the private sector in order to supply services. The figures in Tables C16 and C17, therefore, do not reflect the total value of the contracts.

Table C17: Estimated aggregated capital value of projects at preferred bidder stage

		£ million		
	Estimate	**Projections**		
	2000–01	**2001–02**	**2002–03**	**2003–04**
Defence	0	228	293	280
Foreign and Commonwealth Office and International Development	0	0	0	0
Agriculture, Fisheries and Food[1]	0	13	8	0
Trade and Industry	10	16	12	3
Environment, Transport and Regions[2,3]	0	10	41	13
Education and Employment[4]	0	0	0	0
Home Office	11	110	11	65
Legal Departments	3	14	29	8
Culture, Media and Sport	0	0	0	0
Health	68	30	0	0
Social Security	0	2	0	0
Scotland	19	81	11	0
Wales	3	82	15	0
Northern Ireland	22	54	24	0
Chancellor's Departments	0	0	0	0
Cabinet Office	0	2	4	4
Local Authorities[5]	266	203	91	40
Total	**402**	**845**	**539**	**413**

[1] Includes Forestry Commission.

[2] Includes the private sector capital investment in Channel Tunnel Rail Link.

[3] In addition, substantial private investment is levered in through housing, urban regeneration and other programmes.

[4] Excludes PPP/PFI activity in the further and higher education (FHE) sectors, which are classified to the private sector.

Includes projects in Voluntary Aided schools only: schools projects funded through Revenue Support Grant are included in the Local Authority figures.

[5] *PFI activity in local authority schools is included in the local authorities line.*

Table C18: Estimated payments under PFI contracts – March 2001 (signed deals)

	£ million		
2000–01	2906	**2013–14**	3806
2001–02	3595	**2014–15**	3676
2002–03	4084	**2015–16**	3681
2003–04	4478	**2016–17**	3680
2004–05	4524	**2017–18**	3619
2005–06	4509	**2018–19**	3059
2006–07	4554	**2019–20**	3038
2007–08	4505	**2020–21**	3149
2008–09	4466	**2021–22**	3026
2009–10	4371	**2022–23**	3024
2010–11	4140	**2023–24**	2980
2011–12	4090	**2024–25**	2994
2012–13	3863	**2025–26**	2661

C67 Table C18 shows a forecast of the estimated payments by the public sector flowing from private investment in signed projects over the next twenty-five years. Actual expenditure will depend on the details of the payment mechanism for each contract. There has been a technical change to the treatment of local authority expenditure within this table, which now takes into account the full cost to government of the PFI contracts rather than simply the capital support element. The capital element remains consistent with the levels reported for Budget 2000.

C68 Table C19 shows estimated receipts from asset and loan sales from 1990–00 to 2002–03. Following two years of total sales of fixed assets of over £4 billion a year, the Government continues to forecast further sales of some £4 billion in 2000–01 and each of the next two years.

C69 The figures for sales of financial assets include proceeds from the Public Private Partnership for National Air Traffic services and the Defence Evaluation and Research Agency.

Table C19: Loans and sales of assets

	£ billion			
	Outturn	**Estimate**	**Projections**	
	1999–00	**2000–01**	**2001–02**	**2002–03**
Sales of fixed assets[1]				
Central Government	1.1	1.3	1.0	1.0
Local Authorities	3.7	2.8	2.8	2.8
Total sales of fixed assets	**4.8**	**4.1**	**3.8**	**3.8**
Loans and sales of financial assets				
Sale of student loans portfolio				
Other loans and sales of financial assets	– 1.7	– 3.4	– 2.5	– 3.1
Total loans and sales of financial assets	**– 1.7**	**– 3.4**	**– 2.5**	**– 3.1**
Total loans and sales of assets	**3.1**	**0.6**	**1.3**	**0.7**

[1] National accounts definition of capital. Excludes single use fighting equipment by Ministry of Defence, which is treated as capital under resource accounting, and expenditure on and sale of which will be included in the capital budget under resource budgeting.

FINANCING REQUIREMENT

Table C20: Public sector net cash requirement[1]

	£ billion							
	2000–01				**2001–02**			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing	**–16.0**	**0.4**	**0.7**	**–15.0**	**–5.1**	**0.0**	**0.5**	**–4.7**
Financial transactions								
Net lending to private sectorand abroad	3.2	–0.1	0.0	3.1	2.8	–0.1	0.0	2.7
Cash expenditure on company securities[2]	0.2	0.1	0.0	0.3	–0.2	0.0	0.0	–0.2
Accruals adjustments on receipts	–18.8	0.2	0.0	–18.6	2.5	0.3	0.0	2.8
Other accruals adjustments	–2.6	0.0	0.0	–2.6	–0.4	0.0	0.0	–0.4
Miscellaneous financial transactions	–1.8	–0.1	0.4	–1.6	–0.7	0.0	0.0	–0.7
Own account net cash requirement	–35.9	0.5	1.0	–34.3	–1.1	0.2	0.5	–0.4
Net lending within the public sector	2.6	–1.5	–1.0	0.0	1.4	–1.0	–0.4	0.0
Net cash	–33.3	–1.0	0.0	–34.3	0.3	–0.8	0.1	–0.4

requirement[3]

1 *The figures in this table include the windfall tax and associated spending. Excluding windfall tax receipts and associated spending, the public sector net cash requirement was –£9.3 billion (–1.0 per cent of GDP) in 1999–2000 and is projected to be £–35.7 billion (–3.8 per cent of GDP) in 2000–2001. It is projected at £–1.9 billion (–0.2 per cent of GDP) in 2001–02 and £4 billion (0.4 per cent of GDP) in 2002–03.*

2 *Net acquisition of UK company securities and subscriptions to international development banks etc.*

3 *Market and overseas borrowing for local government and public corporation sectors.*

C70 Table C21 updates the financing arithmetic for 2000–01. It also outlines the financing arithmetic for 2001–02. As a consequence of the success of the Spectrum auction, the Gilts Remit was revised and the new remit was published on 12 June 2000. Gross gilts issuance was fixed at £10.0 billion for the remainder of the financial year – a £2.2 billion reduction from the original remit issued in March 2000. The contingencies outlined in the Debt Management Report 2000–01 were exercised and it was announced that the surplus would be used for reducing net debt. In the Pre-Budget Report, a new CGNCR forecast of –£28.2 billion was published. Further decisions were made over the composition of the reduction in net debt. It was also announced that the DMO would be holding a short term net cash surplus which they would unwind over the next three financial years.

C71 The forecast for the CGNCR in 2001–02 is for a modest positive requirement. In order to maintain the level of gross issuance, the Government has decided to pre-finance foreign currency debt due in 2003. Additionally, the Government plans to purchase £1.0 billion of gilts through secondary market buy-backs. Both of these measures will help boost the net financing requirement and to address the current liquidity problems in the gilts market. Details of the Government's debt management plans for 2001–02, including the remits for the DMO and National Savings are published today in the Debt and Reserves Management Report 2001–02.

Table C21: Financing requirement forecast

		2000–01			**2001–02**
	Mar 2000	June 2001	Nov 2000	Mar 2001	Mar 2001
£ billion	Budget Remit	Revised remit[1]	Pre–Budget Report	Budget	Budget
Central government net cash requirement	**–4.9**	**–4.9**	**–28.2**	**–33.3**	**0.3**
Unanticipated spectrum receipts		**–19.5**			
Accrued uplift on maturing index–linked gilt					1.1
Net financing of official reserves	3.5	9.5	9.3	9.3	1.3
Gilt redemptions	18.6	18.6	18.6	18.6	16.7
Debt buy–backs	3.5	3.5	5.0	5.5	1.0
Gilt sales residual from 1999–2000	–9.5	–12.8	–12.8	–12.8	–
Gross financing requirement	**11.2**	**–5.6**	**–8.1**	**–12.7**	**20.4**
Less					
Assumed net National Savings contribution	–0.8	–0.8	–1.5	–0.7	–3.0
DMO's cash deposit	–0.2	–0.2	–0.2	–0.2	–
Net financing requirement	**12.2**	**–4.6**	**–6.4**	**–11.8**	**23.4**
Financed by					
Gross gilt sales	12.2	10.0	10.0	10.0	13.5
Changes in net short-term debt[2]		–14.7	–16.4	–21.8	9.9

Note: Figures may not sum due to rounding.

1 *Remit revised following outturn of the 1999–2000 CGNCR and outcome of the 3G Spectrum auction.*

2 *This comprises a repayment of the Ways & Means Facility at the Bank of England, changes in the planned Treasury bill stock and changes in the Debt Management Office's (DMO) net cash position. For 2001–02, it comprises a £5.0 billion increase in the Treasury bill stock and a £4.9 billion reduction in the DMO's net cash position.*

Table C22: Public sector transactions by sub-sector and economic category

		£ billion 2000–01				
		General government				
	Line	**Central government**	**Local authorities**	**Total**	**Public corporations**	**Public sector**
Current receipts						
Taxes on income and wealth	*1*	145.0	0.0	145.0	–0.2	144.8
Taxes on production and imports	*2*	132.3	0.2	132.5	0.0	132.5
Other current taxes	*3*	3.6	13.9	17.5	0.0	17.5
Taxes on capital	*4*	2.2	0.0	2.2	0.0	2.2
Social contributions	*5*	60.9	0.0	60.9	0.0	60.9
Gross operating surplus	*6*	5.1	8.6	13.7	3.8	17.5
Rent and other current transfers	*7*	1.8	0.0	1.8	0.6	2.4
Interest and dividends from privatesector and abroad	*8*	4.4	0.7	5.1	0.3	5.3
Interest and dividends from public sector	*9*	5.8	–3.6	2.2	–2.2	0.0
Total current receipts	*10*	**361.1**	**19.8**	**380.9**	**2.3**	**383.2**
Current expenditure						
Current expenditure on goods and services	*11*	107.6	70.0	177.6	0.0	177.6
Subsidies	*12*	4.3	0.8	5.1	0.0	5.1
Net social benefits	*13*	102.4	12.5	114.9	0.0	114.9
Net current grants abroad	*14*	0.1	0.0	0.1	0.0	0.1
Current grants (net) within public sector	*15*	67.5	–67.5	0.0	0.0	0.0
Other current grants	*16*	21.7	0.0	21.7	0.0	21.7
Interest and dividends paid	*17*	26.6	0.3	26.8	–0.3	26.5
Apportionment of DEL reserveand AME margin	*18*	0.0	0.0	0.0	0.0	0.0
Total current expenditure	*19*	**330.1**	**16.1**	**346.3**	**–0.3**	**346.0**
Depreciation	*20*	4.7	6.6	11.3	3.6	14.9
Surplus on current budget	*21*	**26.3**	**–3.0**	**23.3**	**–1.0**	**22.3**
Capital expenditure						
Gross domestic fixed capital formation	*22*	5.8	6.9	12.6	4.0	16.6
Less depreciation	*23*	–4.7	–6.6	–11.3	–3.6	–14.9
Increase in inventories	*24*	0.4	0.0	0.4	0.2	0.6
Capital grants (net) within public sector	*25*	4.4	–3.5	0.9	–0.9	0.0
Capital grants to private sector	*26*	4.4	1.3	5.7	0.0	5.7
Capital grants from private sector	*27*	0.0	–0.6	–0.6	0.0	–0.7

Apportionment of DEL reserve	*28*	0.0	0.0	0.0	0.0	0.0
Net capital expenditure	*29*	**10.3**	**–2.6**	**7.7**	**–0.3**	**7.4**
Net borrowing	*30*	**–16.0**	**0.4**	**–15.6**	**0.7**	**–15.0**

Table C22: Public sector transactions by sub-sector and economic category

	£ billion 2000–01					
	General government					
Line	**Central government**	**Local authorities**	**Total**	**Public corporations**	**Public sector**	
						Current receipts
1	151.9	0.0	151.9	–0.2	151.7	Taxes on income and wealth
2	137.3	0.2	137.5	0.0	137.5	Taxes on production and imports
3	3.5	14.7	18.2	0.0	18.2	Other current taxes
4	2.3	0.0	2.3	0.0	2.3	Taxes on capital
5	62.8	0.0	62.8	0.0	62.8	Social contributions
6	5.3	9.0	14.3	4.1	18.3	Gross operating surplus
7	2.0	0.0	2.0	0.7	2.7	Rent and other current transfers
8	3.8	0.8	4.6	0.3	4.8	Interest and dividends from private sector and abroad
9	5.9	–3.5	2.4	–2.4	0.0	Interest and dividends from public sector
10	**374.9**	**21.0**	**395.9**	**2.5**	**398.4**	**Total current receipts**

						Current expenditure
11	116.7	73.6	190.3	0.0	190.3	Current expenditure on goods and services
12	5.6	0.9	6.5	0.0	6.5	Subsidies
13	108.6	12.9	121.6	0.0	121.6	Net social benefits
14	–0.9	0.0	–0.9	0.0	–0.9	Net current grants abroad
15	71.5	–71.5	0.0	0.0	0.0	Current grants (net) within public sector
16	24.4	0.0	24.4	0.0	24.4	Other current grants
17	23.1	0.1	23.3	–0.2	23.0	Interest and dividends paid
18	2.2	0.0	2.2	0.0	2.2	Apportionment of DEL reserve and AME margin
19	**351.2**	**16.1**	**367.3**	**–0.2**	**367.0**	**Total current expenditure**
20	4.9	6.8	11.7	3.8	15.5	Depreciation
21	**18.8**	**–1.9**	**16.9**	**–1.1**	**15.9**	**Surplus on current budget**
						Capital expenditure
22	7.6	8.5	16.1	3.9	20.0	Gross domestic fixed capital formation
23	–4.9	–6.8	–11.7	–3.8	–15.5	*Less* depreciation
24	0.4	0.0	0.4	0.0	0.4	Increase in inventories
25	5.1	–4.3	0.8	–0.8	0.0	Capital grants (net) within public sector
26	5.0	1.3	6.3	0.0	6.3	Capital grants to private sector
27	0.0	–0.7	–0.7	0.0	–0.7	Capital grants from private sector
28	0.6	0.0	0.6	0.0	0.6	Apportionment of DEL reserve
29	**13.7**	**–1.9**	**11.8**	**–0.6**	**11.2**	**Net capital expenditure**
30	**–5.1**	**0.0**	**–5.1**	**0.5**	**–4.7**	**Net borrowing**

Table C23: Historical series of public sector balances, receipts and debt

Per cent of GDP

	Public sector current budget[1]	**Public sector net borrowing**[1]	**Public sector net cash requirement**[1]	**General government net borrowing**[2]	**Net taxes and social security contributions**	**Public sector current receipts**	**Public sector net debt**[3]	**General government gross debt**	**Public sector net worth**[4]
1970–71	6.7	–0.6	1.2	–2.0		43.1			
1971–72	4.1	1.0	1.4	–0.7		41.2			
1972–73	1.9	2.8	3.6	2.2		38.8			
1973–74	0.7	4.4	5.8	4.1		39.7			
1974–75	–0.9	6.4	9.0	4.0		42.5	52.1	60.4	
1975–76	–1.6	7.0	9.2	4.8		42.5	53.1	58.7	
1976–77	–1.3	5.6	6.4	4.3		43.6	53.5	59.1	
1977–78	–1.4	4.2	3.7	3.6		41.3	48.8	57.1	
1978–79	–2.4	4.8	5.2	4.0	33.4	40.5	47.3	56.2	
1979–80	–1.7	3.9	4.7	2.8	34.0	41.0	44.1	51.8	

1980–81	–2.9	4.6	5.1	3.6	35.4	42.4	45.5	52.9	
1981–82	–1.3	2.1	3.4	3.1	38.8	46.2	46.6	51.7	
1982–83	–1.6	3.0	3.2	3.1	38.9	45.6	44.8	50.4	
1983–84	–2.1	3.7	3.2	3.8	38.2	44.6	45.5	50.4	
1984–85	–2.7	4.1	3.1	3.8	38.8	43.9	45.2	50.3	
1985–86	–1.2	2.3	1.6	2.5	38.1	43.4	43.6	49.5	
1986–87	–1.5	2.1	0.9	2.4	37.7	42.0	41.0	48.9	
1987–88	–0.4	0.9	–0.7	1.2	37.6	41.2	36.9	46.5	75.3
1988–89	1.7	–1.5	–3.0	–1.0	36.9	40.8	30.7	40.6	82.0
1989–90	1.5	–0.4	–1.3	0.2	36.3	40.1	27.9	35.5	74.1
1990–91	0.6	0.7	–0.1	1.2	36.4	39.2	26.1	33.3	62.0
1991–92	–1.9	3.6	2.3	3.5	35.2	38.8	27.5	34.4	54.7
1992–93	–5.8	7.7	5.9	7.6	34.0	36.5	32.2	40.4	42.0
1993–94	–6.3	7.8	7.1	7.8	33.3	36.0	37.4	46.3	29.7
1994–95	–4.9	6.3	5.3	6.5	34.3	37.0	41.0	49.6	29.3
1995–96	–3.6	4.9	4.4	5.1	35.3	38.0	43.1	52.4	21.6
1996–97	–3.0	3.6	3.0	3.8	35.2	37.6	44.0	52.4	17.6
1997–98	–0.5	1.0	0.4	0.7	36.5	38.9	41.9	49.6	14.0
1998–99	0.8	–0.3	–0.6	–0.7	37.0	39.1	39.6	46.8	12.2
1999–00	2.1	–1.8	–1.0	–1.7	36.9	39.6	36.8	43.7	17.4

1 *Including windfall tax and associated spending*.
2 *UK national accounts definition*.
3 *At end-March, GDP centred on end-March*.
4 *At end-December, GDP centred on end-December.*

Table C24: Historical series of government expenditure

	£ billion (1999–2000 prices)				Per cent of GDP			
	Public sector current expenditure	Public sector net capital expenditure	Public sector gross investment	Total Managed expenditure	Public sector current expenditure	Public sector net capital expenditure	Public sector gross investment	Total Managed Expenditure
1970–71	152.7	28.7	47.3	200.0	32.5	6.1	10.1	42.5
1971–72	160.0	25.1	44.4	204.4	33.0	5.2	9.2	42.2
1972–73	168.0	24.2	44.4	212.4	33.0	4.7	8.7	41.7
1973–74	184.8	27.2	49.8	234.6	34.8	5.1	9.4	44.1
1974–75	203.9	28.8	52.9	256.8	38.8	5.5	10.1	48.9
1975–76	208.9	28.2	52.6	261.5	39.5	5.3	10.0	49.5
1976–77	214.5	23.0	48.1	262.6	40.2	4.3	9.0	49.2
1977–78	211.1	15.6	40.7	251.8	38.2	2.8	7.4	45.5
1978–79	217.4	13.6	39.2	256.6	38.4	2.4	6.9	45.3
1979–80	223.9	12.5	38.5	262.4	38.3	2.1	6.6	44.9
1980–81	231.0	9.8	36.3	267.3	40.6	1.7	6.4	47.0
1981–82	241.0	4.8	31.2	272.2	42.8	0.8	5.5	48.3

1982–83	246.9	8.1	33.8	280.7	42.7	1.4	5.9	48.6
1983–84	254.2	10.1	35.7	289.9	42.4	1.7	6.0	48.3
1984–85	260.8	8.8	33.3	294.1	42.6	1.4	5.4	48.0
1985–86	261.5	7.2	29.3	290.8	41.1	1.1	4.6	45.7
1986–87	265.8	3.9	26.4	292.3	40.1	0.6	4.0	44.1
1987–88	269.1	3.7	24.6	293.6	38.6	0.5	3.5	42.1
1988–89	262.8	1.9	23.3	286.1	36.1	0.3	3.2	39.3
1989–90	264.3	8.1	29.7	294.0	35.7	1.1	4.0	39.7
1990–91	265.7	9.4	28.7	294.4	36.0	1.3	3.9	39.9
1991–92	281.3	12.5	28.9	310.2	38.4	1.7	3.9	42.4
1992–93	296.2	14.2	29.3	325.5	40.2	1.9	4.0	44.2
1993–94	305.3	11.5	26.4	331.7	40.4	1.5	3.5	43.9
1994–95	316.1	10.7	26.0	342.1	40.0	1.4	3.3	43.2
1995–96	320.6	10.0	25.6	346.3	39.7	1.2	3.2	42.9
1996–97	322.9	5.1	20.0	342.9	38.8	0.6	2.4	41.2
1997–98	321.8	4.0	18.6	340.5	37.5	0.5	2.2	39.6
1998–99	320.2	4.1	18.8	339.0	36.4	0.5	2.1	38.6
1999–00	325.3	3.5	18.2	343.5	35.9	0.4	2.0	37.9

CONVENTIONS USED IN PRESENTING THE PUBLIC FINANCES

FORMAT FOR THE PUBLIC FINANCES

The June 1998 Economic and Fiscal Strategy Report (EFSR), set out a new format for presenting the public finances that corresponded more closely to the two fiscal rules. The three principal measures are:

- **the surplus on current budget (relevant to the golden rule);**
- **public sector net borrowing, and**
- **the public sector net debt ratio (relevant to the sustainable investment rule).**

These measures are based on the national accounts and are consistent with the new European System of Accounts 1995 (ESA95). Estimates and forecasts of the public sector net cash requirement (formerly called the public sector borrowing requirement) are still shown in the FSBR, but they are given less prominence.

The fiscal rules are similar to the criteria for deficits and debt laid down in the Treaty but there are important definitional differences:

UK fiscal rules cover the whole public sector, whereas the Treaty deficit and debt only includes general (ie: central and local) government;

- **the fiscal rules apply over the whole economic cycle, not year-to-year;**
- **the current budget excludes capital spending, which is included in the Treaty deficit measure; and**
- **the UK debt measure is net of liquid assets, whereas the Treaty measure uses gross debt.**

From February 2000 the Treaty deficit moved to being reporting on an ESA95 basis.

NATIONAL ACCOUNTS

The national accounts record most transactions, including most taxes (although not corporation tax), on an accruals basis, and impute the value of some transactions where no money changes hands (for example, non-trading capital consumption). The principal measures drawn from the national accounts are described below.

The **current budget** (formerly known as the current balance) measures the balance of current account revenue over current expenditure. The definition of the current balance presented in this chapter is very similar to the national accounts concept of net saving. It differs only in that it includes taxes on capital (mainly death duties) in current rather than capital receipts.

Public sector net borrowing (formerly known as the financial deficit in the UK national accounts) is the balance between expenditure and income in the consolidated current and capital accounts. It differs from the public sector net cash requirement because it is measured on an accruals basis and because certain financial transactions (notably net lending and net acquisition of other financial assets, which affect the level of borrowing but not the public sector's net financial indebtedness) are excluded from public sector net borrowing but included in the public sector net cash requirement.

General government net borrowing, which excludes net borrowing of public corporations, is the most internationally comparable measure of the budget deficit. It is reported to the European Commission under the Treaty, using the definitions in ESA95.

CASH BASIS

The cash approach measures the actual cash transactions between the public sector and the rest of the economy. It is the starting point for monthly estimates of net borrowing.

PUBLIC SECTOR CURRENT RECEIPTS

Net taxes and social security contributions in Table C10 are measured on a cash basis, rather than a national accounts (accruals) basis, and, as far as possible, relate to actual cash flows. Income tax credits are netted off. VAT is net of refunds to the public sector. These refunds are part of "other taxes and royalties" in Table C7. 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.). "Good causes" receipts from the National Lottery are included in "other taxes and royalties".

The **accounting adjustments** put these cash figures on to a national accounts (accruals) basis. Those elements of the UK contribution to the EC budget which relate to the UK tax base are deducted as, under ESA95, they are treated for national accounts as taxes imposed directly by the EU. Tax credits which score as expenditure in the national accounts are added back. Certain income tax reliefs are payable regardless of an individual's liability to income tax; thus some payments are made to non-taxpayers. Examples are mortgage interest relief paid under the MIRAS (mortgage interest relief at source) scheme, life assurance premium relief on pre-1984 policies and private medical insurance premium relief for over-60s. The working families tax credit also falls into this category. Total tax relief paid under these schemes is shown as income tax credits in Table C7. Income tax receipts are shown gross of these tax credits. All such tax credits are shown in the national accounts as expenditure. From 2001–02, income tax credits include the Children's Tax Credit, which is treated in the national accounts as negative tax receipts. Hence, payments of Children's Tax Credit are not added back in deriving total receipts on a national accounts basis.

TOTAL MANAGED EXPENDITURE (TME)

Public expenditure control regime

The Economic and Fiscal Strategy Report (EFSR) in June 1998 also reformed the planning and control regime for public spending.

- **Overall plans are based on sound economic principles, with a new distinction between current and capital spending;**
- **Firm 3-year plans (Departmental Expenditure Limits – DEL) will provide certainty and flexibility for long-term planning and management;**
- **Spending outside DEL, which cannot reasonably be subject to firm multi-year limits commitments, will be reviewed annually as part of the Budget process. This Annual Managed Expenditure (AME) is also subject**

to constraints;

- **Large public corporations, not dependent on government grants, will have more flexibility;**

Detailed plans under this regime were given in the 2000 Spending Review in July 2000 for the years 2001–02 to 2003–04.

Public sector **capital expenditure** is shown in Table C15. It includes:

(i) gross domestic fixed capital formation (ie expenditure on fixed assets – schools, hospitals, roads, computers, plant and machinery, intangible assets etc) net of receipts from sales of fixed assets (eg council houses and surplus land);

(ii) grants in support of capital spending by the private sector; and

(iii) the value of the physical increase in stocks (for central government, primarily agricultural commodity stocks).

Net investment in Table C2 nets off depreciation of the public sector's stock of fixed assets.

Departmental Expenditure Limits (DEL) have distinct resource and capital budgets, shown in Table C13.

Annually Managed Expenditure (AME) components are shown in Table C11. These include all of social security spending, housing revenue account subsidies, the Common agricultural policy, export credits, net payments to EC institutions, spending by self financing public corporations, public service pensions net of contributions, spending financed by the national lottery and central government gross debt interest.

Total Managed Expenditure (TME), the sum of DEL and AME, is shown in Table C11.

Export Credits Guarantee Department programme includes the activities of the Guaranteed Export Finance Corporation (GEFCO), whose sole business is to refinance export loans guaranteed by ECGD, thus reducing the cost to Government. The refinancing activities are financial transactions affecting only the net cash requirement and so are netted out in the accounting adjustments.

Locally financed expenditure comprises local authority self–financed expenditure (LASFE) and Scottish spending financed by local taxation (non–domestic rates and, if and when levied, the Scottish variable rate of income tax). LASFE is the difference between total local authority expenditure, including most gross debt interest but net of capital receipts, and central government support to local authorities (ie Aggregate External Finance (AEF), specific grants and credit approvals).

Central government debt interest is shown gross. Only interest paid within central government is netted off; all other receipts of interest and dividends are included in current receipts. The capital uplift on index–linked gilts is scored as interest at the time it accrues, whereas the net cash requirement records the actual payments of capital uplift on the redemption of index–linked gilts (the uplift which accured while the stock was in market hands). Interest paid includes the amortisation of discounts on gilts at issue.

The **accounting adjustments** include various items within TME but outside DEL, which are not shown separately in Table C11. These details are shown in Table C14. The definition of each line is as follows:

Line one adds the value of general government non–trading capital consumption.

Line two adds back VAT refunded to central government departments, local authorities and certain public corporations. DEL and AME programme expenditure are measured net of these refunds, while Total Managed Expenditure is recorded with the VAT paid.

Line three deducts traditional own resources (ie payments of Customs duties and agricultural and sugar levies) and VAT contributions to the European Community, which are included in the net payments to EC institutions line in AME, but excluded from TME.

Line four adds income tax credits which score as public expenditure under national accounting conventions. This includes Mortgage Interest Relief, Life Assurance Premium Relief, and (from 1999–00) the Working Families' Tax Credit and Disabled Person's Tax Credit.

Line five moves the scoring of public corporations' current and capital spending on to a national accounts basis. It adds in capital expenditure and debt interest payments to the private sector that do not score in departmental budgets and removes capital grants to public corporations and operating surpluses that do not score in departmental budgets.

Line six removes intra–public sector debt interest and dividend payments and receipts which are included elsewhere in Departmental Expenditure Limits and Annually Managed Expenditure.

Line seven deducts those financial transactions, which are scored in Departmental Expenditure Limits and Annually Managed Expenditure.

Line eight removes the deduction of receipts relating to regulation of industry that are netted off in DEL but should not be netted off in TME. It also deducts certain local authorities' receipts that are netted off TME.

Line nine shows other adjustments and include, amongst others, the deduction of grants paid to local authorities by non–departmental public bodies classified to the central government sector. In 1999–2000 it also includes a one-off accruals adjustment reflecting the new accounting convention used in departmental budgets.

DEBT AND WEALTH

Public sector net debt is approximately the stock analogue of the public sector net cash requirement. It measures the public sector's financial liabilities to the private sector and abroad, net of short-term financial assets such as bank deposits and foreign exchange reserves.

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 worth represents the public sector's overall net balance sheet position. It is equal to the sum of the public sector's financial and non-financial assets less its total financial liabilities. The estimates of tangible assets are 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 in time to an improvement in data quality, as audited information compiled from detailed asset registers becomes available.

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LIST OF ABBREVIATIONS

AEI	Average Earnings Index
AESOP	All-Employee Share Ownership Plan
AME	Annually Managed Expenditure
APPs	Appropriate personal pensions
AWP	Affordable Warmth Programme
BCC	British Chambers of Commerce
BCS	British Crime Survey
CAT	Charges Access Terms
CBI	Confederation of British Industry
CCL	Climate Change Levy
CED	Consumers' expenditure deflator
CFCs	Controlled Foreign Companies
CGT	Capital gains tax
CHP	Combined Heat and Power
CIPS	Chartered Institute of Purchasing and Supply
CITC	Community Investment Tax Credit
CMF	Capital Modernisation Fund
CO_2	Carbon Dioxide
COMPS	Contracted-out money purchase schemes
COSRS	Contracted-out salary related schemes
CPA	Crop Protection Association
CSR	Comprehensive Spending Review
DEL	Departmental Expenditure Limits
DETR	Department of the Environment, Transport and the Regions
DfEE	Department for Education and Employment
DGFT	Director General of Fair Trading
DIS	Departmental Investment Strategy
DLA	Disability Living Allowance
DPTC	Disabled Person's Tax Credit
DTI	Department of Trade and Industry
DVLA	Driver and Vehicle Licensing Agency
DWA	Disability Working Allowance

EAC	Environmental Audit Committee
EA(PC)	Cabinet Committee on Productivity and Competitiveness
EC	European Commission
EEA	European Economic Area
EFSR	Economic and Fiscal Strategy Report
EIS	Enterprise Investment Scheme
EMA	Education Maintenance Allowance
EMIs	Enterprise Management Incentives
EMU	Economic and Monetary Union
EPC	Economic Policy Committee
ES	Employment Service
ESA79	European Systems of Accounts 1979
ESA95	European Systems of Accounts 1995
ETG	Emissions Trading Group
ETC	Employment Tax Credit
EU	European Union
FE	Further education
FEFC	Further Education Funding Council
FRES	Federation of Recruitment and Employment Services
FSA	Financial Services Authority
FSMB	Financial Services and Markets Bill
FSBR	Financial Statement and Budget Report
G5	Group of Five. A group of five major industrial nations (comprising: France, Germany, Japan, UK and US).
G7	Group of Seven. A group of seven major industrial nations (comprising: Canada, France, Germany, Italy, Japan, UK and US).
GCSE	General Certificate of Secondary Education
GDI	Gasoline Direct Injection
GDP	Gross Domestic Product
GFC	Green Fuel Challenge
GTC	Green Technology Challenge
g/km	grams per kilometre
HEES	Home Energy Efficiency Scheme
HEROBC	Higher Education Reach Out to Business and the Community
HICP	Harmonised Index of Consumer Prices
HIPC	Heavily Indebted Poor Countries
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome
HMF	Haulage Modernisation Fund
HRA	Human Rights Act
ICC	Integrated Child Credit
ICT	Information and communications technologies
ICTA	Income and Corporation Tax Act
IDA	Individual Development Account
IFS	Institute for Fiscal Studies
IIP	Investors in People

ILA	Individual Learning Account
ILO	International Labour Organisation
IMF	International Monetary Fund
IPA	Individual Pension Account
IPPC	Integrated Pollution and Prevention Control
IPRs	Intellectual Property Rights
IRB	Incomerelated benefits
IRU	Indefeasible Right of Use
IS	Income Support
ISMI	Income Support for Mortgage Interest
ISA	Individual Savings Account
IT	Information Technology
ITCE	Information Technology and Communication Engineers
JSA	Jobseeker's Allowance
LEL	Lower earnings limit
LFS	Labour Force Survey
LLP	Limited Liability Partnership
LPG	Liquefied Petroleum Gas
LRP	Lead Replacement Petrol
LSP	Local Strategic Partnership
LTCS	Landfill Tax Credit Scheme
MA	Maternity Allowance
MCA	Married Couple's Allowance
MCT	Mainstream corporation tax
MDR	Marginal Deduction Rate
MFR	Minimum Funding Requirement
MIG	Minimum Income Guarantee
MIRAS	Mortgage Interest Relief at Source
MIT	Massachusetts Institute of Technology
MPC	Monetary Policy Committee
MtC	Million tonnes of carbon
NAIRU	Non-accelerating inflation rate of unemployment
NAO	National Audit Office
NAR	National Asset Register
NDDP	New Deal for Disabled People
NDLP	New Deal for Lone Parents
NDYP	New Deal for Young People
ND25+	New Deal for 25+
ND50+	New Deal for the over 50s
NESI	New Enterprise Support Initiative
NETCEN	National Environmental Technology Centre
NFC	Non-financial company
NHS	National Health Service
NICs	National Insurance Contributions

NIESR	National Institute of Economic and Social Research
NMW	National Minimum Wage
NOP	National Opinion Polls
NOx	Nitrogen Oxides
NSTF	National Skills Task Force
OECD	Organisation for Economic Cooperation and Development
OFGEM	Office of Gas Electricity Markets
OFT	Office of Fair Trading
OFTEL	Office of Telecommunications
OGC	Office of Government Commerce
OLS	Overseas Labour Service
ONS	Office for National Statistics
OPEC	Organisation of Petroleum Exporting Countries
OPRA	Occupational Pensions Regulatory Authority
PAT	Policy Action Team
PAYE	Pay As You Earn
PBR	Pre-Budget Report
PEP	Personal Equity Plan
PFI	Private Finance Initiative
PNFC	Private non-financial corporation
PPC	Pollution Prevention and Control
PPG3	Policy Planning Guidelines (3)
PPI	Pooled Pension Investment
PPPs	Public Private Partnerships
PRT	Petroleum Revenue Tax
PSA	Public Service Agreement
PSNB	Public sector net borrowing
PT	Primary threshold
PUK	Partnerships UK
RAB	Resource Accounting and Budgeting
R&D	Research and development
RDAs	Regional Development Agencies
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
RSLs	Registered Social Landlords
SBIT	Small Business Investment Taskforce
SBRI	Small Business Research Initiative
SBS	Small Business Service
SDA	Service Delivery Agreement
SEE	Small Earnings Exception
SERPS	State Earnings Related Pensions Scheme
SEU	Social Exclusion Unit
SITF	Social Investment Taskforce
SME	Small and medium-sized enterprise

SMP	Statutory Maternity Pay
SNA	System of National Accounts
SRA	Strategic Rail Authority
TESSA	Tax Exempt Special Savings Account
TME	Total Managed Expenditure
TTWA	Travel To Work Area
TUC	Trades Union Congress
UEL	Upper earnings limit
UfI	University for Industry
UK	United Kingdom
ULSD	Ultralow sulphur diesel
ULSP	Ultralow sulphur petrol
UN	United Nations
UNDP	United Nations Development Programme
URC	Urban Regeneration Companies
US	United States
VAT	Value Added Tax
VCTs	Venture Capital Trusts
VDP	Vaccine Damage Payment
VED	Vehicle Excise Duty
VOCs	Volatile Organic Compounds
WFTC	Working Families' Tax Credit
WRAP	Waste and Resources Action Programme
WTAS	Windfall Tax and Associated Spending

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Table B7: Gross domestic product and its components

	Household consumption	General government consumption	Fixed investment	Change in inventories	Domestic demand	Exports of goods and services	Total final expenditure	Less imports of goods and services	Plus statistical discrepancy	GDP at market prices
2000	551.3	152.6	155.7	2.3	862.3	270.8	1133.2	313.3	–0.2	819.7
2001	568.5 to 570.3	159.1	164.3 to 164.8	–2.3 to –1.8	889.7 to 892.4	285.8 to 286.7	1175.5 to 1179.1	336.4 to 337.4	–0.2	838.9 to 841.5
2002	582.3 to 586.9	164.3	169.1 to 170.4	–0.4 to 0.9	915.2 to 922.5	299.5 to 301.9	1214.7 to 1224.4	357.8 to 360.6	–0.2	856.8 to 863.6
2003	594.8 to 602.4	169.2	174.9 to 177.1	–2.4 to –0.2	936.4 to 948.5	316.1 to 320.2	1252.5 to 1268.7	377.3 to 382.2	–0.2	875.1 to 886.4

2000 1st half	273.2	75.5	77.0	1.4	427.3	133.5	560.7	153.8	–0.1	406.8
2nd half	278.1	77.1	78.7	0.9	435.1	137.4	572.5	159.5	–0.1	412.9
2001 1st half	282.4 to 282.9	78.9	82.0 to 82.2	–2.1 to –1.9	441.2 to 442.1	141.3 to 141.5	582.5 to 583.6	165.2 to 165.5	–0.1	417.2 to 418.0
2nd half	286.2 to 287.4	80.2	82.3 to 82.7	–0.3 to 0.1	448.4 to 450.3	144.6 to 145.2	593.0 to 595.5	171.2 to 172.0	–0.1	421.7 to 423.5
2002 1st half	289.6 to 291.5	81.4	83.7 to 84.3	0.0 to 0.6	454.7 to 457.8	147.9 to 148.9	602.6 to 606.6	176.4 to 177.5	–0.1	426.1 to 429.0
2nd half	292.7 to 295.4	82.8	85.4 to 86.1	–0.4 to 0.4	460.5 to 464.7	151.7 to 153.0	612.2 to 617.8	181.4 to 183.1	–0.1	430.7 to 434.6
2003 1st half	295.8 to 299.3	84.0	86.8 to 87.8	–1.0 to –0.1	465.6 to 471.1	155.9 to 157.7	621.5 to 628.8	186.2 to 188.4	–0.1	435.2 to 440.3
2nd half	298.9 to 303.2	85.2	88.0 to 89.3	–1.3 to –0.2	470.8 to 477.4	160.2 to 162.5	631.0 to 639.9	191.1 to 193.8	–0.1	439.8 to 446.1

Percentage changes on previous year[4,5]

2000	3¾	2½	2¼	½	3¾	7½	4½	8¾	0	3
2001	3¼ to 3½	4¼	5½ to 5¾	−½	3¼ to 3½	5½ to 5¾	3¾ to 4	7½ to 7¾	0	2¼ to 2¾
2002	2½ to 3	3¼	3 to 3½	¼	2¾ to 3¼	4¾ to 5¼	3¼ to 3¾	6¼ to 6¾	0	2¼ to 2¾
2003	2¼ to 2¾	3	3½ to 4	−¼	2¼ to 2¾	5½ to 6	3 to 3½	5½ to 6	0	2¼ to 2¾

[1] *Includes households and non-profit institutions serving households*.

[2] *Also includes acquisitions less disposals of valuables*.

[3] *Expenditure adjustment*.

[4] *For change in inventories and the statistical discrepancy, changes are expressed as a per cent of GDP*.

[5] *Growth ranges for GDP components do not necessarily sum to the ½ percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges*.