Building Long-term Prosperity for all

Pre-Budget Report
November 2000

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The Economic and Fiscal Strategy Report and the Financial Statement and Budget Report contain the Government's assessment of the medium-term economic and budgetary position. They set out the Government's tax and spending plans, including those for public investment, in the context of its overall approach to social, economic and environmental objectives. This Pre-Budget Report includes, with other material, updated forecasts for the economy and projections for the public finances. The status of the latter are subject to the points made in paragraph [1.27]. After approval for the purposes of Section 5 of the European Communities (Amendment) Act 1993, these reports will form the basis of submissions to the European Commission under Article 99 (ex Article 103) and Article 104 (ex Article 104c) of the Treaty establishing the European Union.

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Overview

The Pre-Budget Report is now an established and integral part of the Government's annual Budget process. It provides a progress report on what the Government has achieved so far and the next stage of policy reforms on which the Government will be consulting in the run up to the next Budget.

The key objective of the Pre-Budget Report is to launch a national debate on important economic issues, including taxation and spending, seeking the views of people and business in all regions of the country and all sectors of the economy to inform the Government's Budget decisions.

The publication of this Pre-Budget Report, *Building long-term prosperity for all*, and a range of associated documents, will be followed by a series of regional meetings to discuss the issues raised and to listen to people's views.

INTRODUCTION

1.1 The Government's central economic objective, set out in 1997, is high and stable levels of growth and employment. Its aim is to fulfil Britain's national economic potential, building a stronger economy and a fairer society in which everyone can contribute to and share in rising prosperity and a better quality of life.

1.2 Over the past three and a half years, the Government has taken the tough decisions necessary to secure a platform of stability. Through extensive reforms and a prudent approach to both monetary and fiscal policy, economic stability is now being delivered. The challenge in the period ahead is to remain focused on the long term and avoid the mistakes of past decades where short-termism in decision making was a major cause of economic instability.

1.3 Locking in stability provides the opportunity to raise Britain's productivity performance and deliver stronger sustained growth in output and employment with low and stable levels of inflation and interest rates. The Government believes that workforces and management also have a key role to play in meeting the challenge of achieving a high productivity economy and that working together it is possible to build a stronger and fairer Britain with rising long-term prosperity for all.

1.4 The key elements of the Government's economic strategy, as set out in this Pre-Budget Report, are:

- delivering macroeconomic stability *(Chapter 2)*;
- meeting the productivity challenge *(Chapter 3)*;
- increasing employment opportunity for all *(Chapter 4)*;
- ensuring fairness for families and communities *(Chapter 5)*; and
- protecting the environment *(Chapter 6)*.

1.5 The following section describes the comprehensive strategy which the Government is pursuing to meet its objectives. Each element of the strategy forms the basis of the subsequent chapters of this report, with an overview of each in the second part of this chapter. Full details of the Government's updated forecasts for the economy and the public finances are set out in Annexes A and B respectively.

1.6 The Pre-Budget Report discusses the economic challenges now facing Britain, and outlines further measures which the Government is considering to boost productivity performance and deliver higher prosperity. The Government wants the Pre-Budget Report to be followed by a national debate on these major economic issues. It wants to hear the views of others and will be consulting widely over the coming months in the run up to Budget 2001

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.

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THE GOVERNMENT'S ECONOMIC STRATEGY

1.7 At the heart of the Government's economic strategy is the goal of full employment and rising prosperity for all. The Government's aim is to achieve sustainable growth in Britain's economic prosperity - ensuring that a strong economy goes hand in hand with a fair society and steps to protect and, where possible, improve the environment.

Delivering macroeconomic stability

1.8 Economic history clearly demonstrates that stability is an essential platform for achieving high and stable levels of growth and employment. Past instability in output, inflation and interest rates - as seen in the British economy over the past 30 years - created uncertainty and led to short-termism in the savings and investment decisions of individuals and businesses alike.

1.9 Much of the economic instability seen in the UK in recent decades reflects policy errors by successive governments, themselves often the fault of weaknesses in the policy framework. Since 1997, the Government has therefore put in place a new open and transparent macroeconomic policy framework with well-defined policy objectives and clear and accountable divisions of responsibility. Ensuring a foundation of domestic stability is particularly important in what is an increasingly integrated but volatile and uncertain global economy.

1.10 The economy which the Government inherited in 1997 was characterised by emerging inflationary pressures and a large structural deficit in the public finances. But through pre-emptive action and tough decisions under the new fiscal and monetary policy frameworks, a return to the stop-go cycle of the past was avoided and steady and stable growth is now being accompanied by record levels of employment, historically low inflation and a sound fiscal position. This has enabled the Government to raise investment in Britain's key public services on a sustainable basis in the 2000 Spending Review.

1.11 The challenge moving forward is to lock in this stability for the long term and to take advantage of the opportunity which it offers to secure sustainable increases in growth, employment and higher living standards.

Raising Britain's growth potential

1.12 Macroeconomic stability is a necessary condition for raising Britain's long-term growth potential, but it alone is not sufficient. That is why the Government is pursuing a long-term strategy to increase the trend rate of growth of the UK economy, focusing on removing barriers to productivity and employment.

1.13 The mid-point of the ranges for the Government's growth forecasts is based on a trend growth assumption of $2^1/_2$ per cent a year - the Government's neutral assessment of the economy's medium-term growth potential. The upper ends of the forecast ranges illustrate the potential for stronger non-inflationary growth over the medium term. The Government has set a Public Service Agreement target to raise the trend rate of growth over the next four years.

1.14 The Government believes that this is an achievable target given the measures it has already put in place and the next stage of reforms it is planning. However, the projections of the public finances continue to be based - as they will be for Budget 2001 - on the low end of the forecast ranges, consistent with the deliberately cautious assumption of $2^1/_4$ per cent a year trend growth. Changing the trend growth assumption underlying the fiscal projections before there is firm evidence of an improvement in long-term growth prospects would be imprudent and risk repeating the mistakes of the past. Previous governments too readily concluded that the economy's long-term growth potential had increased and therefore mistook a cyclical improvement in the public finances for a structural one.

Meeting the productivity challenge

1.15 Productivity is the main driver of economic growth. Meeting the Government's long-term ambition of raising Britain's productivity performance and closing the productivity gap with other major countries will therefore be essential in increasing the economy's trend rate of growth. A lack of domestic competition, insufficient incentives and opportunities for enterprise and innovation, poor skills and a history of under-investment are some of the key causes which the Government has identified for Britain's poor productivity record and the Government's strategy to increase productivity, described in Chapter 3, addresses each of these issues.

1.16 To succeed in meeting this productivity challenge requires a shared effort on the part of the Government, management, workers and trades unions. The Government has its role to play. But in a dynamic and increasingly competitive economy, individual businesses and sectors of the economy need to remain flexible and able to respond quickly to changing economic circumstances. Firms and industries which fail to learn from best practice elsewhere, do not invest in new technology and strong management, and which allow shortfalls in skills and training to persist will find it increasingly difficult to survive and expand.

Increasing employment opportunity for all

1.17 As well as by increasing productivity, the economy's trend rate of growth can be increased by achieving increasing levels of labour market participation. The Government's employment ambition is to deliver high and stable levels of employment, taking account of the economic cycle, so that at least three quarters of the working age population are in work by the end of the decade. Research also shows that work provides the best route out of poverty and therefore has an important role to play in building a fairer and more inclusive society. The Government's strategy for increasing employment opportunity for all who can work, set out in Chapter 4, matches rights with responsibilities. It comprises helping people move from welfare to work, easing the transition into work and making work pay. Once in work, the Government wants to ensure that people can work their way up into higher skilled, higher paid jobs.

Fairness for families and communities

1.18 At the same time as creating a strong and productive economy, the Government is working to build a fairer and more inclusive society in which everyone can contribute to and benefit from rising economic prosperity. A strong economy and a fair society both matter for a country's standard of living. Chapter 5 explains how the Government is delivering fairness for families and communities. The Government is pursuing an extensive programme to tackle poverty, particularly child and pensioner poverty, deliver strong and dependable public services, reward saving and strengthen community life. This does not just involve government action, but is often about bringing the private sector, voluntary and community groups, and the public sector together to find the best solutions to community problems.

Protecting the environment

1.19 Just as the economy cannot be thought of in isolation from wider social issues, nor can economic developments be allowed to proceed in a way which ignores the implications for the physical environment. The Government is committed to protecting and, where possible, improving the environment - both for the current generation and future ones. Too often in the past, economic growth has taken place at the expense of clean air, the efficient use of natural resources and sufficient consideration of the impact on the places in which people live and work. The Government has therefore developed an environmental strategy - explained in Chapter 6 - aimed at tackling climate change, improving air quality, regenerating towns and cities and protecting the countryside.

Conclusion

1.20 The Government has put in place a comprehensive strategy to deliver rising prosperity, with enterprise and employment open to all in every region of Britain. As a result of taking the necessary tough decisions, economic stability is being delivered. Now is the time to remain focused on the long term, maintaining fiscal and monetary discipline and avoiding quick fixes to short-term difficulties which would put at risk the gains made to date and the prospect of higher growth and employment in the future.

The Pre-Budget Report describes how - with the Government, workforces, managers, trades unions and investors all working together - it is possible to remove long-standing barriers to productivity and employment and build long-term prosperity for all. It outlines the next stage of reforms which the Government is considering and consulting on in the run up to Budget 2001.

DELIVERING MACROECONOMIC STABILITY

1.21 Chapter 2 sets out the macroeconomic policy framework which the Government has put in place and shows how it is working to deliver economic stability. It also summarises the Government's updated projections for the UK economy and the public finances (which are set out in full in Annexes A and B).

The policy framework

1.22 The Government has put in place new frameworks for monetary and fiscal policy, based on the principles of transparency, responsibility and accountability, to deliver economic stability for the long term. The **monetary policy framework** with monetary independence for the Bank of England is designed to deliver low and stable inflation, while the **fiscal policy framework** underpinned by two strict fiscal rules is designed to deliver sound public finances. Integrated into the fiscal framework, a new **public spending framework** provides greater certainty for long-term planning and a greater focus on the outcomes which will be delivered.

1.23 Under these new policy frameworks, the Government is now delivering a strong and stable economy. Output growth has remained stable and positive, inflation has remained close to the Government's $2^1/_2$ per cent target and interest rates have been lower and more stable than in the past. At the same time, the public finances have been restored to a healthy and sustainable position.

1.24 Budget 2000 set out firm overall spending totals for the next three years, allowing for current spending to rise by $2^1/_2$ per cent a year in real terms and a more than doubling of net investment by 2003-04. It ensured that the Government remained on track to meet its fiscal rules over the economic cycle.

1.25 The 2000 Spending Review, which reported in July, set out detailed spending plans for the next three years consistent with the firm spending envelope set in Budget 2000. Within these limits, as a result of savings on debt interest payments and social security spending, the Government was able to provide a substantial and sustainable increase in resources for priority public services including education, health and transport over the next three years while ensuring that the fiscal stance was on track to be at least as tight as set out in Budget 2000.

The economy

1.26 The UK economy has experienced continued strong growth in output and employment combined with low inflation in 2000. The Pre-Budget Report forecast shows that:

- **GDP** is expected to increase by 3 per cent in 2000 as a whole, in line with the Budget 2000 forecast, easing to its estimated sustainable rate of $2^1/_4$ to $2^3/_4$ per cent in 2001 and later years;
- **RPIX inflation** is expected to rise gradually back to $2^1/_2$ per cent by mid-2001, remaining at the Government's target thereafter; and
- short-term upside inflationary **risks** from stronger consumer demand and higher business investment are balanced by the possibility of continued favourable developments in costs and margins. However, the recent sharp increase in oil prices poses a significant risk to global prospects if sustained.

The public finances

1.27 The public finance projections published in this Pre-Budget Report, and summarised in Tables 2.4 and 2.5, provide an interim forecast update. They do not necessarily represent the fiscal outcome which the Government is seeking and they therefore have a quite different status from those published at the time of the Budget since the latter include the effects of all Budget policy decisions. In line with the *Code for Fiscal Stability*, the updated fiscal projections include the effects of all firm decisions announced in the Pre-Budget Report on individual taxes and programmes within Annually Managed Expenditure.

1.28 As noted above, the fiscal projections continue to be based on the deliberately prudent and cautious assumption of $2^1/_4$ per cent a year trend growth, as audited by the National Audit Office (NAO). Under the three-year rolling review of audited assumptions established in Budget 2000, the NAO has reviewed the assumptions for equity prices, price deflators and VAT receipts for this Pre-Budget Report and concluded that it is reasonable that the assumptions continue to be used.

1.29 A current budget surplus of £16$^1/_2$ billion is now expected in 2000-01, around £2$^1/_2$ billion higher than the Budget 2000 forecast. Much of this reflects stronger than expected receipts. This improvement in the current year is expected to persist across the projection period.

1.30 In making discretionary policy changes in the Pre-Budget Report, the Government has ensured that the fiscal rules will continue to be met over the economic cycle, including in the cautious case. The updated forecast takes account of policy announcements in the Pre-Budget Report, including additional support for pensioners of £2$^1/_2$ billion a year by 2003-04 and a one year freeze in all fuel duties in cash terms in Budget 2001. These are summarised in Table B4. Consistent with the *Code for Fiscal Stability*, the forecast does not take account of measures proposed in the Pre-Budget Report for consultation in the run up to Budget 2001. Decisions on these measures will be taken in the Budget when the Government will also review its AME forecast and the AME margin. In line with the usual convention adopted in previous Pre-Budget Reports, changes to the forecast for AME programmes have been offset in the AME margin.

1.31 Taking account of the stronger than expected fiscal developments and the policy measures announced in the Pre-Budget Report, the fiscal stance is expected to be at least as tight as set out in Budget 2000 and the Government remains on track to meet its fiscal rules over the economic cycle, including in the cautious case.

MEETING THE PRODUCTIVITY CHALLENGE

1.32 Productivity in Britain lags behind that of other major economies. Raising productivity performance is the key to achieving sustained increases in the economy's growth potential and higher living standards. The Government has put in place a long-term strategy designed to meet this productivity challenge and bridge the productivity gap with Britain's major competitors.

Measures already announced

1.33 The Government's strategy focuses on five key drivers of productivity performance, and it has already introduced an extensive set of reforms spanning each of these areas. These include:

- **competition:** to ensure vigorous domestic and international competition, greatly enhanced powers for the Office of Fair Trading under the new Competition Act and new measures to improve competition and services to customers in the banking industry;
- **enterprise and innovation:** to develop a culture and incentives that promote enterprise and innovation in every region of Britain, major reforms to capital gains tax, permanent 40 per cent first year capital allowances for small and medium-sized enterprises, a new all-employee share ownership plan and R&D tax credit, and a greater regional focus on enterprise and regeneration through the Regional Development Agencies and the new Small Business Service;
- **skills:** to provide a wide spread and high quality of skills in the workforce, substantial increases in education spending to raise standards in primary and secondary schools, measures to increase participation in higher education, the launch of individual learning accounts and learndirect to provide greater opportunities for life-long learning, and changes to the work permits system;
- **investment:** to create the right conditions for investment, reductions in corporation tax rates, the abolition of advance corporation tax, a new 10p rate for the smallest companies, and a review of whether there are factors discouraging institutional investors from investing in smaller companies; and
- **public sector productivity:** to deliver continuous improvements in the productivity of the public sector, output and efficiency targets for public service delivery through Public Service Agreements, the Public Services Productivity Panel, the new Office of Government Commerce to bring about a step change in public procurement practice, and Partnerships UK to help the public sector build more effective, value for money partnerships with the private sector.

Next steps

1.34 The Pre-Budget Report outlines the next steps in the Government's programme of reforms to increase Britain's productivity performance:

- a package of measures from April 2001 to **help small and medium-sized firms manage their entry into the VAT system, reduce their administrative burden and improve their cashflow;**

- extending, subject to consultation, the benefit of the **business assets rate of taper relief in capital gains tax** to employee shareholdings in a range of non-trading companies;
- consultation on ways to expand **Enterprise Management Incentives** so that small businesses can make more flexible use of the benefits in a way best suited to their needs;
- consultation on the Social Investment Taskforce's proposals for a **Community Investment Tax Credit**, and working closely with the venture capital industry and others on setting up the first **Community Development Venture Fund**, both to stimulate more private investment in under-invested communities;
- significantly increased freedom for the **Regional Development Agencies** from next year, enabling them to target resources more effectively - as a major step towards their strengthened role and additional resources and flexibility from April 2002 announced as part of the 2000 Spending Review; and
- **an independent review of the management of the radio spectrum** to advise on the principles which should govern spectrum management and what more needs to be done to ensure that all users are focused on using their spectrum in the most efficient way possible.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.35 The Government is working to deliver employment opportunity for all - the modern definition of full employment. Expanding the effective supply of labour will allow the economy to grow more rapidly without running into skills shortages and creating inflationary pressures. By providing employment opportunities for all, the Government is also tackling a key underlying cause of deprivation and helping to break the inter-generational cycle of poverty.

Measures already announced

1.36 The Government's strategy is based on helping people to move from welfare to work, easing the transition to work, making work pay and securing progression once in work. The Government has already introduced radical reforms of the tax and benefit system backed up by active labour market policies:

- **welfare to work:** with New Deal programmes for 18-24 year olds, 25+, the over- 50s, lone parents, people with disabilities and partners of the unemployed. Action Teams and Employment Zones are tackling the problems of worklessness in the most disadvantaged areas;
- **easing the transition to work:** with a new Job Grant of £100 from spring 2001, a four-week Income Support for Mortgage Interest run-on and simplified rules for the Housing Benefit Extended Payments Scheme, and increased provision of childcare facilities under the National Childcare Strategy; and
- **making work pay:** with the Working Families' Tax Credit, reform of NICs, a new 10p rate of income tax from April 1999 and a cut in the basic rate to 22p from April 2000. This is underpinned by the National Minimum Wage, the adult rate of which was increased to £3.70 an hour from October 2000.

Next steps

1.37 As a result of the 2000 Spending Review and the Pre-Budget Report, the Government is taking further steps to promote work:

- an extension of the **New Deal for lone parents** starting from autumn 2001 to provide help and support to all lone parents on Income Support who are not working, or who are working less than 16 hours a week;
- a new **Job Transition Service** to provide extra help to areas affected by large-scale redundancies, building on existing provision to help people into new jobs; and
- as confirmed in the 2000 Spending Review, the **New Deal 25+ will be extended and intensified from April 2001,** on a national basis.

In addition, the Government will continue to work on the detailed design issues of the employment tax credit to be introduced from 2003.

FAIRNESS FOR FAMILIES AND COMMUNITIES

1.38 At the same time as increasing the overall prosperity of the nation, the Government is working to build a fairer and more inclusive society. In particular, the Government is tackling child poverty, helping pensioners, rewarding saving, investing in public services and ensuring a fair tax system.

Measures already announced

1.39 The Government has already introduced a wide range of measures to ensure fairness for families and communities, including:

- **support for families and children:** through significant increases in Child Benefit, the introduction and subsequent increases in the Working Families' Tax Credit, the introduction of the Children's Tax Credit from April 2001, targeted support for low-income parents in the early months following the birth of their child and a new Children's Fund set up as part of the 2000 Spending Review;

- **fairness for pensioners:** through the Minimum Income Guarantee uprated by earnings for the poorest pensioners, an annual winter fuel payment of £150 for every 60+ household and concessionary TV licences for those aged 75 and over; and

- **delivering strong and dependable public services:** through substantial additional resources for Britain's frontline public services over the next three years in the 2000 Spending Review, including average annual real growth of 5.4 per cent for education and 5.6 per cent for health.

Next steps

1.40 Building on what has already been achieved, the Pre-Budget Report takes further steps towards a fairer society. These include:

- **further measures to help raise the standards in schools** with £5 million to help establish the National e-Learning Foundation and a £200 million investment to be paid directly to schools in 2000-01 to provide further help to tackle repairs;
- **a major package of measures to boost pensioner incomes,** in advance of the introduction of the Pension Credit in 2003 which will deliver substantial gains to all pensioners on low and modest incomes:
  - **increasing the winter fuel payment, which is set at £150 for future years, to £200 this winter.** So this winter, 8.5 million pensioner households will be eligible for a payment of £200 - almost £4 a week - double the amount of last year's payment;
  - **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 of 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, raise this by earnings, and further, by the real increase in the basic state pension, so that all pensioners gain fully from the increase in the basic state pension. **From April 2001, the new, simplified MIG will be £92.15 a week for single pensioners, and £140.55 a week for couples.**

- **a £200 million a year package of measures helping disabled people and carers,** to be announced by the Secretary of State for Social Security in the coming days;
- **abolition of the £500 capital limits in the Sure Start Maternity Grant and Funeral Payments** by October 2001, providing additional help for families on low incomes to cover the costs associated with the birth of a baby or the death of a close relative;
- retaining the current £7,000 **Individual Savings Account (ISA)** annual contribution limit (and the associated £3,000 cash limit) for a further five years until April 2006, rather than reducing it to £5,000 (£1,000 cash) in April 2001 as previously planned, and making cash ISAs available to 16 and 17 year-olds for the first time in April 2001; and
- further discussions about **modernising General Betting Duty,** with a view to an announcement at the time of Budget 2001.

PROTECTING THE ENVIRONMENT

1.41 Economic growth must take place in a way which protects and, where possible, enhances the environment. The Government has therefore developed a clear framework to take account of the environmental impact of economic growth, focusing on tackling climate change and improving air quality, regenerating Britain's cities and protecting the countryside.

Measures already announced

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

- **climate change and air quality:** the climate change levy to be introduced in April 2001 to encourage more efficient business use of energy, reforms to VED and company car tax, a reduction in the duty on ultra-low sulphur petrol relative to unleaded from October 2000 and substantial additional investment in transport under the new Ten Year Transport Plan; and

- **regenerating Britain's cities and protecting the countryside:** new stamp duty relief for some Registered Social Landlords to encourage social housing provision and make better use of the existing housing stock, continuing annual increases in the standard rate of landfill tax, a new aggregates levy from April 2002 to tackle the environmental costs of quarrying and continuing work to reduce the environmental impact of pesticides use.

Transport

1.43 The Pre-Budget Report introduces a package of targeted measures which, consistent with the Government's environmental principles, will help motorists and improve the competitiveness of the UK transport sector while protecting the environment in the longer term. It includes specific help for farmers, and will encourage the modernisation of the road haulage sector in an environmentally-friendly way.

1.44 Taking account of the strength of world oil prices, and the measures being taken to tackle climate change, **the Government has decided to freeze all fuel duties in cash terms in Budget 2001. This will lower taxes on petrol and diesel by around $1^1/_2$ pence per litre in real terms, at a total cost of around £560 million in 2001-02.**

1.45 Subject to consultation in each case on the details and the environmental merits, the Government also intends to:

- **cut the duty on ultra low sulphur petrol (ULSP) and widen its differential with standard unleaded petrol by a further 2 pence per litre in Budget 2001, on top of the 1 penny per litre reduction which came into effect on 1 October 2000**. This would be conditional on the oil companies guaranteeing nationwide access to its environmental benefits. In these circumstances, the duty on ULSP would therefore have been cut by a total of 3 pence per litre since Budget 2000;
- subject to the cut in ULSP discussed above, **cut the duty on ultra low sulphur diesel by 3 pence per litre in Budget 2001** to maintain the existing balance between duty rates on the most commonly available petrol and diesel;
- **remove the 2 pence per litre duty premium on lead-replacement petrol;**
- invite British industry to develop proposals for practical alternative fuels. Following consideration of these proposals, **the Chancellor will announce major reductions in duty rates for the most promising environmentally-friendly alternative fuels;**
- **a further extension of the "small car" engine capacity threshold in vehicle excise duty (VED) to existing cars with engines up to 1,500cc**, cutting VED for a further 5 million car owners;
- **reform the system for lorry VED in Budget 2001** to reflect better the environment and track costs of different lorries. The reform is intended to reduce the cost of VED on lorries for British industry by around £300 million a year (equivalent to over 50 per cent);
- as a transitional arrangement, a **rebate in lorry VED fees in the current year meaning cuts of 50 per cent for many of the largest vehicles, worth up to £4,000 each;**
- introduce a **"vignette" or "user charge" scheme for lorries** so that foreign hauliers start to contribute towards the costs of maintaining the UK road network and the environmental costs that they impose;
- **set up a £100 million ring-fenced fund to offer further incentives or allowances for scrapping older, more-polluting lorries or encouraging cleaner lorries and technology** to secure environmental benefits and help the haulage industry modernise;
- **help to improve the quality of training,** especially for small haulage firms, working with the Road Haulage Forum which has already initiated a review of this area; and
- **abolish VED for tractors,** saving farmers in total over £9 million a year, or £40 for every agricultural vehicle.

1.46 In total, these proposed measures would cost up to £$1^3/_4$ billion a year, in addition to the cost of the freeze in duties. If all the measures which the Government is announcing and consulting on in the Pre-Budget Report are implemented then the tax on motorists will fall by the equivalent of about 4 pence per litre in real terms. Together with the reduction in ultra low sulphur diesel proposed and the freeze in fuel duties, the measures in the Pre-Budget Report would represent a reduction for freight transport of around £750 million a year in real terms, equivalent to a reduction of about 8 pence per litre for diesel used in road haulage.

Next steps

1.47 The Pre-Budget Report also sets out other steps to protect and improve the environment:

- a £1 billion cumulative package of tax measures over five years to help regenerate Britain's towns and cities, including:
    - **a complete exemption from stamp duty for all property transactions in Britain's most disadvantaged communities from April 2001;**
    - the intention to introduce an accelerated payable tax credit for the costs incurred in **cleaning up contaminated land**;
    - immediate tax relief to property owners for the costs of **converting redundant space over shops and other commercial premises into flats** for letting; and
    - a **reduced rate of VAT for the services of converting residential properties into a different number of dwellings, for example, houses into flats**, and an adjustment to the zero rate of VAT to provide relief for the renovation and sale of homes that have been empty for more than 10 years;
- a new £35 million **aggregates Sustainability Fund** to deliver environmental benefits to the areas subject to the environmental costs of quarrying; and
- building on the £30 million announced in the 2000 Spending Review to provide a financial incentive for firms to take on binding emissions reduction targets, consultation on outline proposals and options for the basic rules of the **Emissions Trading Scheme**.

Environmental appraisal

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

Chart 1.1

GOVERNMENT SPENDING AND REVENUES

1.49 Chart 1.1 presents public spending by main function. Total public spending (Total Managed Expenditure - TME) is expected to be around £372 billion in the current financial year, 2000-01. TME is divided into Departmental Expenditure Limits, shown in Table B14, and Annually Managed Expenditure, shown in Table B17. 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 B14 and B17.

1.50 Chart 1.2 shows the sources of government revenue. In total, public sector current receipts are expected to be around £380 billion in 2000-01. Table B11 in Annex B provides a more detailed breakdown of receipts consistent with the above chart.

Chart 1.2

2

Delivering macroeconomic stability

The Government's macroeconomic framework is continuing to deliver macroeconomic stability, which is a precondition for high and stable levels of growth and employment. The policy framework is designed to achieve:

- **low and stable inflation** - the monetary policy framework is forward-looking, transparent and accountable with clear and precise objectives:
  - inflation and inflation expectations remain low and stable, and in line with the Government's target.
- **sound and sustainable public finances** - the fiscal policy framework is based on coherent principles and objectives and strict fiscal rules. The interim forecast shows that:
  - the fiscal stance is expected to be at least as tight as in Budget 2000 and that fiscal policy continues to support monetary policy over the cycle; and
  - by taking a prudent approach and ensuring that cyclical improvements are not assumed to be structural, the Government remains on track to meet its fiscal rules, including in the cautious case.
- **improved investment in public services** - the public spending framework allows for sensible planning of public spending over the longer term and emphasises the importance of outcomes as well as inputs:
  - savings from prudent management of the public finances are making room for substantial investment in frontline public services as set out in the 2000 Spending Review.

The challenge for the Pre-Budget Report is to maintain and protect economic stability for the long term and to put in place policies that promote higher productivity and opportunity that will make the UK stronger and deliver rising prosperity for all.

A FRAMEWORK FOR STABILITY

2.1 Economic stability is an essential precondition for achieving the Government's objective of high and stable levels of growth and employment. The macroeconomic policy framework which the Government has introduced is designed to deliver stability and avoid a return to the cycles of boom and bust that have characterised the British economy in the past.

2.2 Economic instability imposes significant costs on the economy and society:

- it makes it difficult for individuals and firms to plan ahead, especially over the longer time horizons which business investment needs. Low levels of investment reduce the potential for long-term growth;
- high volatility in output growth - the stop-go cycles which the UK economy has experienced - results in a deterioration in the skills of people made unemployed, often having the largest impact on those with the lowest incomes; and
- high and volatile inflation has significant costs. Prices are a signal for the efficient market allocation of resources. Volatile inflation makes it more difficult to distinguish price movements caused by changes in demand and supply for particular goods and services from general increases in the price level due to excessive demand. The consequence is inefficient allocation of resources.

2.3 The UK's economic record has made clear the importance the establishing a macroeconomic policy framework which promotes stability:

- between 1980 and 1997, among G7 countries the UK had the second highest average inflation (over 6 per cent) and greater inflation variability than all other G7 countries except France and Italy;

- over the same period, the UK suffered two of the deepest and longest recessions since the war, and had one of the worst records on growth instability of any of the G7 countries;

- interest rates have also been more volatile in the UK than in other G7 countries: for example, between January 1985 and April 1997, official interest rates in the UK were over twice as volatile as those in the US; and

- as a consequence of economic instability, as well as other factors, the UK's record on investment has been poor: before 1999, the UK invested less of its national income than the G7 average in every year since at least 1965.

2.4 The economic outlook when the Government took office meant that the task of tackling economic instability had to be addressed urgently. GDP was growing at an unsustainable rate, household consumption was increasing sharply and, with rising equity and house prices and windfall payments from building society demutualisations, this trend was set to continue. Inflationary pressures were building, requiring a rise in interest rates to prevent a sharp rise in inflation. In addition, the public finances had deteriorated rapidly in the early 1990s, and in 1996-97 public sector net borrowing stood at £28 billion.

2.5 The immediate task was to ensure domestic demand was restrained and to prevent inflation from accelerating, while at the same time bringing the public finances into line with what the economy could afford. The Government recognised the importance of tackling the problem within a well-defined and transparent framework for macroeconomic policy, which set clear rules and long-term objectives for policymaking.

The macroeconomic framework

2.6 The Government therefore put in place new frameworks for both monetary policy and fiscal policy to achieve economic stability for the long term. The monetary policy framework aims to deliver low and stable inflation, while the fiscal policy framework is designed to achieve sound public finances over the medium term, and to support monetary policy over the short term. Sound public finances are also a prerequisite of sustainable investment in public services.

2.7 The policy framework is underpinned by four key propositions:

- there is no long-run trade-off between inflation and unemployment;
- for an open economy in a world of liberalised capital markets, a monetary policy framework based on rules which rely on a stable relationship between money and prices does not provide a reliable anchor for policy;
- the discretion necessary for the effective conduct of economic policy can only be exercised within a framework that commands credibility in the markets and generates public trust; and
- the credibility of a policy framework depends on clearly defined long-term policy objectives, a high degree of openness and transparency and policymakers' accountability to Parliament and the public. Accountability, openness and transparency all work together in a mutually reinforcing way to enhance the credibility of the policy framework.

2.8 The importance of a credible framework to achieve stability is even greater now than in the past, as other economies have liberalised their capital account regime, floated their exchange rates and global capital flows have grown rapidly. The development of global markets emphasises the importance of global stability - as well as delivering economic stability at home, the Government is committed to promoting economic stability and growth and employment in the global economy (see Box 2.1).

Box 2.1 Promoting international stability

The UK Government is playing a leading role in international efforts to strengthen the international financial system and to ensure that all countries are able to participate fully in the world economy and share in the benefits of rising global prosperity. Building on a blueprint for reform agreed under the UK Presidency of the G7, the international community has made substantial progress in putting in place new rules and procedures to promote stability and growth. These include:

- a framework of internationally agreed codes and standards covering the key areas that all countries need to address if they are to achieve stability and participate in the international financial system. Developed following a UK proposal, these codes and standards can provide the transparency on which stability depends. The IMF has the lead role in the surveillance of countries' adherence to codes and standards;
- new models of cooperation in global financial regulation. The Financial Stability Forum has been established, bringing together the international and national bodies responsible for financial sector supervision. Over time, the Forum can become an early warning system for regional and global financial risk;

- a new framework for crisis resolution has been developed, based on a partnership between public and private sectors. The private sector has been successfully involved in the handling of a number of recent cases;
- wide-ranging reform of the IMF's various lending instruments, including the Contingent Credit Line, to better adapt them to the changing nature of the global economy. Taken together, these measures will enable the Fund to play a more effective role in supporting member countries' efforts to prevent financial crises; and
- the World Bank and UN are developing principles of good practice in social policy which will help to ensure that the burden of economic adjustment is not placed on the poorest and most vulnerable sectors of society.

The monetary policy framework

2.9 The UK's long-standing poor inflation record prior to the introduction of the current monetary policy framework reflected shortcomings in the previous design and conduct of monetary policy. Monetary policy in the UK did not have well-specified objectives, was not sufficiently forward-looking and lacked transparency and accountability. Decisions were too easily subject to the influence of short-term political considerations, harming credibility; and the roles and responsibilities of the Government and the Bank of England were not clear or consistent. The monetary framework implemented from 1997 onwards addressed these concerns and has helped to keep inflation close to the Government's target.

2.10 *Under the framework introduced in May 1997, the objectives of monetary policy are clear and precise*. The primary objective of monetary policy, set out in the Bank of England Act 1998, is price stability. The Monetary Policy Committee (MPC) is required to hit a specific inflation target - $2^1/_2$ per cent for the 12-month increase in the Retail Prices Index excluding mortgage interest payments (RPIX) - at all times. This provides an anchor for inflation expectations and allows the MPC's performance to be assessed objectively. The fact that the target is symmetric - deviations below target are treated as seriously as those above - means that there is no incentive for the MPC to drive inflation below target at the cost of lost output and employment.

2.11 *Policy is implemented by an independent Monetary Policy Committee*. Interest rate decisions are therefore removed from short-term political pressures and based solely on the long-term interests of the economy. While the main monetary policy instrument of the MPC is the two-week repo rate, and UK exchange rate policy is set by the Government, the MPC also has limited foreign exchange reserves available for intervening in the foreign exchange market to support its monetary policy objective (see Box 2.2).

Box 2.2: Exchange rate intervention - roles and responsibilities

The Government is responsible for determining UK exchange rate policy. As set out in the Chancellor's letter of 6 May 1997 to the Governor of the Bank of England, if the Government so instructs, then the Bank, acting as its agent, may intervene in the foreign exchange market by buying or selling the Government's foreign exchange reserves. Intervention in the foreign exchange market under instruction from the Treasury is conducted through the Exchange Equalisation Account (EEA) which holds the Government's official foreign currency reserves.

Any intervention undertaken by the Bank on behalf of the Government would be automatically sterilised to avoid interfering with the MPC's monetary policy objective to meet the inflation target, with the Debt Management Office offsetting the impact of the Treasury's intervention on liquidity in the sterling money markets.

The Monetary Policy Committee may instruct the Bank of England to use its own resources to undertake foreign exchange operations but only in support of its monetary policy objectives as defined in the annual remit letter from the Chancellor to the Governor. The details of any such action would be published in a manner consistent with section 14 of the Bank of England Act 1998.

The intervention to support the euro, on 22 September 2000, was part of a G7 action. Following the co-ordinated intervention the G7 explained in a joint statement:

> "This action was taken as part of a concerted intervention by the G7 monetary authorities because of the shared concern about the potential implications of recent movements in the euro for the world economy."

Details of the total holdings of official UK reserves are published monthly in a press release. In keeping with the UK Government's commitment to greater transparency, details of the 22 September intervention were published in the official reserves press release on 4 October.

2.12 *Improving the transparency and accountability of monetary policy tends to increase its credibility.* The MPC is accountable to Parliament through the appearances of its members before the Treasury Select Committee and the Lords Select Committee on the MPC. Transparency is achieved through various different channels: the MPC publishes the minutes of its meetings and the voting record of its members as well as a quarterly Inflation Report.

2.13 *Monetary policy is able to respond sensibly to shocks*. The monetary policy framework allows flexibility in the MPC's response to economic shocks (see Box 2.3). However, if inflation deviates from target by more than one percentage point, the Governor of the Bank must send an open letter to the Chancellor explaining why this has happened, the corrective policy action being taken by the MPC, the period within which inflation is expected to return to target and how the MPC's approach is consistent with the Government's objectives for growth and employment. The open letter system ensures that monetary policy is fully transparent and accountable during periods of possible stress and makes it possible to respond sensibly to shocks.

Box 2.3: Supply shocks and the macroeconomic framework

A supply shock to the economy alters the cost of producing goods and services, with knock-on effects on the prices that firms charge and therefore the general level of prices. The difficulty for policymakers is to decide on the appropriate policy response to a supply shock.

The short-run impact of an adverse supply shock is a fall in output combined with a rise in the general level of prices. If policymakers react to the increase in the price level by increasing interest rates to bring the price level back down, output will fall even further as aggregate demand is squeezed by the rise in real interest rates. However, if the supply shock is temporary but accommodated, so that the negative output effect of the supply shock is partially offset by allowing aggregate demand to expand, it leaves open the danger of a wage-price spiral and a permanently higher level of inflation, especially if inflation expectations also increase and are reflected in higher wage bargains.

Economic policymakers must therefore carefully balance the objective of mitigating the negative impact of an adverse supply shock on output with ensuring price stability.

There are several reasons why the UK macroeconomic framework, which rests on the pillars of the monetary and fiscal frameworks, is now more robust to adverse supply shocks:

- under its monetary framework, the Government has set an explicit inflation target of $2^1/_2$ per cent for the 12-month increase in the retail prices index excluding mortgage interest payments (RPIX) which the Bank of England Monetary Policy Committee (MPC) must target at all times under the Bank of England Act 1998. This provides an explicit anchor for inflation expectations;
- the independent status of the Bank of England has put monetary policy on a more credible footing, removing political influence from the setting of interest rates. Enhanced credibility has in turn meant that inflation expectations are now more firmly anchored to the Government's inflation target and are less fragile to temporary deviations of inflation from the target;
- becaues the inflation target is symmetric it ensures that the MPC responds sensibly to economic shocks. The Bank of England Act 1998 framework makes it clear that the MPC should support the Government's objective of high and stable levels of growth and employment subject to meeting the inflation target. If inflation deviates from target by one percentage point or more, the Governor of the Bank of England is required to write an open letter to the Chancellor. This transparency reinforces the accountability built into the monetary policy framework, further enhancing its credibility; and
- the Government's fiscal rules are set over the economic cycle to ensure that the automatic stabilisers built into fiscal policy are allowed to work to dampen the effects of economic shocks on output, while ensuring sound public finances in the medium term.

The fiscal policy framework

2.14 The public finances deteriorated rapidly in the early 1990s. By 1997, the ratio of net debt to GDP had risen to over 44 per cent and the current deficit exceeded £20 billion. This impacted on the quality of public services. Public investment as a share of GDP had fallen sharply and public sector net worth was falling. Fiscal policy failed to promote stability, with an insufficient focus on the long term. A lack of clear and transparent fiscal objectives and an inadequate basis for full and effective public and parliamentary scrutiny of fiscal policy contributed to the earlier deterioration in the public finances.

2.15 The Government therefore took significant steps to strengthen the framework for fiscal policy. It implemented a new framework based on a set of five principles - transparency, stability, responsibility, fairness (including between generations) and efficiency. These principles were enshrined in the Finance Act 1998 and the *Code for Fiscal Stability*, approved by the House of Commons in December 1998. The Code sets out how these principles relate to the formulation and implementation of fiscal policy in practice.

2.16 The Government's key objectives for fiscal policy are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly both within and across 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.

2.17 These objectives are embodied in 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. It is met when, over the economic cycle, the current budget is in balance or surplus; 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, a reduction in public sector net debt to below 40 per cent of GDP over the economic cycle is desirable.

2.18 The golden rule distinguishes between current spending, which benefits the current generation, and capital spending which benefits both current and future generations. By allowing the current generation to borrow only to fund capital spending, with current spending met by current receipts, the golden rule helps to match the cost and benefits of public spending over time. This is consistent with the Government's objective of generational equity. The golden rule also enhances the efficiency of government spending because it means that growth-enhancing public investment is not sacrificed for current spending. The sustainable investment rule complements the golden rule by ensuring that borrowing for public investment is conducted in a responsible way.

2.19 Consistent with these objectives and the strict fiscal rules, firm action has been taken to return the public finances to a sound footing. Difficult decisions were required. The Government worked within the spending plans it inherited from the previous Government for its first two years. The Government also made a number of tax decisions, for example, continuing until the Pre-Budget Report 1999 announcement to raise fuel duties by more than inflation in line with the escalator introduced by the previous Government. This fiscal prudence led to a cumulative structural fiscal improvement of about $4^1/_2$ per cent of GDP between 1996-97 and 1999-2000, returning the public finances to a sustainable position.

2.20 Sound public finances which are sustainable over the economic cycle are not only essential to ensure economic stability, they are also necessary for sustainable investment in public services[1]

The new public spending framework

2.21 In parallel with the strict control of public expenditure in the first two years of this Parliament, the Government undertook a root and branch assessment of spending needs. The Comprehensive Spending Review in 1998 addressed the issue of strategic reforms to planning and control of public spending, as well as setting new plans for the remaining three years of the Parliament. These plans were extended to 2003-04 in the 2000 Spending Review which reported in July. The Government's spending framework is based on:

- Department Expenditure Limits (DEL) which have now been set for all government departments. The DELs provide departments with a solid basis for planning their own costs effectively; and
- 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. This Pre-Budget Report provides revised projections of individual AME programmes.

2.22 Together DEL and AME sum to Total Managed Expenditure (TME). For each department, separate budgets are set for resource (current) and capital spending, consistent with the distinction in the fiscal rules. Departments are required to manage their resource and capital budgets separately. This removes the bias against investment that was present in the previous planning regime. The switch to resource accounting and budgeting in the 2000 Spending Review builds on the previous arrangements by requiring departments to plan, control and account for their spending on a full accruals basis.

2.23 Ensuring modernisation of public services and a focus on efficient and effective service delivery is also an important element of the new spending framework. Each department is committed, through Public Service Agreements (PSAs), to achieve specific performance targets. Departments have also drawn up Departmental Investment Strategies (DIS), first published in March 1999, to show how they will manage capital effectively and how investment decisions are taken on a robust basis so as to maximise the benefits of the extra investment.

2.24 PSAs were first published after the 1998 Comprehensive Spending Review and have since been developed further. Progress against targets is monitored quarterly, with performance considered by Cabinet level committee. New PSAs form an integral part of the 2000 Spending Review settlement, with fewer targets that are more focused on outcomes. Service Delivery Agreements (SDAs) have been devised to complement and underpin the PSAs, providing more operational detail on how priorities will be delivered efficiently and effectively. These were published on 3 November and revised Departmental Investment Strategies will be published shortly.

Box 2.4: Whole of Government Accounts

The Government has already introduced resource accounting and budgeting to improve the management and measurement of public spending and is now working towards producing Whole of Government Accounts (WGA) as a further step in ensuring that best-practice accounting methods are used to construct the public accounts and fiscal reporting is as transparent as possible, as required by the *Code for Fiscal Stability*.

WGA are commercial-style "true and fair" accounts covering the whole of the public sector. Like departmental resource accounts, WGA will be produced on an accruals basis and use generally accepted commercial accounting standards and practices, adapted where necessary for government. They will treat government as if it were a single entity by eliminating all significant transactions and amounts owed between public sector entities.

WGA will provide better quality and more transparent data for the planning of fiscal policy, and facilitate better management of public services and more effective distribution of resources. In particular, WGA will give audited data to underpin the operation of the golden rule, and allow the public sector balance sheet to be used in fiscal management.

Central Government Accounts (CGA) are a necessary first step towards WGA. The plan is to produce 'dry-run' CGA for 2001-02 and 2002-03, with the first CGA published for 2003-04. However the full benefits for fiscal policy will only be achieved when WGA covering the entire public sector are available. The aim is to produce 'dry-run' WGA for 2003-04 and 2004-05, with the first WGA published for 2005-06.

2.25 The envelope for current spending announced in the 1998 EFSR set real growth in current spending at $2^1/_4$ per cent a year over the three year period covered by the Review, in line with what could be afforded while ensuring the fiscal rules were satisfied. This allowed more efficient long-term management and planning of public spending, while ensuring that fiscal consolidation was successful in delivering savings in debt interest and social security expenditure as the fiscal position moved into surplus and unemployment continued to fall. These savings have helped make room for the additional investment announced in the 2000 Spending Review.

Performance of the frameworks

2.26 Collectively, these reforms to the monetary and fiscal frameworks and public spending regime have created a broad and coherent strategy to put the UK economy on a sustainable path to deliver high and stable levels of growth and employment.

2.27 The new macroeconomic framework has helped to deliver economic stability and avoid large and destabilising fluctuations in output. Despite a large external shock in 1998, output growth has remained stable and above 2 per cent in each of the last three years, with growth of 3 per cent expected this year. The latest economic forecast indicates that growth is expected to remain in the range of $2^1/_4$ to $2^3/_4$ per cent next year and thereafter.

2.28 Large swings in output have been avoided for a number of reasons:

- interest rate decisions have been made in a forward-looking manner, taking account of the fact that they impact on output and inflation with a lag. Interest rates have thus been set pre-emptively to counteract any large swings in output and inflation before they occur. Rates have peaked at a much lower level than in previous economic cycles when they often responded to economic shocks too late; and
- fiscal policy has supported monetary policy throughout the economic cycle. The substantial fiscal tightening in 1997-98 and 1998-99 supported monetary policy when output was above its trend level, while also eliminating the large structural deficit. The fiscal tightening continued in 1999-2000, at a time when inflationary pressures were mounting.

The MPC raised the repo rate until February this year. Since then it has remained unchanged at 6 per cent, while market interest rate expectations have fallen by over 50 basis points.

2.29 Since May 1997, RPIX inflation has moved in a narrow band between a low of 1.9 per cent and a high of 3.2 per cent, averaging 2.5 per cent over this period, in line with the Government's target (see Chart 2.1).

Chart 2.1

2.30 Inflation expectations, as measured by survey and financial markets data, show that inflation is expected to remain close to the Government's target, having fallen from over 4 per cent in 1997. This suggests that the MPC continues to command a high degree of credibility and that wage and price setters in the economy may be keeping increases in real wages and prices more in line with increases in productivity and profits.

2.31 The new fiscal framework has restored the public finances to a healthy and sustainable position, making possible the investment in public services awarded in Spending Review 2000, while allowing fiscal policy to support monetary policy through the economic cycle.

Box 2.5: 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. The Government has said that it will produce another assessment of the five tests early in the next Parliament. Because of the magnitude of the decision, the Government believes that, whenever a decision to enter is taken by Government, it should be put to a referendum of the British people.

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 provided a range of practical help for UK businesses trading in the euro, including case studies, fact sheets and electronic tools. It has carried out surveys, and worked 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.

FISCAL STRATEGY

Budget 2000

2.32 The Government's fiscal strategy continues to be underpinned by the macroeconomic framework. Building on the achievement of sound public finances and the platform of stability which is now being delivered, Budget 2000 set a firm spending envelope for the three years covered by the 2000 Spending Review. The Budget locked in the fiscal tightening of Budget 99 and ensured that the Government remained on track to meet its fiscal rules, while also releasing resources for vital public services, allowing:

- an increase in real current spending of $2^1/_2$ per cent a year in line with the Government's neutral view of the economy's trend rate of growth; and
- a more than doubling of net investment by 2003-04.

2.33 These spending increases were also consistent with meeting the fiscal rules in a more cautious case where the level of trend output is assumed to be 1 percentage point lower than in the central case. Maintaining this cautious approach is essential, given the inherent uncertainties surrounding projections of the public finances.

2000 Spending Review

2.34 The 2000 Spending Review in July provided a detailed breakdown of spending plans for the next three years, consistent with the spending limits announced in Budget 2000. Revised economic and fiscal projections were not published as part of the Spending Review outcome, but estimates of AME were revised incorporating the effects of updated assumptions. Within the Budget envelope, the Government was able to allocate additional resources to key public services as a result of prudent management of the public finances. Among the areas in which the Government has made savings are:

- 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 mobile phone licences.

As a result, changes in social security benefits and debt interest payments are expected to account for 17 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 Pre-Budget Report measures. This means that a greater share of extra 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%	22%	21%
Central Government Debt interest payments	9%	-3%	-4%

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

2.35 The Government also decided in the 2000 Spending Review to manage prudently the DEL underspends. The actual outturn for the DEL underspend in 1999-2000 was £2 billion above the Budget 2000 estimate of £1 billion. Instead of carrying forward the full amount, the Government used £$^1/_2$ billion of the additional underspend to repay debt and carried forward only £1$^1/_2$ billion. This £1$^1/_2$ billion was spread equally between 2000-01 and 2001-02 to help smooth the path of public spending.

2.36 The additional resources provided for in the 2000 Spending Review settlement will have an important impact on the productivity and sustainable growth of the economy. They will improve economic infrastructure and the skills of the labour force enhancing capital accumulation. They will support research and development and improve the way technology brings together these resources. Important areas of investment include:

- increased capital investment in schools amounting to £7.8 billion over 2000-01 to 2003-04;
- the Ten Year Plan for Transport which set out a balanced package of investment in high quality public transport and targeted improvements to the road network; and
- a £1 billion Science Research Investment Fund, in partnership with the Wellcome Trust, to boost investment in buildings, laboratories and equipment over two years.

2.37 This investment programme demonstrates the Government's commitment to the renewal and modernisation of the capital stock, reversing years of under-investment by delivering rapid growth in public investment over the next three years. Chapter 5 provides more details.

2.38 At the same time, the Government has ensured that economic stability is not put at risk. The Government adhered to the fiscal rules in setting the firm spending envelope in Budget 2000, and in the Spending Review announcement in July.

2.39 The challenge for this Pre-Budget Report is to ensure that the Government not only remains on track to meet its strict fiscal rules over the economic cycle, but that it also underpins the 2000 Spending Review settlement by putting in place policies that will improve public services and create higher levels of productivity and employment. In doing so, it remains important that fiscal policy continues to support monetary policy over the cycle.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

2.40 The Pre-Budget Report presents an update on the position and outlook for the economy and the public finances, taking into account economic and other developments since the Budget. The two are interdependent, and this section looks at the economy first before discussing the impact on public finances. This is the first full update covering the economy, receipts and spending to incorporate the outcome of the 2000 Spending Review.

Recent economic developments

2.41 The UK economy has witnessed continued strong growth combined with low inflation since Budget 2000. GDP grew by 0.7 per cent in the third quarter and 2.9 per cent on a year earlier, exceeding its estimated trend rate. The balance of growth has also improved, with stronger world demand boosting net exports and domestic demand growth moderating in 2000 - for example, in volume terms, total UK manufacturing exports grew by more than 12 per cent in the year to July 2000 despite the continued weakness of the euro against the pound. Domestic costs have decelerated significantly keeping RPIX inflation close to 2 per cent despite stronger external pressures, in particular due to the further sharp rise in oil prices. The combination of a pre-emptive monetary policy and supportive fiscal policy continues to ensure that there should be no repeat of the late 1980s. Then, an inappropriate macroeconomic policy stance failed to restrain aggregate demand in line with sustainable levels which resulted in a rapid rise in the output gap and inflation, precipitating a deep and long recession in the early 1990s when policy was forced to tighten.

2.42 Favourable economic developments in 2000 and recent years reflect a clear underlying improvement in labour market performance. The Labour Force Survey (LFS) measure of employment has risen by 330,000 over the past year, driving unemployment to its lowest rates since the 1970s. Underlying earnings growth has, nevertheless, fallen just below $4^1/_2$ per cent, with the headline measure falling further in 2000 as the impact of strong bonuses and millennium-related payments dissipated. With no upward trend in unit wage cost growth in recent years, it appears that the sustainable rate of unemployment (NAIRU) has fallen broadly in line with actual unemployment, to around $5^1/_2$ per cent on the ILO measure.

2.43 This has contained inflationary pressures and helped to keep interest rates historically low. Box A1 examines some possible explanations, in particular highlighting sharp falls in long-term unemployment related to a succession of labour market reforms including the New Deals. Nevertheless, the judgement on the NAIRU is subject to considerable uncertainties, with important implications for trend output and the public finances. This chapter later shows that the Government would remain on course to meet its fiscal rules even on much more cautious assumptions concerning the current cyclical position of the economy.

The economic cycle

2.44 Growth in domestic costs and measures of domestically-generated inflation have remained relatively subdued since the first half of 1997, when the economy is previously judged to have been on trend. The evidence suggests that output returned to potential around mid-1999, after moving above trend in 1997 and 1998, and was followed by a small deviation below trend in early 1999. Since then most survey measures of capacity and labour utilisation have begun to move above their long-run averages. Buoyant output growth - averaging just over $2^1/_2$ per cent between the first half of 1997 and mid-1999 - therefore appears to have been matched by a corresponding expansion in potential output over the same period.

2.45 This assessment of the probable shape of the UK economic cycle since 1997 is broadly unchanged from Budget 2000. But recent revisions to measured GDP have increased estimates of potential output and trend growth over recent years. The Treasury's revised assessment is set out in detail in Annex A. Although trend growth has been boosted by sustainable increases in employment, underlying productivity growth has yet to improve. This is surprising, especially given increased ICT usage in the UK economy. The contrast with developments in the US may partly reflect measurement issues, but this productivity gap also highlights both the necessity and opportunity for a stronger performance in the period ahead.

2.46 Given the closeness to trend throughout 1997 to 1999, possible measurement errors and the prospect of future data revisions, it is difficult to conclude for certain whether the economy has completed a full, albeit short and shallow, economic cycle between the first half of 1997 and mid-1999. For the purposes of this Pre-Budget Report and the assessment of the 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. On these bases, the fiscal rules were clearly met over this period.

Economic prospects

2.47 Buoyant output growth can be accommodated for a period, given the starting position of RPIX inflation below the Government's $2^1/_2$ per cent target. However, as argued in Budget 2000 and as noted by the Bank of England's MPC, it is important that domestic demand falls back to sustainable rates. Interest rates were raised pre-emptively in the six months up to the Budget, with the full impact on private spending likely to build further into 2001. Household consumption growth has already slowed markedly, reinforced by slower growth in wealth. As in Budget 2000, GDP growth is forecast to ease from 3 per cent in 2000 to its estimated sustainable rate of $2^1/_4$ to $2^3/_4$ per cent in 2001 and later years.

Table 2.2: Summary of forecast

			Forecast		
	1999	**2000**	**2001**	**2002**	**2003**
GDP growth (per cent)	$2^1/_4$	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)	$2^1/_4$	$2^1/_4$	$2^1/_2$	$2^1/_2$	$2^1/_2$

2.48 RPIX inflation has remained subdued, despite the inflationary impulse of dearer oil. Firms have experienced difficulties passing on increases in costs, particularly in manufacturing. However, stronger import price inflation overall, and a less negative contribution from falling business margins, is expected to return RPIX to the Government's target rate by mid-2001. Further moderation in domestic demand should help keep earnings growth within sustainable limits, though there remain some clear upside risks. In particular, the recent fall in the net household saving ratio has been unexpectedly sharp, as a result of higher borrowing by households, notwithstanding lower precautionary saving due to low inflation and greater economic stability (see Box A4). Chapter 5 describes the steps the Government is taking to promote savings.

2.49 The inflation outlook, nevertheless, remains very finely balanced. In the short run, a stronger than forecast compression of retail margins is entirely plausible. The medium-term mix of growth and inflation might be more permanently improved through an underlying improvement in supply performance. Manufacturing firms will be looking to build on recent improvements in productivity growth to restore profitability. Moreover, the Pre-Budget Report forecast does not assume any underlying improvement in productivity growth associated with the rapid adoption of new economy technologies and associated diffusion of related know-how across the economy. Box A2 looks at these supply-side opportunities in more detail.

RECENT FISCAL TRENDS AND OUTLOOK

2.50 The public finance projections in the Pre-Budget Report have a different status to those included in the EFSR and FSBR at Budget time. They present an interim forecast update and do not necessarily represent the outcome the Government is seeking. The fiscal effect of firm decisions announced now have been incorporated into the fiscal projections in accordance with the requirements of the *Code for Fiscal Stability*. In addition, a number of possible transport measures, detailed in Chapter 6, are subject to consultation, costing in the order of £$1^3/_4$ billion a year. Decisions on these and other issues will be taken in the Budget and, along with revised forecasts for the public finances and the economy, will impact on the final Budget forecast.

2.51 Nonetheless, the projections allow for an updated assessment of progress against the Government's two fiscal rules. They update the projections in Budget 2000 for the latest information and are presented in line with the November 1999 Treasury paper *Analysing UK Fiscal Policy*, under the five key themes of fairness and prudence, sustainability, economic impact, financing and European commitments. Full details of the updated fiscal projections are set out in Annex B.

2.52 While the economic forecast is based on a neutral estimate of $2^1/_2$ per cent a year trend growth looking forward over the projection period, the public finances projections continue to be based on the deliberately prudent and cautious trend growth assumption of $2^1/_4$ per cent a year. 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. The public finances will continue to be projected on the cautious assumption of $2^1/_4$ per cent a year trend growth in Budget 2001.

2.53 The trend growth assumption is just one of a number of key assumptions audited by the National Audit Office (NAO) under a three-year rolling review established in Budget 2000. For this Pre-Budget Report, the NAO has reviewed the assumptions for equity prices, price deflators and VAT receipts. In each case the Comptroller and Auditor General has concluded that it is reasonable that the assumptions continue to be used. In addition, the NAO has audited the performance of these assumptions in the past three years as well as the assumption underlying the projected savings from Spend to Save programmes. The public finances projections which follow show the Government's central projection, based on these cautious assumptions and the latest information on receipts and public expenditure.

Receipts

2.54 Receipts for 2000-01 are now expected to be stronger than expected in the Budget. Full details of changes in tax and spending since the Budget are in Annex B. The better than anticipated position for receipts reflects a number of factors, including:

- higher outturns in 1999-2000 than expected at the time of Budget 2000, in particular for income tax. This has raised the forecast base, affecting the profile into future years;
- buoyant current year receipts, notably income tax and North Sea revenues, where outturns have been better than expected; and
- greater than expected proceeds from the radio spectrum auction which have increased receipts on an accruals basis and have also resulted in lower debt interest payments and higher receipts of interest and dividends.

However, some offsets to these gains arise from lower expected receipts from corporation tax and capital gains tax.

2.55 The detailed forecast shows that, while the outturn for receipts in the first half of this fiscal year has been strong in comparison to the equivalent period last year, the comparative increase for the second half of the year is expected to be less. Table B12 shows, in particular, the effects of corporation tax reforms to the timing of receipts in year. For April-September, receipts are £1 billion higher than the comparable period last year. Based on early outturns for October, the forecast is that receipts for October - March will be £3 billion lower than the same period last year. In addition, the forecast also shows that, based on a lower than expected outturn for receipts in 1999-2000 and latest information on asset disposals, the projection for this year for capital gains tax is £0.4 billion lower than expected at the Budget.

2.56 Higher forecasts for receipts this year raise the forecast base for future years and the projections, based on the cautious assumptions, indicate that receipts will be higher than expected in the Budget throughout the forecast period. Higher income tax receipts resulting from stronger employment and earnings growth continue to offset reductions to the corporation tax forecast.

Annually managed expenditure

2.57 On public expenditure, projections for TME are unchanged for 2000-01 from the Spending Review White Paper. Projections for DEL from 2000-01 to 2003-04 are also unchanged compared to the Spending Review except for a single classification change which means a transfer from DEL to AME detailed in table B13. Since the Budget there have been significant savings in social security benefits and debt interest payments, before the effect of new Pre-Budget Report measures is taken into account. Table 2.3 decomposes the elements into those which were included in the Spending Review projections due to updated assumptions and further changes for this Pre-Budget Report.

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

	£billion			
	2000-01	2001-02	2002-03	2003-04
Changes from Budget 2000 to Spending Review 2000 due to updated assumptions				
Social security benefits[1]	-0.1	-0.4	-0.4	-0.8
Central government debt interest	-0.8	-1.0	-1.4	-1.5
Changes from Spending Review 2000 to PBR 2000				
Social security benefits[2]	-0.8	-1.4	-1.4	-1.9
Central government debt interest	-0.1	-1.5	-0.5	-0.3

[1]*Changes in social security benefits, including Housing Revenue Account Subsidy, due to updated assumptions in unemployment, spend to save and interest rates.*

[2]*Excluding PBR measures.*

2.58 Before taking into account the new measures, social security and debt interest payments are forecast to be about £1 billion lower this year and around £3 billion lower in 2001-02 than at the Spending Review, although there are some increases to forecasts for other AME spending programmes. Table B19 shows further details, including the offset in the AME margin.

Discretionary policy changes

2.59 In considering the impact of additional discretionary policy changes on the fiscal position, the Government has considered:

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

2.60 Within these strict constraints, and in the light of improved forecasts, it has been possible to:

- release additional resources for pensioners worth £2$^1/_2$ billion a year by 2002-03;
- introduce a package of tax reforms to encourage UK productivity, while protecting the environment in the longer term.

In the light of a reduced forecast for AME expenditure in the current year, the £50 increase in this year's winter fuel payment and the rebate of lorry VED, costing £0.7 billion in total, have been absorbed within the AME margin in 2000-01. From 2001-02, the additions to AME arising from discretionary policy changes have been added to TME.

2.61 Table B4 gives further details of the measures. As noted above, the Pre-Budget Report also includes a number of transport measures which have not been included in the forecast since they are subject to consultation. These would cost in total around £1$^3/_4$ billion a year if they were all to be implemented[1]. Decisions on these measures will be taken in the Budget when the Government will also review its AME forecast and the AME margin. In line with the usual convention adopted in previous Pre-Budget Reports, changes to the forecast for AME programmes have been offset in the AME margin. The interim forecast shows that the
interim AME margin has increased over the level set in the 2000 Spending Review by £1.7 billion for 2001-02, £1.6 billion in 2002-03, and £1.6 billion in 2003-04.

FISCAL POSITION AND MEDIUM-TERM PROJECTIONS

2.62 Table 2.4 compares the medium term projections for the surplus on current budget and public sector net borrowing with those in Budget 2000. The changes are decomposed into those explained by the policy measures and those explained by forecasting revisions and other changes. Annex B gives greater detail on these revisions, including the decisions taken in the Spending Review. Table B4 sets out the detail of the PBR policy measures.

Table 2.4: Fiscal balances comparison with Budget 2000[1]

	Outturn[2]			**Projections**		
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Fiscal balances (£billion)						
Surplus on current budget[1]						
Budget 2000	**17.1**	**14**	**16**	**13**	**8**	**8**
Effect of SR2000/forecasting changes	2.3	2.5	3	5	4	5
Effect of PBR policy measures on receipts		0.0	-1	-1	-1	-1
Effect of PBR policy measures on spending		0.0	-2	-3	-3	-3
PBR 2000	**19.4**	**16.6**	**16**	**14**	**8**	**8**
Net borrowing[1]						

Budget 2000	**-11.9**	**-6**	**-5**	**3**	**11**	**13**
Effect of SR2000/forecasting changes	-4.5	-3.6	-4	-6	-5	-5
Effect of PBR policy measures on receipts		0.0	1	1	1	1
Effect of PBR policy measures on spending		0.0	2	3	3	3
PBR 2000	**-16.4**	**-10.1**	**-6**	**1**	**10**	**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**
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] *Excluding windfall tax receipts and associated spending. Figures may not sum due to rounding.*

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

[1]Tax changes subject to consultation are not included in projections of the net tax burden set out in Table B10.
If implemented, they would have the following impact: (per cent of GDP)

2001-02	2002-03	2003-04	2004-05
-0.2	-0.2	-0.2	-0.2

2.63 The fiscal position for 2000-01 has improved since the Budget. A current budget surplus of £16 $^1/_2$ billion is now expected for 2000-01, around £2 $^1/_2$ billion higher than the Budget 2000 forecast. The net borrowing position is also better than expected at the time of Budget 2000. A repayment of about £10 billion is now estimated for 2000-01, about £3 $^1/_2$ billion higher than the Budget forecast.

2.64 The table distinguishes between the headline figures and the underlying structural position, which includes adjustments for the effects of the economic cycle. This is necessary because the Government takes care not to treat cyclical improvements to the public finances as structural improvements. The cyclically adjusted current surplus for 2000-01 is projected to equal 1.5 per cent of GDP, up on the Budget forecast of 1.3 per cent.

2.65 Looking at Public Sector Net Borrowing (PSNB) on a cyclically-adjusted basis, a surplus of 0.8 per cent of GDP is estimated for the current fiscal year, compared with the Budget 2000 estimate of 0.5 per cent of GDP. In each year of the projection period, the fiscal stance - as measured by the cyclically-adjusted PSNB - is on track to be at least as tight as set out in Budget 2000. The Pre-Budget Report projections show that fiscal policy is continuing to support monetary policy, promoting economic stability.

Table 2.5: Summary of public sector finances1

				Per cent of GDP			
	Outturn						**Projections**
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Fairness and prudence							
Surplus on current budget	2.1	1.7	1.6	1.3	0.7	0.7	0.7
Average surplus since 1999-2000	2.1	1.9	1.8	1.7	1.5	1.4	1.3
Cyclically-adjusted surplus on current budget	1.9	1.5	1.4	1.1	0.6	0.7	0.7
Long-term sustainability							
Public sector net debt[2]	36.8	32.3	30.9	30.1	30.2	30.3	30.4

Net worth[2,3]	17.3	18.7	20.1	20.4	20.3	20.1	19.6
Primary balance	4.3	3.3	2.6	1.8	0.8	0.7	0.5
Economic impact							
Net investment	0.3	0.7	1.0	1.4	1.7	1.8	1.8
Public sector net borrowing (PSNB)	-1.8	-1.1	-0.6	0.1	0.9	1.0	1.1
Cyclically-adjusted PSNB	-1.6	-0.8	-0.3	0.3	1.1	1.1	1.1
Financing							
Central government net cash requirement[2]	-1.0	-3.0	-0.1	0.5	1.4	1.4	1.4
European commitments							
Maastricht deficit[4]	-1.8	-1.1	-0.6	0.1	0.9	1.0	1.1
Maastricht debt ratio[5]	43.6	40.1	37.7	36.1	35.6	35.5	35.4
Memo: Output gap	0.2	0.5	0.4	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]*Previously net wealth.*

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

[5]*General government gross debt.*

Golden rule

2.66 Table 2.5 demonstrates that, given non-discretionary changes to receipts and spending and after releasing additional resources, the Government remains well on course to meet both fiscal rules. The surplus on current budget represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the costs of paying for the public services they use and so is an important indicator of the generational fairness of the finances.

2.67 The surplus on current budget is projected to be equivalent to 1.7 per cent of GDP in 2000-01. It is then projected to decline to 0.7 per cent of GDP by 2003-04, because of the increased current spending provided by 2000 Spending Review , thereafter remaining broadly stable.

2.68 On a cyclically-adjusted basis, the current surplus remains clearly positive through the 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 over 1 per cent over the next five years. On this basis, the Government is on track to meet the golden rule.

Chart 2.2

Sustainable investment rule

2.69 Net debt has declined more sharply than predicted. With the benefits of sound public finances, lower interest rate expectations and the proceeds from the auction of spectrum licences, the public sector net debt ratio is projected to fall to around 32 per cent of GDP this year and then to about 30 per cent in 2002-03, thereafter remaining broadly stable and well below 40 per cent. Debt interest payments are forecast to be £6 billion a year lower in 2003-04 than in 1997-98. The Government is firmly on track to meet the sustainable investment rule, while also releasing resources for investment in priority public services and maintaining a cushion against further shocks. Chart 2.2 shows the projections of the current budget remaining in surplus and falling net debt.

2.70 Another measure of the sustainability of public finances is net worth, the difference between the total assets and liabilities of the Government. Net worth is projected to rise to at least 20.3 per cent of GDP by 2003-04. This follows a prolonged period in which the poor state of the public finances led to net worth falling below 15 per cent of GDP. The primary balance (PSNB excluding debt interest payments) also remains in surplus over the forecast period. It is forecast to be 3.3 per cent of GDP for 2000-01, falling to 0.5 per cent by 2005-06.

Box 2.5: The radio spectrum auction and the public finances

The recent auction of licences covering the use of part of the UK's radio spectrum raised £22.5 billion in total, considerably more than forecast at Budget time. In line with the view of the Office for National Statistics, the proceeds from the auction will be accrued over the length of the licences, which expire in 2021.

The Government has decided that the payments will be used to reduce public sector net debt. The effect of this is to reduce debt interest payments over the next few years and beyond. This is in line with the Government's prudent approach, ensuring that a long-term view is taken of the public finances while fiscal policy continues to support monetary policy in the short term.

Savings from lower debt interest payments were factored into the Spending Review and are making room for additional spending on key public services over several years and not just in the first year the money is received. This ensures that the proceeds from the auctions are spread over time so that future generations also benefit from the one-time improvement in the public finances - in line with the Government's objective of generational equity.

Economic impact

2.71 The overall impact of fiscal policy on the economy can be assessed by examining changes in PSNB. The interim 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 cyclically-adjusted PSNB is projected to be tighter this year than the Budget 2000 forecast by an amount equivalent to 0.3 per cent of GDP. The difference between this cyclically-adjusted figure and the headline figure (amounting to 0.3 per cent of GDP for 2000-01) shows the effect of the automatic stabilisers, which are continuing to dampen the cycle. Looking forward, PSNB is projected to move into deficit by 2003-04 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 the fiscal rules since net debt is being kept at a stable and prudent level, well below 40 per cent.

Chart 2.3

Financing

2.72 The forecast for the central government net cash requirement (CGNCR) has been revised from - £4.9 billion to -£28.2 billion, a difference of £23.3 billion. This revision is largely due to the proceeds from the spectrum licence auction which were £19.5 billion higher than the Budget assumption. It was decided that these proceeds should be used to reduce net debt. In light of this, a revised Gilts Remit for 2000-01 was published on 12 June 2000. Planned gross gilt sales were cut by £2.2 billion to £10.0 billion and fixed at that level for the remainder of the financial year. Additionally, the remaining contingencies outlined in the Debt Management Report 2000-01 were exercised. It was also announced that further decisions on allocating the proceeds in the light of the revised forecast of the CGNCR would be announced at the time of the Pre-Budget Report. The further reductions in net debt in 2000-01 will be achieved by:

- increasing the total of planned debt buy-backs by £1.5 billion;
- increasing the reduction in the Ways and Means advance by £1.6 billion;
- reducing the planned Treasury Bill stock for end March 2001 by a further £4.5 billion; and
- planning for the residual cash position of £6.3 billion (to be reduced over the next three financial years).

2.73 The rest of the financing requirement is accounted for by a further forecast decline of £0.7 billion in net financing from National Savings. Full details of these measures and an updated table for the Government's Financing Requirement for 2000-01 can be found in Annex B. Gross gilt sales for the financial year to date have been £4.9 billion with a further £5.1 billion planned.

European commitments

2.74 The Government also remains on course to meet the Maastricht Treaty and Stability and Growth Pact commitments. These require Governments to keep general government net borrowing below 3 per cent of GDP and general government gross debt below 60 per cent of GDP. The Pre-Budget Report projections indicate that these values will comfortably be achieved.

The need for caution in the public finance projections

2.75 Projections of the public finances necessarily involve a significant element of uncertainty. Public revenue and spending projections depend heavily on forecasts of economic growth and, in particular, on assumptions made about the position of the economy in relation to its long-term trend path. This means that projections of strong public finances in the medium term can quickly deteriorate if most of the strength was cyclical and if the economy slows to below trend over the forecast horizon. Therefore, it is important to build in a safety margin, as well as forecasting with cautious and prudent assumptions.

2.76 Chart 2.4 illustrates a cautious case in which the level of trend output is assumed to be 1 percentage point lower in relation to actual output than in the central case. Even on this basis, the Government is on track to meet the golden rule over the economic cycle. This increases the probability of meeting the fiscal rules and, by minimising the need for unexpected changes of direction, allows a smoother path for public spending.

The outlook for trend growth

2.77 The Government entered office against an uncertain economic background. The Government judged that it was sensible to present its forecasts for economic growth in the form of opportunity ranges around a deliberately cautious assumption for trend growth of $2^1/_4$ per cent a year. This illustrated the potential for supply-side improvements to deliver stronger growth above the prudent $2^1/_4$ per cent a year assumption used for the fiscal projections.

Chart 2.4

2.78 The factors that influence trend growth can be grouped under those that determine trend population growth, the trend employment rate and those that determine trend labour productivity. The November 1999 Pre-Budget Report gave a firmer indication of the outlook for trend growth - on the basis of a careful and balanced assessment of past and future trends, the Government's neutral estimate of the UK's trend growth rate year-on-year over the future was raised to $2^1/_2$ per cent. This assessment is unchanged.

2.79 This neutral assessment of trend output growth is, however, subject to considerable upside potential. Government policies to secure further progress towards full employment and continued responsibility in wage bargaining can help prolong the recent improvement in underlying labour market performance. But the key challenge now facing businesses, individuals and Government is to secure significantly stronger growth in productivity. In the US, rapid adoption of 'new economy' technologies and related diffusion of 'know-how' associated with ICT has been credited with securing a significant improvement in productivity and hence sustainable growth potential. Building on the UK economy's foundation of economic stability and policies to raise investment and innovation in a competitive business environment, there is the opportunity for firms to emulate US performance. These factors create the potential for stronger sustainable growth beyond the upper limits of the Pre-Budget Report forecast ranges. Chapter 3 describes the action which the Government is taking to build on this potential to improve productivity.

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[1]See *Planning Sustainable Public Spending: Lessons from Previous Policy Experience*, HM Treasury, November 2000.

3

Meeting the productivity challenge

The economy's productivity performance is the key to long-term growth and sustained increases in living standards. The Government's aim is that productivity in the UK will rise faster than in our major competitor countries over the next decade. To achieve this aim, it has put in place a long-term strategy built around macroeconomic stability and microeconomic reform through the five drivers of productivity growth:

- **competition** motivates firms to raise their game, innovating and minimising their costs. It rewards those firms that raise their productivity performance and reduces prices for customers;
- **enterprise and innovation** are at the heart of a dynamic business sector - new ideas for products and processes provide opportunities for productivity improvement. These chances can be exploited by entrepreneurs willing to take the risks necessary for success;
- **investment** underpins development of physical and human capital to produce productivity improvements in the future;
- higher **skill** levels not only help individuals and firms to be more productive but also encourage rapid take-up of new technologies and working practices; and
- alongside promoting macroeconomic stability and microeconomic reform, the Government can directly drive up **public sector productivity**.

Improved productivity cannot be achieved by the Government alone. The sustainable improvements in opportunities and living standards that productivity growth promises can only be attained through an effort shared with managers and employees across the country, in public and private sectors alike.

THE PRODUCTIVITY CHALLENGE

Raising UK productivity

3.1 Raising productivity is one of the central conditions for meeting the Government's objective of high and stable levels of growth and employment and delivering sustained increases in living standards. This chapter sets out how and why the Government is working to increase productivity, the challenges that it faces and the environment that it is seeking to create.

3.2 Over the past three years, the Government has secured a platform of stability which provides the basis for raising productivity. The challenge for business, unions, educationalists and other organisations across the regions is together to tackle the productivity issue. Meeting this challenge offers the prospect of higher growth and increased employment opportunities with low inflation and low interest rates. The Government is determined not to pass up this opportunity.

3.3 The Government's strategy for productivity growth[1] is based around **macroeconomic stability** and **microeconomic reform.** It is an agenda for Government, management and employees across the economy to raise their performance and take the opportunity for sustainable higher growth.

UK productivity performance

3.4 Productivity can be defined in a number of ways. Labour productivity can be measured as output per worker or output per hour worked. Total factor productivity measures the combined productivity of capital and labour in the economy. Whatever measures are used, the UK has long displayed lower productivity levels than its major competitor nations, and continues to do so (see Chart 3.1).[2]

Chart 3.1

3.5 Increasing productivity growth and starting to close the productivity gap should increase trend output growth, and so deliver greater economic and employment opportunities, and better living standards. The Government set a long-term ambition in the 1999 Pre-Budget Report: that the UK will have a faster rise in productivity than its main competitors over the next decade. To further this aim, the DTI and the Treasury have a joint Public Service Agreement (PSA) target to 'improve UK competitiveness by narrowing the productivity gap with the US, France, Germany and Japan over the economic cycle'. The DTI is preparing jointly with the DfEE a paper setting out their strategy to help achieve this.

Meeting the challenge

3.6 Closing the productivity gap cannot be achieved without a broader drive from workforces and managers across the country. In October the Chancellor therefore invited the TUC and the CBI to work together on an agenda for improving UK productivity. Six particular areas were identified for joint working:

- **remedying shortfalls in workplace skills and training;**
- **overcoming long-term under-investment;**
- **accelerating the use and spread of technology;**
- **making business more effective in adopting best practice and innovative techniques from elsewhere, and from one another;**
- **by benchmarking the best, making modern industrial relations more effective; and**
- **improving the quality of management at every level to make it genuinely world-class.**

3.7 Together with educationalists and other organisations, the Chancellor invited the TUC and CBI to identify case studies of strong and poor performance. They have been asked to seek proposals from individual employers and unions for concrete improvements and to highlight issues for the Government to address. This will provide a starting point from which everyone can play a full role in raising UK productivity growth.

Macroeconomic stability

3.8 The first part of the Government's contribution to meeting the productivity challenge is to provide a platform of macroeconomic stability. Economic instability makes it difficult for individuals and firms to plan, save and invest all of which are essential for productivity growth.

3.9 As Chapter 2 sets out, implementation of the Government's fiscal and monetary frameworks has provided low inflation, significantly reduced volatility in output growth and a more favourable environment for long-term investment.

3.10 UK productivity growth, slow throughout most of the 1990s, has shown recent signs of improvement (see Chart 3.2). But growth still trails that of the United States, which has seen an extraordinary acceleration in recent years (as discussed in Box 3.1)

Chart 3.2

Microeconomic reform

3.11 The Government's microeconomic reforms are focused around the five drivers of productivity growth: **competition, enterprise and innovation, investment, skills** and **public sector productivity**. These address two issues:

- improving the quality and quantity of inputs (principally capital and labour); and
- improving the ways in which these inputs are used.

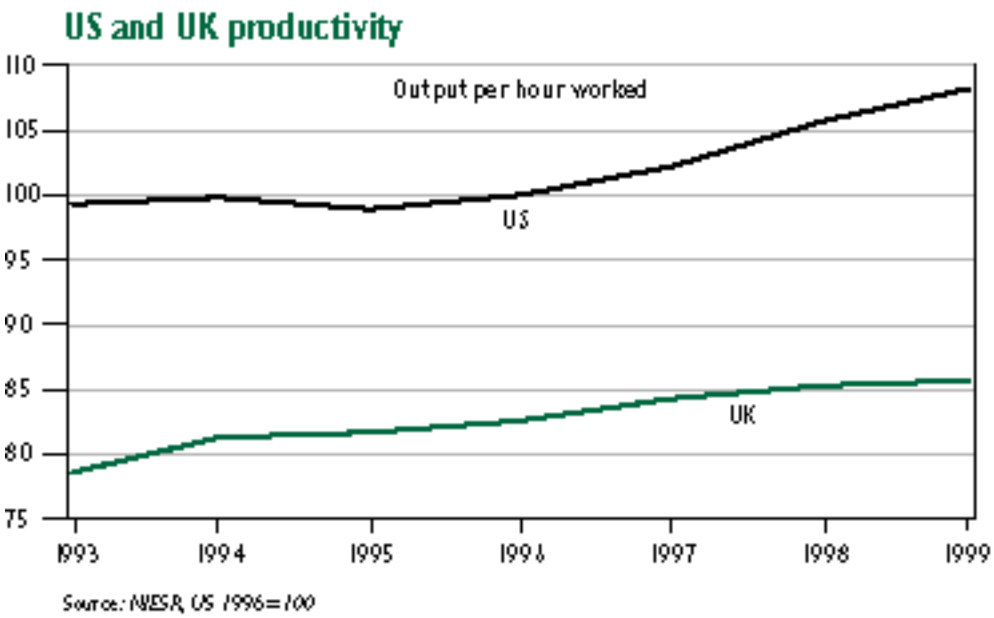
3.12 Competition drives better use of inputs. It motivates firms and individuals to improve their productivity, rewarding those who perform better and sorting them from those who do not. The Government has a vital role to play through ensuring that the regulatory environment is right and that markets are as open as possible to the forces of competition.

3.13 Achieving these improvements requires **enterprise and innovation**. Entrepreneurs who are able to spot opportunities and to take on the necessary risks to achieve them are an energising force for productivity improvement. Equally, new ideas form the basis of many of these opportunities, whether innovations in processes or products.

3.14 The Government can assist the development of a more entrepreneurial culture by reducing the fear of failure and promoting the benefits of success. This intervention can be particularly effective in cities and disadvantaged areas, where barriers to entrepreneurship can be especially severe. Further, it can encourage innovation across the economy by providing incentives for companies to carry out more research and helping them to extract the best from innovations developed elsewhere.

Box 3.1: ICT, the 'new economy' and the opportunity for UK productivity

The US economy has achieved an exceptional combination of high GDP growth and low inflation since the mid 1990s. This has been underpinned by strong productivity growth. In the year to the second quarter of 2000, US labour productivity grew by 5.1 per cent the fastest rate since 1983. In manufacturing, productivity growth was even higher, at almost 7 per cent.



Most economists agree that developments in information and communications technologies (ICT) are the principal cause of this strengthening in US productivity growth. Not only are companies that manufacture these technologies operating in a more productive way, but other sectors are investing heavily in ICT and there are 'spillover' effects from technological progress that give the broader economy the opportunity to improve.

The US has led world productivity growth in recent years[1]. But the UK is well placed to benefit from these 'new economy' effects. A report by Merrill Lynch[2] published in August 2000 rates the UK as the leading European country in terms of progress towards economic reform, and second only to the US globally. In some areas (such as mobile communications use and lack of barriers to entrepreneurship), the UK leads the US.

Other new evidence shows that the UK has invested extensively in ICT over the past decade. This investment does not pay off instantly, and developments such as widespread use of the internet are too recent to have yet had a dramatic effect on productivity.

But over the next few years, ICT should both give UK companies new opportunities to make productivity improvements and generate competitive pressure on them to do so. Combined with the effect of structural changes, this provides a basis for improving productivity growth in coming years, and so raising trend growth. As a recent study argued: "[T]here is now a good chance of a strong revival in productivity growth even without allowing for any special new economy effects. Adding the effects of ICT investment strengthens the likelihood of this."[3]

[1]There are, however, some important measurement issues affecting the comparative use of US data as referred to in Annex A.

[2]*Benchmarking the New Economy*, Merrill Lynch, 2000.

[3]'The New British Economy', Richard Kneller and Garry Young, NIESR, 2000.

3.15 The quality and quantity of inputs are both important. Sufficient **investment** needs to be available and it needs to be used productively. The UK is fortunate to have highly- developed capital markets. However, it has also suffered from prolonged under-investment in many areas. Despite strong growth in business investment, a cumulative investment gap with our competitors persists. The Government is working to improve this situation through ensuring that the tax framework is favourable, by promoting efficient financial markets, and by reversing a long trend of under-investment in the public sector.

3.16 Both the quality and quantity of **skills** available affect productivity. Addressing the barriers that keep people from developing their full potential in the labour market is not only vital to address deprivation, it is key to driving economic growth. The Government is providing new opportunities for individuals to improve their skills and for companies to make the most of their human capital. It has invested in modernising education, providing lifelong learning and addressing skills shortages to close the gap between the UK skills base and those of our major competitors.

3.17 Improvements in inputs will benefit **public sector productivity** as well as private sector productivity. Government has different mechanisms, however, at its disposal to motivate improvements in how these inputs are used. Achieving such improvements not only ensures better use of public money, but also increases productivity across the economy as a whole.

3.18 These five drivers are inter-related in principle: competition, for instance, not only drives improvements in the use of inputs but can also improve inputs (for instance competition between training providers). They are also inter-related in practice: policies to motivate entrepreneurship can strengthen competition, for example.

3.19 Since 1997, the Government has worked to reform and improve aspects of all five drivers (see Table 3.1).

Table 3.1: The Government's productivity reforms

Competition	• Competition Act, 1998; • Cruickshank Review of competition in banking; • Utilities Act 2000, establishment of OFGEM to strengthen competition in gas and energy markets; and • mergers reform, to take ministers out of merger decisions.
Enterprise and innovation	• reforms to corporate tax framework; improvements to Enterprise Investment Scheme and Venture Capital Trusts; • creation of Small Business Service; • establishment of Regional Development Agencies (RDAs); • Social Investment Taskforce; • investment in research infrastructure, such as the Higher Education Innovation Fund and University Challenge Fund; R&D tax credit; • initiatives to promote clusters, including planning guidance and funding for RDAs to co-finance business incubators; • Enterprise Management Incentives; • Corporate Venturing Scheme; • promoting employee share ownership; and • National Campaign for Enterprise.
Investment	• 2000 Spending Review: doubling of net public sector investment by 200304; • Myners review of institutional investment; and • reforms of capital gains tax and corporation tax (now reduced to 30, 20 and 10 pence rates) to encourage investment.
Skills	• investments in education and training in 2000 Spending Review; • national literacy and numeracy strategies; • learndirect (the brand name for the University for Industry); • Individual Learning Accounts; and • work permit reforms.
Public sector productivity	• Public Service Agreements setting performance targets covering every government department;

- creation of the Office of Government Commerce, to deliver £1 billion of savings on government procurement; and
- Public Services Productivity Panel, helping the public sector to innovate and deliver change.

The role of regional policy

3.20 The building blocks for productivity growth are grounded in the strengths of regions, and the rural areas and cities within them. The Government is committed to a regional policy that exploits these strengths, not through top-down initiatives but through regional and local initiatives enabled by a national Government that provides the necessary flexibility and resources.

3.21 Through establishing Regional Development Agencies (RDAs), the Government has enabled regions to take a lead in developing productivity and delivering national and regional policies. The Pre-Budget Report gives RDAs more flexibility to make the most of their role as strategic leaders of regional and local economic development (see paragraphs 3.643.67).

3.22 To promote enterprise in our communities the RDAs will work closely with Local Strategic Partnerships (LSPs). LSPs will bring together the local authority, all service providers (such as the police, schools and health and social services), local businesses and community groups in a single coalition for a community. By developing Community Strategies they will play a key role in maximising local strengths and addressing local problems.

The European dimension

3.23 The Government is committed to pursuing economic reform within the European Union, and the goal of raising productivity is shared by all EU member states. At the Lisbon summit in March 2000, EU Heads of Government established a new strategic goal for the new decade for Europe, "to become the most competitive and dynamic knowledge-based economy in the world". To achieve this, the Lisbon and Feira summits agreed concrete action plans and deadlines in a range of areas, including venture capital, electronic commerce, financial services and telecoms liberalisation.

3.24 By monitoring performance through the use of agreed Europe-wide structural indicators, Member States are able to learn from each other and to share best practice. At the Stockholm Council in March 2001, the Government will look to build on the progress made since Lisbon.

3.25 The Government has begun to make the changes necessary to meet the productivity challenge by ensuring that markets are able to operate efficiently and providing the incentives for businesses to grow. It has established a platform of macroeconomic stability from which microeconomic reform can proceed. Now it is necessary to build on this start and to seize the opportunity. This will ensure that increases in productivity performance are sustained, securing higher prosperity for all.

COMPETITION

The importance of competition

3.26 The Government has placed competition policy at the heart of its strategy to close the productivity gap. A competitive environment plays a central role in driving productivity growth in an economy. It encourages firms to innovate by reducing slack putting downward pressure on costs and providing incentives for the efficient organisation of production. It also reorganises market structure, by reallocating resources away from inefficient firms.

3.27 In this way, competition creates an environment within which productive firms flourish. When more productive firms gain market share and less productive firms shrink and exit the market, the overall level of productivity rises. Attempts to quantify this effect in the US and UK have led to broadly similar results, attributing 30 to 50 per cent of manufacturing productivity growth to the sorting of productive and unproductive plants.[3]

Creating a framework for competition

3.28 The Government has introduced a range of measures to improve competition in the economy as a whole. It has modernised the legal and institutional framework in order to ensure that market discipline acts across the economy to motivate productivity improvements and to sort the more and less productive firms.

3.29 The Office of Fair Trading (OFT) has greatly enhanced powers to tackle anti-competitive practices, due to the Competition Act 1998, and to scrutinise the competition effects of financial services regulation, in light of the Financial Services and Markets

Act. The Utilities Act, now in place, enhances the competition duty for the energy regulator.

3.30 It is also important to ensure that the competition authorities have the resources and structures to use these powers effectively. The OFT received an additional £10.2 million over three years in the 2000 Spending Review, and has a new Director General in John Vickers, former Chief Economist at the Bank of England.

3.31 The regime put in place by the Competition Act 1998 is already making an impact on competition in the UK:

- the OFT is targeting its resources on detecting and deterring as much anti-competitive behaviour as possible;
- in the first eight months of operation of the new Act, the numbers of complaints are running at around two to three times the rate received under the previous legislation;
- the OFT is currently formally investigating more than 15 cases of suspected infringement and has used its new investigation powers on numerous occasions including exercise of powers to enter premises under warrant;
- it has dealt with a number of requests for informal advice and guidance from business and has received two applications for leniency;
- the deterrent effects of the Act are also becoming clearer. Some cartels known about by the OFT appear to have ceased after 1 March 2000; and
- in a number of cases the mere act of complaining to the OFT has led alleged infringers to modify their behaviour to the complainants' satisfaction.

3.32 The Government is also consulting on the creation of a new board structure for the OFT. The Government believes that in view of the increased responsibilities and powers under the Competition Act it is no longer appropriate for all the body's powers to be vested in one individual. This should depersonalise regulation and broaden the basis of the decision making that informs it.

3.33 The Government has announced how it plans to reform the process for controlling mergers to deliver the objective of depoliticising decisions and making competition the sole focus of assessment in the vast majority of cases. These changes require primary legislation to be implemented fully, but as a first step towards delivering these objectives, the Secretary of State for Trade and Industry has already committed himself to accepting the Director General of Fair Trading's (DGFT) advice on whether a merger should be referred to the Competition Commission, other than in exceptional circumstances.

Ensuring competition in particular markets

3.34 The new legal and institutional framework provides a powerful basis for ensuring effective competition. In key markets where competition has broader benefits for the economy as a whole (such as telecoms and banking), or where repeated questions about competitive pressure have been raised (such as the new car market), the Government has gone further to stimulate competitive intensity.

Banking

3.35 In Budget 2000, the Chancellor announced that the Government would act upon the recommendations of Don Cruickshank's report to improve competition and services to customers in the banking industry. The Government's immediate response included:

- a commitment to legislation, opening up access to payment systems and overseeing access charges; and
- referring the supply of banking services to SMEs to the Competition Commission.

3.36 In August 2000, the Government and the Financial Services Authority published their detailed responses to the Cruickshank review. The Government announced a number of new measures, including:

- reviewing self-regulatory codes such as the Banking Code to see if they deliver real consumer benefits. The Consumer Codes Review Group is being chaired by DeAnne Julius, who currently also sits on the Monetary Policy Committee, and has members from a range of backgrounds, including those from consumer groups and the industry. The Group has been asked to report by April 2001;
- encouraging the provision of comparative information for consumers on banking products;
- agreeing to a two year review of the effect of the Financial Services and Markets Act on competition;
- introducing CAT standards for credit cards and consulting on extending CAT standards to other financial products;
- reforming the Treasury's objectives on promoting competition in financial services; and
- developing a payments strategy for all government departments to ensure a coordinated approach to e-commerce and modernising government.

New cars

3.37 Following the Competition Commission's investigation into the new car market, the Government has introduced measures to increase competition in the supply and sales of new cars. As a result, consumers have seen significant reductions in the new car prices on offer from major manufacturers.

Supermarkets

3.38 In its recent report on supermarkets, the Competition Commission found the industry to be broadly competitive. However, it raised a concern about the relationship between supermarket chains and their suppliers. The Commission made a number of recommendations which would put relations between supermarkets and their suppliers on a clearer and more predictable basis, including a Code of Practice. The Secretary of State for Trade and Industry has accepted their recommendations, and has asked the DGFT to seek appropriate undertakings from the leading supermarkets. The DGFT is due to report back at the end of the year.

Water

3.39 As the Department of the Environment, Transport and the Regions has recently announced, the Government is committed to ensuring that water consumers also benefit from the improvements in price, quality of service and choice which competition can deliver. The Government is now carrying out further work, involving the industry regulator Ofwat, on how best to implement this commitment while protecting environmental and public health standards. Options being examined include licensing new entrants for common carriage, separate licensing of different parts of the industry and how to ensure new entrants have access on reasonable terms to water resources. A full statement of conclusions will be made.

Competition in the professions

3.40 The OFT is also conducting a review of the state of competition in the professions. This is focusing on whether statutory or self-regulation unnecessarily restricts or distorts competition in key markets such as accountancy and legal services and the associated conduct of the businesses active in these sectors. The OFT issued a consultation document in May which elicited a wide range of representations. Consultants were appointed in early July to carry out a detailed study, taking into account the points raised. They have since spoken to a range of organisations, including representatives of consumer interests as well as practitioners and their regulators.

3.41 The DGFT will submit a report to Ministers on the findings of the review at the turn of the year. The Government will then need to consider what reforms may be appropriate, balancing any detrimental effects on competition with other public policy objectives, and ensuring that any restrictions on competition are both proportionate and do not go further than is necessary to deliver policy objectives.

Airports

3.42 The Deputy Prime Minister has been conducting a review of competition in the airport sector. The conclusions of this review will be announced shortly. The Government will work actively in Europe for a new slot allocation regulation that promotes competition and efficient use of capacity.

Communications

3.43 The Government is to publish a Communications White Paper later in the year on its vision and objectives for communications in the twenty-first century, including its regulation in the age of convergence of broadcasting and telecommunications. In parallel, the UK is working with its European partners to modernise and make more flexible European Union telecommunications regulation, ensuring that competition and the consumer are centre stage.

ENTERPRISE AND INNOVATION

3.44 A dynamic environment with opportunities for enterprise and innovation is vital to improving economic performance. The Government wants to make the UK the most attractive environment for business in Europe, removing obstacles to entrepreneurship and promoting the development and spread of new ideas. Productivity improvements thrive in a climate of new ideas, new businesses and new opportunities.

3.45 The Government is particularly concerned that these opportunities are open to everyone. If entrepreneurship is confined to a narrow segment of society, not only are many people denied the chance to succeed, but also the economy wastes a valuable resource for fulfiling its potential.

Improving the tax system

3.46 To provide the right incentives for enterprise, the Government has undertaken radical reforms of the tax framework for businesses, including:

- reforming corporation tax, making the UK main rate of corporation tax the lowest among major industrialised countries;
- reducing corporation tax for SMEs, with a starting rate of 10p which is the lowest in the EU. The average corporation tax bill of a small company has been reduced by nearly 25 per cent since 1997;
- introducing a capital gains tax taper reducing the effective tax rate on business assets to 10 per cent after four years; and 40 per cent first year capital allowances for SMEs, made permanent in Budget 2000; and
- reforming the double taxation relief system, introducing for the first time in the UK a new system of on-shore pooling. This removes the incentive for mixing profits in an offshore holding company and makes it available in non-abusive situations to all UK companies.

3.47 In this Pre-Budget Report, the Government is announcing further initiatives to make the UK the best possible environment in which to do business. Building on announcements made in Budget 2000, it is:

- planning to abolish from April 2001 the requirement to withhold tax on interest and royalties between companies within the charge to corporation tax. **Subject to consultation on the details, legislation will be introduced in Finance Bill 2001.** This follows the announcement of the abolition of withholding tax on bond interest and other payments in Budget 2000;
- launching the next stage in the reform of the taxation of intellectual property, goodwill and other intangible assets. More than 80 responses were received to a Technical Note setting out the options, which was published by the Inland Revenue in June 2000, and the Inland Revenue is publishing alongside this Pre-Budget Report a further Technical Note setting out how a new regime could operate in light of these responses. The Government intends to legislate in Finance Bill 2001;
- easing the impact of VAT on SMEs (see Box 3.2);
- proposing to extend the on-shore pooling rules to allow relief for eligible unrelieved foreign tax, even if it arises at several levels in a chain of companies overseas. In addition, the Government will be acting in Finance Bill 2001 to ensure that the calculation of foreign tax applies in all cases as originally intended;
- publishing proposals to simplify and modernise the legislation concerning corporate debt, financial instruments and foreign exchange gains and losses in an Inland Revenue Technical Note; and
- considering responses to the proposals for simplifying National Insurance contributions for employees issued as a Technical Discussion Paper by the Inland Revenue in June. These responses have been generally supportive and have given some guides to further areas of interest. The Government will respond in detail.

Box 3.2 Easing the impact of VAT on SMEs

The Government is proposing to introduce a major package of measures from April 2001 to allow small and medium sized enterprises (SMEs) to manage their entry into the VAT system, reduce their VAT administration burden and improve their cash flow. The package will include:

- **extending the benefit of the cash accounting scheme to 40,000 traders** by expanding the turnover limit from £350,000 to a new consolidated SME turnover level for VAT of £600,000. This will help more SMEs manage their VAT, while easing their cash flow burdens;
- **allowing at least 100,000 more businesses to benefit from lower compliance costs** through the ability to file VAT returns on an annual rather than quarterly basis. The upper turnover limit for qualification will be raised from £300,000 again to the new consolidated SME turnover level of £600,000;
- **providing better advice for SMEs**, through launching a lifelong business support programme and a national contact centre for general enquiries, extending the national importers and exporters programme and developing e-business measures;
- **increasing the VAT threshold in line with inflation, keeping the UK threshold at the highest level in Europe**. This will ensure that another 8,000 businesses will be entitled to operate without the need to charge VAT; and
- **consultation on rationalising the frequency of VAT payments due from traders under the annual accounting regime and introducing a lower SME turnover limit of £100,000, under which these SMEs will be able to**:
  - use a "flat rate scheme". Within this scheme, SMEs will be able to calculate their VAT liabilities as a percentage of their turnover and avoid having to account internally for VAT on all of their purchases and

sales. The scheme would be designed to generate broadly the same amount of VAT payable, but would be simpler to use; and
  - enter the annual accounting regime immediately rather than having to wait until they have completed a year of VATable trading.

Encouraging enterprise

3.48 The right tax framework can make a critical contribution to achieving an environment in which enterprise and innovation flourish. The Government will continuously review the tax system to ensure that it is meeting this goal. But there is more that the Government can and has done to improve the situation for business.

Reforming insolvency and business rescue

3.49 The fear of failure can act as a powerful disincentive to potential entrepreneurs considering starting their own businesses. Inefficient or inappropriate treatment of businesses in difficulty may stifle entrepreneurs who could otherwise have turned their situation around. The Government is examining the possibilities for reforming corporate rescue and insolvency and the report of a review group on this subject was published on 2 November.

3.50 The report recommends that the Inland Revenue and Customs and Excise should adopt a more commercial approach. In response, a new Inland Revenue/Customs and Excise unit is being set up to consider proposed rescue plans put forward by businesses. The unit will ensure that from April 2001 rescue proposals put forward by businesses (so-called Voluntary Arrangements) receive individual consideration. The unit will consider proposals in the same way as commercial creditors considering the full range of discretion available, and recognising that helping a business through a difficult period is often the best way to secure repayment of debts. New and strict timetables for dealing with vulnerable businesses will be published and adhered to.

3.51 A consultation is now under way in relation to a number of other recommendations and options for change. These include:

- a "single gateway" procedure for trading companies, simplifying the currently wide range of options by allowing the courts to make a temporary administration order when a petition to wind up a trading company is presented;
- the development of a simple financial health check for small firms which will encourage them to raise the standard of their financial and business management;
- the removal of the right of a floating charge holder to veto the making of an administration order; and
- a change in the law to ensure that the extent of a fixed charge over a company's book debts be determined at the date of the company's entry into either a Voluntary Arrangements moratorium or administration.

Limited Liability Partnerships

3.52 The Government has modernised the legal framework for business in the UK by introducing Limited Liability Partnerships (LLPs). Designed to appeal particularly to the professional business community, this arrangement allows members to limit their liabilities but structure their activities as a partnership. LLPs will be available from 6 April 2001.

3.53 In order to ensure that the commercial choice between using an LLP or a partnership is not distorted, the LLP will be treated for tax purposes as a partnership. The Government is concerned to ensure that the new structure is not used to create an unfair advantage through tax avoidance and the Inland Revenue is publishing alongside this Pre-Budget Report its proposed way forward and inviting comments.

Encouraging employees to share in success

3.54 Employee share ownership can help to align the incentives of all those in an enterprise. In order to encourage employees to take a stake in the success of their companies, the All-Employee Share Ownership Plan (AESOP) was introduced in Finance Act 2000. Over 160 companies have applied to set up a new AESOP, with 20 company schemes (covering more than 30,000 employees) already approved. By 2005, half a million more employees are expected to have shares in their companies through schemes of this type, bringing the total number who have a stake to over 2.5 million.

3.55 To encourage further employee shareholding and foster a more enterprising and productive relationship between firms and their employees, the Government extended in Finance Act 2000 the more generous business assets rate of capital gains tax taper relief to all disposals of shares held by employees in their companies where the companies were wholly (or almost wholly) trading. So that more companies and employees can benefit and to reduce their compliance costs, the Government is proposing tc extend the benefit of the business assets taper to include employees of a range of non-trading companies from 6 April 2000. The

Government will consult regarding the appropriate level of revenue protection.

Employer NICs

3.56 Since 6 April 1999 National Insurance Contributions (NICs) have been payable by both the employer and employee on the gains arising when share options are exercised outside an Inland Revenue approved scheme, if the shares are readily convertible into cash. The rapid growth in the stock market since April 1999 has led to concerns by companies with volatile share prices that their exposure to an unpredictable NICs liability could endanger their investment strategies and damage their future growth by deterring investors.

3.57 The Government announced on 19 May 2000 that it was introducing legislation in the Child Support, Pensions and Social Security Act to allow the employer's NICs to be recovered or transferred to the employee, following agreement between companies and their employees. This will solve the accounting problem and help smaller start-up companies with limited cash flow.

3.58 Having addressed the concern over share options issued after 19 May 2000, new legislation will be introduced to cover share options issued between 6 April 1999 and 19 May 2000. Under these rules, companies will have the option of removing all uncertainty through settling their NICs liabilities on those options based on market values at the time of this Pre-Budget Report. This will remove future growth from the charge to employer's National Insurance. Together with the option of transferring liability to the employee, this will solve the difficulties for those high growth firms.

Encouraging SME financing and growth

3.59 A thriving small and medium sized business sector is important to driving productivity growth. In particular, the creation and growth of new firms promotes the exploitation of new ideas and opportunities, and sharpens competition.

3.60 Smaller, high risk companies often experience problems recruiting and remunerating key employees, and, in acknowledgement of this, the Government introduced in Budget 2000 tax-favoured Enterprise Management Incentives. This allowed the individual company to issue up to £100,000 of tax-favoured share options to up to 15 key employees. This has proved popular and, since the launch in July, over 100 companies have notified the Inland Revenue that they have granted options to a total of over 500 people, and it is estimated that 2,500 companies will use EMIs over the next three years.

3.61 However some companies have commented that they would like more flexibility, including the opportunity to issue these options to all their employees. The Government will therefore consult on replacing the limit on the number of employees with a total amount of tax-favoured options that the company can allocate in the way best suited to its business. In addition, rather than keeping the limit at the current level of £1.5 million, the Government will consult on raising the limit to £2.5 million. These two changes will increase the benefits of EMIs and make them available to more employees.

3.62 The Government has introduced a wide range of measures designed to boost the supply of risk capital finance to SMEs with growth potential, which might otherwise be under-supplied by the market. In particular, to improve the supply of equity to smaller, higher-risk companies, the Government has improved the Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) scheme. Total investment to date is around £750 million for EIS and £1 billion for VCT. Encouraging a different source of capital for smaller companies, the Government has introduced a corporate venturing tax relief scheme from April 2000. This is designed to promote mutually beneficial investment by corporates in smaller higher risk trading companies.

Box 3.3: The Small Business Service

To maximise the opportunities for start-ups and small businesses, the Small Business Service (SBS) was launched in April 2000. With the recruitment as Chief Executive of David Irwin, founder of Project North East, one of the UK's leading enterprise and economic development agencies, the SBS is a strong voice for small business at the heart of Government.

The SBS will make Government support for small business simpler and more coherent, and help small firms deal with regulation. In its first six months of operation, the SBS has:

- commenced a research programme to ensure a detailed understanding of the needs of small businesses and to establish performance measures;
- launched a Small Business Investment Task Force in September 2000 under the chairmanship of Sir David Cooksey to advise on ways to stimulate the supply of SME finance, including the establishment of regional venture capital funds. An extra £100 million for these purposes was announced in Budget 2000;
- launched the UK High Technology Venture Capital Fund in July 2000. The Fund has now raised well over £100

million towards its target of £125 million and is already making investment commitments to UK-based specialist technology funds; and
- started to transform the existing Business Link partnerships into a slimmer, fitter, higher-quality network, by selecting new local franchises to be operational from April 2001. To date, 39 of the existing Business Links have been awarded franchises on the quality of their applications, in five areas other operators have been selected, and the SBS is currently out to tender on the final area. The SBS has recruited nine Regional Managers from the private who will be based in the Regional Development Agencies from April 2001.

With £30 million funding from the Invest to Save Budget and Budget 2000, the SBS is also currently building up its 'Gateway' - to provide high quality information and advice on-line and via call centres to 3 million businesses, compared with the 600,000 that currently access Business Link support.

The SBS is committed to promoting enterprise across society and particularly among disadvantaged groups, including women who currently originate only 30 per cent of new business start-ups in the UK. In the November 1999 Pre-Budget Report, the Government allocated £30 million to the Phoenix Fund to invest over three years in promoting better access to business support and finance in disadvantaged areas. This funding was more than trebled in the 2000 Spending Review. The SBS manages the Phoenix Fund, the results of which include:

- 500 volunteer business mentors have been appointed, with a further 500 to be in place by April 2001;
- bids for a £3 million fund for new and existing community finance initiatives are now being evaluated the fund has been seven times oversubscribed and a second bidding round will take place by autumn 2001;
- over 200 bids to the £12 million (over three years) Development Fund are now being evaluated. The Fund was set up specifically to promote innovative enterprise support in disadvantaged areas; and
- the Inland Revenue is working with the SBS to identify how the Revenue's Business Support Teams can support new and small businesses in disadvantaged areas. It will have agreed plans in place for April 2001.

Box 3.4: An Urban Renaissance: successful towns and cities

The Government is committed to maximising the potential of all towns and cities to build on success and ensure that thriving places continue to prosper, while helping those places that are currently falling behind. Successful towns and cities have always been at the heart of economic development and the creation of prosperity. The national economy depends on their success.

The forthcoming Urban White Paper will set out, for the first time in 20 years, a comprehensive strategy for improving the performance of all towns and cities, while the National Strategy for Neighbourhood Renewal will set out how the Government intends to narrow the gap between the most disadvantaged communities and the rest.

The Government's strategy is to create attractive places for individuals and business places that create and share prosperity, and that provide good quality services that meet the needs of everyone. It builds on the challenge set to the Government by Lord Rogers' Urban Task Force, to create an environment which people and business find attractive. All towns and cities should:

- **aim to be places where people want to live and businesses choose to locate** through efficient land use, quality design, modern infrastructure and sustainable use of resources;
- **provide employment opportunities and support wealth creation** by building on their economic assets and encouraging enterprise and innovation, promoting private investment and access to capital, providing economic opportunities for all and supporting lifelong learning, and adapting to the challenges of the modern economy; and
- **provide high quality public services** delivering decent homes, substantial reductions in crime, good schools and healthcare and efficient transport, to attract and retain dynamic people and enterprises.

To ensure success, government at all levels needs to work with the people who know their towns and cities best. The White Paper will set out a coherent framework for delivering improved performance through national policies, regional strategies and local community action. For example:

- at the national level, the substantially increased resources provided by the 2000 Spending Review will from April 2001 help to reduce crime, boost employment and improve education, health and housing especially in the most disadvantaged areas (supported by Public Service Agreements see Chapter 5);
- in the regions, an enhanced role for Regional Development Agencies (RDAs) will enable them to use their substantially increased budgets and increased funding flexibility and single cross-Departmental budget from April 2002 to focus their help on underperforming towns and cities;
- at the local level, modernised local authorities will help to develop Community Strategies for their local areas and

promote Local Strategic Partnerships (LSPs); and

- in every community, the forthcoming Action Plan for Neighbourhood Renewal will help to galvanise action.

In order to improve their performance, less successful cities and towns need to build a better understanding of their economic strengths and capitalise on their assets. Many are already doing so and there is a major opportunity to learn from what works both elsewhere in the UK and internationally. One key constraint to exploiting markets in underperforming areas is access to capital. The Bank of England will shortly publish the first in a new series of reports on finance for small businesses in disadvantaged communities. Building on this, the Government will:

- fund the RDAs to work with Local Strategic Partnerships and others on City Growth Strategies, which will map the economic asset base and develop detailed action plans for business growth in a number of key cities over three years; and
- sponsor with the private sector the Inner City 25, which will showcase some of the fastest growing, unquoted companies in the most under-invested inner-city areas.

The Government plans to introduce a package of measures to help regenerate the most disadvantaged communities and relieve pressure on the countryside by encouraging more development on brownfield land. For example:

- at the national level, the package includes a stamp duty exemption for the most disadvantaged communities, accelerated payable tax credit for cleaning up contaminated land, a package of VAT measures to reduce the costs of residential conversions and tax relief for creating new flats from underused space above shops. The Government will be working with the European Commission to introduce these measures consistent with EU state aids guidelines (see Chapter 6);
- at the local level, consulting on business rate relief for small businesses; town improvement zones financed by supplementary business rates; tax increment financing, to allow local authorities to retain and invest some of the additional local tax revenue resulting from successful regeneration; and the reform of planning obligations, including the option of impact fees; and
- at the community level, the Community Investment Tax Credit and Community Development Venture Fund recommended by the Social Investment Taskforce (set out below).

3.63 To take advantage of this increased supply, more SMEs with growth potential need greater understanding of venture capital and specialist advice on how to structure business plans to secure external equity finance, to make themselves 'investment ready'. There is evidence of a gap in this market, akin to the classic 'equity gap'. The Government has therefore asked the SBS, working with the Regional Development Agencies and in consultation with the Small Business Investment Taskforce and market practitioners, to make early progress in identifying measures to bridge this gap, with a view to harnessing the expertise of the private sector as rapidly as possible.

Regional Development Agencies

3.64 Regional Development Agencies (RDAs) are at the heart of the Government's agenda for promoting sustainable regional economic growth, enterprise and regeneration. They provide a key element in the delivery of the Government's strategy for improving UK productivity.

3.65 In the 2000 Spending Review the Government announced that RDAs would have a strengthened role as strategic leaders of economic development, with a key role in promoting innovation and enterprise in their regions. They are to have a substantial increase in resources and a significant increase in flexibility on how to use those resources. The RDAs' overall budgets will rise from £1.2 billion this year to £1.7 billion in 200304. Within this overall sum, RDAs will be subject to the same rules as other government programmes. From April 2002 the separate budgets from DETR, DfEE and DTI will be brought together in a cross-departmental Single Budget.

3.66 The Government welcomes the RDAs' enthusiasm in developing the Single Budget and has decided to take a major step towards this with significantly increased freedom from next year:

- more budgetary flexibility: with this RDAs will be able to target resources more effectively by doubling their flexibility to switch resources between programmes. RDAs may transfer up to 20 per cent out of any programme, with no limit on the amount that may be transferred into any programme, so long as it is consistent with delivery objectives; and
- a new Strategic Programme: RDAs will be able to switch resources into the new Strategic Programme for innovative schemes that meet their economic and other strategic aims. This Strategic Programme will be a test-bed for the Single Budget with new project and appraisal processes.

3.67 As part of this increased flexibility, through consultation RDAs will be asked to provide stretching outcome and output targets to ensure their activities deliver their strategic goals, matching flexibility with greater accountability. These measures give RDAs increased flexibility to spend where they can have the greatest impact in delivering national and regional policies next year, promoting enterprise, innovation and growth. Increased flexibility next year will ensure a smooth transition to the Single Budget the year after.

The Social Investment Taskforce

3.68 The Social Investment Taskforce (SIT), led by leading venture capitalist Ronald Cohen of Apax Partners & Co, reported to the Chancellor in October. Its report, Enterprising Communities: Wealth Beyond Welfare, recommended a five-point programme of action aimed at stimulating enterprise, investment and wealth creation in under-invested communities.

3.69 The report's five main recommendations were:

- a new Community Investment Tax Credit to encourage private investment in both not-for-profit and profit-seeking enterprises in under-invested communities;
- a new Community Development Venture Fund a matched funding partnership between Government on the one hand and the venture capital industry, entrepreneurs, institutional investors and banks on the other;
- disclosure by individual banks of their lending activities to businesses in under-invested communities and the creation of a rating system to reward excellent performance. The SIT believes this should, if possible, be done on a voluntary basis, but if not, then legislation should require disclosure;
- greater latitude and encouragement for charitable trusts and foundations to invest in community development initiatives; and
- support for Community Development Financial Institutions, which provide finance and business support to enterprises just outside the margin of conventional finance; and the appointment of a high ranking "champion" for community development finance, with strong links to government.

3.70 The Government welcomes this innovative report and endorses its central conclusion, that enterprise and wealth creation are vital to building sustainable communities. The Government is already supporting the growth of community development finance for businesses in under-invested areas. In response to the SIT report, the Government will now do more:

- the Government believes that a tax incentive for community investment could prove effective in helping to bring more investment and expertise to the economic renewal of disadvantaged communities. The Government will consult widely on the proposal for a Community Investment Tax Credit, with a view to taking it forward as early as possible;
- the Government will work closely with the venture capital industry and others on setting up the first Community Development Venture Fund;
- the Government attaches great importance to making financial services available to all. To provide greater transparency, the Government will encourage banks to disclose their individual lending activities to businesses in under-invested areas. The Government will look at what obligations should be laid on banks in the context of the overall requirements being asked of them, for example in relation to Universal Banking Services;
- the Government welcomes the Charity Commission's plan to produce early next year new guidance on when charities can make programme related investments, and to issue further subsequent guidance on the role which charities can play in community development finance; and
- the Government believes that the Taskforce has set out very clearly the challenges that lie in front of the community development finance sector in the UK, if it is to achieve its potential. It must be a matter for the sector to respond to those challenges, but the Government will continue to play an active role in support, for example through assistance with training. The Government also recognises that there may be a role for an informal "champion" and will consider how to take this suggestion forward.

Promoting an enterprise culture

3.71 Positive attitudes to enterprise, business and risk-taking are fundamental to an entrepreneurial economy. Often, the UK has been compared unfavourably with some of its rivals on this score[4]. The Government is addressing the need for a more pro-enterprise climate.

3.72 The Government is supporting 'Enterprise Insight', which was launched by the Prime Minister in May 2000. The campaign, led by Chief Executive Oonagh Mary Harpur, aims to create over the next 5 to 10 years a more enterprising culture across the UK, by:

- highlighting the contribution enterprise makes to jobs and wealth creation;
- promoting SMEs as much as big businesses;
- encouraging innovation, change and risk-taking; and
- celebrating successful entrepreneurs and growth companies.

3.73 The campaign will be spearheaded by the Ambassador Programme, where hundreds of entrepreneurs and business people will take part in a range of nationwide enterprise activities, including discussion forums with young people and mentoring young entrepreneurs.

3.74 The Government is helping to foster a spirit of enterprise among young people by providing £10 million this year to boost enterprise activities in schools. This money is being used to:

- improve the quality of the national network that brings schools and businesses together, in readiness for April 2001, when the new local Learning and Skills Councils will be the focal point in the regions for closer school-business liaison;
- increase the scale of enterprise programmes in schools, such as Young Enterprise and Understanding Industry; and
- improve the quality of work experience for pupils and business placements for teachers.

3.75 In Budget 2000, the Government announced the New Entrepreneur Scholarships to provide budding entrepreneurs in disadvantaged areas with the management and business skills they need to turn their business ideas into reality. Three pilot schemes in Manchester, Greenwich and Plymouth have been launched, with more than 30 participants.
The programme will run nationally from September 2001, when 200 places will become available.

Encouraging innovation

3.76 The successful exploitation of new ideas is a crucial component for productivity growth. The UK needs world-class research in universities and the private sector, and the ability to capitalise upon the innovations it produces. But it has not always performed to its full potential in this field. Research and development intensity in the UK, for instance, is lower than in the US, France, Germany or Japan. Since 1997, the Government has reinforced the innovation base and worked to ensure that the economy makes the most of good ideas. Analysis for the pharmaceutical task force has shown that the UK pharmaceutical industry is the most productive in the world, as measured by patents per amount invested.

3.77 To encourage research and development by SMEs, the R&D tax credit has been introduced. This raises the tax relief for qualifying current R&D spending by SMEs from 100 per cent to 150 per cent. The enhanced relief will reduce the cash cost of research and development by 30 per cent where the company pays the small companies rate of corporation tax. Firms not yet in profit can take the relief as a (discounted) cash payment, reducing their costs by 24 per cent.

3.78 The Government will be evaluating the efficacy of the R&D Tax Credit for SMEs once sufficient information on its take-up becomes available. The Government will also be examining the case for complementary measures aimed at boosting R&D across business, drawing on existing analyses and on the research of the CBI, the Engineering Employers Federation, and other interested parties.

3.79 The Small Business Research Initiative (SBRI), announced in the Science White Paper, will encourage more high-tech small firms to start up, or to develop new research capacity. It will open up to SMEs R&D procurement programmes from departments and Research Councils worth up to £1 billion. It has the target of procuring £50 million of research under these programmes from small firms. Each participating department will aim to procure at least 2.5 per cent of their R&D from small firms, with Research Councils moving to meet the target over time.

Making the most of the radio spectrum

3.80 The radio spectrum is an essential raw material for many of the UK's most promising industries of the future. But the amount of spectrum available is finite and ensuring that it is used efficiently is essential if the growth of these industries is not to be impeded.

3.81 The Government has taken steps in recent years to improve the UK's spectrum management regime to provide that spectrum users face the right incentives to use it efficiently. It has introduced administrative pricing and auctions as spectrum management tools.

3.82 The auction of spectrum for third generation mobile services earlier this year demonstrated the importance of spectrum to commercial operators. It also demonstrated that auctions are a very effective way of ensuring that spectrum is assigned to those who value it most.

3.83 The next decade will see significant growth and innovation in wireless communications. The UK has been successful in making spectrum available for new services but it is essential that the framework for spectrum management keeps up with the pace of change if the UK is to remain at the forefront of the information revolution. To help it move forward in this area, the Government will commission an independent review of spectrum management, to report to the Chancellor and to the Secretary of State for Trade and Industry. The review will advise Government on the principles which should govern spectrum management and what more needs to be done to ensure that all users, including non-commercial users, are focused on using their spectrum in the most efficient way possible. In doing so, it will consider the use of spectrum management tools such as spectrum valuation, pricing and trading.

Taking advantage of ICT

3.84 The Government is acting to ensure that the UK takes advantage of the possibilities offered by ICT (see Box 3.1). It is encouraging investment in ICT, access to and use of the internet, and the development of ICT. Initiatives to date include:

- providing tax incentives such as 100 per cent first year capital allowances for small enterprises investing in ICT for three years from April 2000;
- launching UK Online for Business to help UK small businesses exploit the benefits of ICT by raising small business awareness and understanding and providing advice and signposting. An expert call centre advice service will be developed;
- promoting competition in telecoms by supporting Oftel's plans for the the unbundling of the local loop and the successful auction of third generation mobile telephony;
- reforming the legislative framework through the Electronic Communications Act which provides for legal recognition of electronic signatures;
- developing a network of 6,000 UK Online Centres where people will be able to access the internet to include around 1,000 ICT learning centres, of which over 600 have now been funded;
- £1 billion investment in schools' ICT over three years; and
- £1 billion over three years to get government services online.

3.85 The Government has set targets for the UK to be the best place to do e-commerce by 2002, and, by 2005, for everyone who wants it to have internet access and all government services to be online. It has already beaten its target to have 1.5 million SMEs online by
2002 1.7 million are already online.

3.86 But getting business online is only the first challenge. Ensuring e-commerce brings real business benefits is the next step. A recent DTI study found that businesses representing 27 per cent of UK employment are trading online, putting the UK on a par with the US and Canada and ahead of Germany and Sweden. The Government is aiming to increase from 450,000 to 1 million the number of SMEs trading online by 2002.

3.87 The DTI study concluded that the last year had seen good progress by small and micro businesses but that more is required in some respects before they can be considered up with the best in the world. For example, the UK is fifth on the measure of micro businesses trading online with 14 per cent, compared with Germany the best performer at 21 per cent.

Making the most of UK universities

3.88 UK universities are a vital economic resource, nationally and regionally. If they are to play a full part in improving the UK's economic performance the universities need the resources to sustain a world-class science base and the incentives and framework to encourage greater interaction with business. Since 1997, the Government has introduced a number of initiatives to improve universities' contribution to closing the productivity gap.

3.89 The Higher Education Innovation Fund, announced in the Science and Innovation White Paper, is designed to build on universities' potential as drivers of growth in the knowledge economy. Worth £140 million over three years, it seeks to encourage knowledge transfer and help universities in their efforts to promote productivity and competitiveness in small firms. It incorporates the existing Higher Education Reach Out to Business and the Community (HEROBC) fund, tripling existing funding by the third year. The last round of HEROBC funding, in August, allocated £22 million to 50 bids from universities and colleges.

3.90 The University Challenge Fund enables commercial initiatives to be developed from university research to a point where they can raise venture capital. So far, 37 institutions have been involved and 80 projects have received investment from the fund. The first round of funding totalled £45 million, and there will be a second round of funding worth £15 million.

3.91 The Science Enterprise Challenge provides funding to teach science, engineering and technology graduates entrepreneurial skills. In addition to the £29 million already allocated, the 2000 Spending Review added £15 million to its funding. 40,000 students will benefit from the scheme by 2004.

3.92 The Joint Infrastructure Fund, announced in the 1998 Comprehensive Spending Review, allocated £750 million to start reversing years of underinvestment in the science infrastructure. The Wellcome Trust provided £300 million of this money.

3.93 The Science Research Investment Fund, announced in July, continues this partnership with the Trust and will invest a further £1 billion in 200203 and 200304. The Wellcome Trust will contribute £225 million.

3.94 The potential of public sector research establishments, which have produced innovations such as the liquid crystal display, has often not been fully exploited. A report commissioned from John Baker recommended a range of measures. In response the Government has established a £10 million fund for commercialisation of public sector research. It has made changes to civil service rules to give government scientists better incentives and rewards, and Partnerships UK will be advising research establishments on the exploitation of their research.

Box 3.5 Universities and productivity - a key challenge

Universities contribute to productivity in two key ways:

- **generating skills** through their output of trained graduates and postgraduates; and
- **generating knowledge to underpin innovation** through their research and in their direct engagement with business.

On both counts UK universities have been highly successful. The annual output of graduates has doubled in the last two decades, yet economic returns to higher education both for graduates themselves and the wider economy have stayed high. UK research punches above its weight: with 4.6 per cent of world science spending, the UK accounts for 8 per cent of science publications and 9 per cent of citations. Of 152 fields of research, the UK is a world leader in 26. Finally, the contribution to business growth and creation is growing at regional and national level, with universities active in commercial spin-outs, business incubation and other forms of knowledge transfer. The regional role of universities is increasingly clear especially as collaborators with business and as centres of growing clusters of high-tech firms.

Productivity in the knowledge economy will increasingly depend on the ability to innovate and deploy skills, so the underpinning role of universities will remain vital. But to fulfil this role, universities will need to respond to major technological and market change in particular:

- the increasingly global market for top academic talent; and
- the growth of web-based learning and research, which offers new delivery channels and new market opportunities but also threats for universities.

With a view to these challenges, the Government has since 1997 made significant real terms increases in university funding. It has started to reverse a huge backlog of capital investment in university research and, through schemes like University Challenge and Science Enterprise Challenge has given universities new incentives to engage with business, commercialise their research and become more entrepreneurial. The Government aims to achieve 50 per cent participation of those aged 18-30 in higher education by 2010.

In the coming years, the challenges for the Government will include:

- **getting the funding right**: ensuring that universities have the resources they need, and from the right sources with taxpayers, graduates and students paying their fair shares;
- **getting the incentives right**: ensuring that government funding mechanisms promote excellence and innovation, without stifling diversity;
- **promoting world class institutions** nurturing the UK's best universities, while ensuring that the sector as a whole thrives; and
- delivering on the commitment to widen access to higher education.

But the challenge is not just for the Government:

- **universities will have to become more dynamic and business-like to compete**. In an international market they will need to understand and exploit their comparative advantage; and
- businesses will need to do more to **exploit the wealth of skills and knowledge** in universities.

INVESTMENT

Investment in the UK

3.95 The UK has, historically, suffered from problems of under-investment. The greater economic stability now being achieved will promote investment. Low and stable inflation and sound public finances provide individuals and businesses in the UK with the confidence to invest, and attract internationally mobile capital flows in greater volumes and at lower cost. UK long-term interest rates, and hence the cost of capital, have fallen. Business investment, as a proportion of GDP, reached record levels in 1999 which are being maintained this year.

Encouraging investment

3.96 To encourage investment, the Government has reformed the tax system by:

- cutting corporation tax rates to 30, 20 and 10 per cent, their lowest ever levels. The 10 per cent rate, in particular, allows small and growing companies to retain more of their profits for re-investment and growth;
- introducing a capital gains tax taper, reducing the effective tax rate on business assets to 10 per cent after four years; and 40 per cent first year capital allowances for SMEs, made permanent in Budget 2000; and
- expanding the scope of the consultation on the taxation of disposals of substantial shareholdings to consider the issues surrounding a deferral relief regime in more detail and, as part of a wider discussion on competitiveness, whether alternative approaches, including the possibility of a form of exemption regime, might be appropriate. The Inland Revenue is publishing a further Technical Note alongside the Pre-Budget Report.

3.97 A stable macroeconomic climate and the right tax framework are vital. 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 making sure that capital markets are able to work efficiently in allocating investment across the economy.

The Myners review

3.98 In Budget 2000, the Government asked Paul Myners to conduct a review of UK institutional investment. As part of his ongoing review, he has written a letter to the Chancellor and the Secretary of State for Social Security outlining two proposals. These are summarised in Box 3.6.

Business angels and financial promotion

3.99 Individual investors in smaller growing companies ("business angels") provide a key link in the financing chain, helping enterprises to become 'investment ready' for subsequent venture capital funding. Business angels can also bring additional finance and industry expertise to venture capital funds.

3.100 To reduce the time and cost involved for both SMEs and venture funds in raising capital from private investors, the new Financial Services and Markets Act will exempt communications to a defined class of high net worth or sophisticated individual investors from the normal financial promotion rules. The draft Financial Promotion Order, which should come into effect by July 2001, proposes to define high net worth investors as those with annual income above £100,000 or net financial assets above £250,000.

Box 3.6: The Myners review of institutional investment

In Budget 2000, the Government asked Paul Myners, of Gartmore Investment Management, to lead a review of institutional investment in the UK. The Myners Review issued a consultation document in May 2000 covering a range of issues related to life assurance and pension funds, which has received more than 200 responses from a wide range of bodies. The review team have held further discussions with many industry participants, and will report in time for Budget 2001.

Mr Myners has today written an an open letter to the Chancellor and the Secretary of State for Social Security, available on the Treasury website (www.hm-treasury.gov.uk). This sets out two proposals, the first on the Minimum Funding Requirement (MFR) and the second on the regulation of investment in limited partnerships.

The Minimum Funding Requirement

The letter responds to the joint DSS/HM Treasury consultation now under way on the MFR. In considering the issue, Mr Myners has had in mind twin objectives:

- to ensure proper protection for members of defined benefit pension schemes; and
- to examine and seek to ameliorate distortions in investment decision-making.

The letter argues that the MFR is seriously inadequate and should be replaced, because:

- it increases the cost of providing defined benefit pensions by distorting asset allocation. This is due to its use of a set of reference assets to calculate discount rates for liabilities; and
- it does not provide necessary or effective protection. It only records the state of a fund at one point in time, despite the fact that financial markets and economic conditions change constantly, and it is not designed to protect against fraud.

The interim conclusions of the Review also suggest that the MFR encourages the move from defined benefit to defined contribution pensions, and, due to its use of standard and fixed assumptions for calculating assets and liabilities, may give trustees a spurious sense of certainty about funding.

The letter argues that the MFR should be replaced by an enhanced compensation scheme for fraud, mandatory arrangements for safe custody of pension fund assets, and transparency and independent review of pension funds' finances and plans. Each defined benefit fund would produce a 'transparency statement'. This would set out how it planned to invest its assets to enable it to meet its obligations to pay pensions.

This statement would be made publicly available, so that members of pension schemes were able to see for themselves the state of the fund and its future plans. Trades unions, pensioner support groups, the personal finance media and the creditors and shareholders of the sponsor company would also have an interest in the plans and would be able to comment. Members of the pension scheme would be able to raise any concerns with trustees, and if sufficient numbers of beneficiaries voted in favour, the fund would have to commission an independent report on its plans. The Occupational Pensions Regulatory Authority (Opra) would be expected to take an interest in funds where an independent report was produced and would if necessary be able to use powers to disqualify trustees. Members of smaller funds, where routine scrutiny might be less wide, would have an additional safeguard that trustees would have to obtain a statement certifying their investment assumptions as reasonable.

The proposed solution aims to improve institutional decision-making by making it more skilled, transparent, well-informed and better debated, with greater engagement by trustees, in line with the wider principles of the Review.

The letter argues that this approach will provide more effective protection for members of defined benefit schemes without creating major additional regulatory burdens or costs. At the same time, it will help the major capital flows controlled by defined benefit pension funds to be allocated in as rational and well-informed a way as possible. It is preferable to alternatives such as an insurance-based scheme (which would create additional costs, and might be distortionary), using a prudential regulator (which would place too great a reliance on the judgement of those regulating), or a central discontinuance fund (which raises similar issues to insurance).

Private equity and financial services legislation

The Review also argues for reform of the law regarding investment in limited partnerships whose purpose is to undertake investments in private equity. It believes that pension funds are discouraged from investing in such limited partnerships by the prohibition on unauthorised persons carrying on investment business. The letter to the Chancellor and the Secretary of State for Social Security sets out a solution to this problem.

Government response

The Government welcomes the proposals of the Myners Review on the MFR as an important contribution to the consultation process which continues until January 2001. The Government also welcomes the proposal on private equity investment and intends to incorporate changes in secondary legislation under the Financial Services and Markets Act, subject to the consultation on draft legislation already underway.

SKILLS

3.101 Since labour (alongside capital) is one of the key inputs to production, the quantity and quality of skills are crucial to raising productivity. Yet skill levels in the UK are lower than in many of our main competitors. For example, a lower proportion of people in the UK have intermediate skills than in France or Germany. When international adult literacy was last surveyed between 1995 and 1997, the UK came tenth out of twelve countries, lagging behind the US, Canada and Germany. One in five of the UK adult population continues to suffer from very low skills in literacy and numeracy.

3.102 In November 1997, the Secretary of State for Education and Employment announced his intention to establish a National Skills Task Force. The Task Force reported earlier this year, and identified three core components to a National Skills Agenda:

- an action plan for changes in post-16 education and training to produce the required improvements in the skills 'supply side';
- an approach to the continuing management of post-16 education and training that shapes both the demand for, and the supply of, skills over time so minimising skills shortages and gaps in the future; and
- targets for improvements in skill levels, plus measures of performance in managing the match between supply and demand, to raise public confidence, drive progress and monitor success.

3.103 The Government is considering its full response to these findings. It has already endorsed this conception of the National Skills Agenda, and outlined its strategy for addressing this agenda. The key elements of this are:

- strengthening the links between what people learn and the jobs they will have in the future;
- creating excellence in vocational learning for all to reach their potential;
- reaching out with basic skills training and beyond to adults who the system failed first time and building a flexible system of lifelong learning for all; and,
- working with employers to give everyone the chance to boost skills and productivity.

3.104 The level of basic skills and the ability of and opportunity for members of the workforce to adapt to changing technology and working practices are all important. The Government has pledged to reduce the number of adults with literacy or numeracy problems by 750,000 by 2004. Significant extra resources were allocated in the 2000 Spending Review towards this aim, increasing spending from around £240 million in 200001 to over £400 million in 200304.

3.105 Ensuring that Britain's young people enter the workforce with a high level of skills is essential to raising Britain's long-term productivity performance. This means starting from an early age to increase levels of educational attainment and encourage young people to realise their full potential. Chapter 5 explains how education is an important influence on children's life chances. The Government is working to reverse the record of under-investment and under-achievement in Britain's schools, and provide all children with the skills they need to succeed in the modern economy. It has:

- established the Sure Start programme to ensure that all children start school ready to learn (see Chapter 5);
- developed strategies for teaching literacy and numeracy in primary schools; and will set demanding targets for literacy, numeracy, science and ICT at age 14;
- invested in connecting schools to the internet. The Government is well on course to ensuring that all schools are connected to the internet by 2002: 98 per cent of secondary schools and 86 per cent of primary schools in England are now connected. By 2004, there will be one computer for every five pupils in secondary schools;
- begun to modernise the comprehensive school system through the introduction of specialist schools. Independent studies have shown that specialist schools show significant attainment gains, and almost one third of secondary schools will have specialist status by 2004; and
- provided for AS-level options at 16, enabling students to study a broader range of subjects for longer.

Raising the UK skills base

3.106 In addition to raising standards in primary and secondary education and ensuring that young people leave school with a foundation of essential skills, the Government intends that by the end of the decade 50 per cent of the UK's young people will have the opportunity to benefit from higher education by the time they are 30. There they can gain the professional, technical and managerial skills on which a strong and successful economy relies. The 2000 Spending Review provides funding for more places in higher education, including:

- a reversal in the decline of funding per student, with real funding per student set to increase in 2001-02 for the first time in 15 years;
- initiatives to widen access, with additional resources for institutions that have students from disadvantaged areas; and
- two year foundation degree courses, designed to provide focused and vocational higher education for a broad range of students.

Investing in lifelong learning

3.107 The dynamic and ever changing nature of the modern economy means that lifelong learning must be at the forefront of education policy both providing opportunities for adults who have missed the chance to develop basic skills earlier in life, and providing the opportunity and encouragement to individuals and firms to adapt existing skills and gain new ones. This has the potential to produce dramatic benefits for both the individual in terms of greater flexibility and adaptability and the opportunity for higher earnings, and for employers and the wider economy in terms of higher levels of productivity.

3.108 This autumn, learndirect (the brand name for the UfI) is rolling out its ICT-based learning portal and services nationally, opening up a new avenue through which adults can add to basic skills or build on higher skills. This is enabling training to reach further to groups of people unable to take advantage of more formal training opportunities. Users can learn at home, in the workplace or in one of over 700 learndirect centres which are now up and running across the country. A total of 38,000 users have so far registered on an average of two courses each. Early signs are that as many as 40 per cent of learndirect users have not engaged in learning in the past three years.

3.109 In addition, over 600 new ICT learning centres were announced in September 2000, with more to follow in the spring and autumn of 2001. These centres, located across the country, will enable people with low or no skills to acquire basic ICT skills. As well as significantly improving employment prospects, this will open the way to the acquisition of other skills, often through progression to the UfI. Through the inclusion also of ICT access points in libraries, there will be 6,000 UK online centres by 2004.

3.110 As part of its goal to create a highly skilled and adaptable workforce, the Government has also launched a national system of Individual Learning Accounts (ILAs). In England ILAs are available to all people aged 19 or over, but are being particularly targetted at those between 19 and 30, those returning to work, the self-employed, and non-teaching school staff. Learners can benefit from a package of incentives including £150 for the first million account holders to book eligible learning, provided they contribute £25. With almost 400,000 accounts opened so far, the Government is well on course to meet its target of 1 million account holders by March 2002.

3.111 To examine some of the key ongoing issues related to workforce training (see Box 3.7), the Performance and Innovation Unit in the Cabinet Office, working with stakeholders inside and outside government, will shortly start a project to identify the extent, nature and causes of under-investment in workforce development. In the light of this analysis, it will make proposals for solutions.

Improving management skills

3.112 High quality management and leadership skills are an important element of raising the productivity of the UK economy. The Skills Task Force found evidence of both skills shortages and skills deficiencies in UK management and leadership. To examine how management and leadership can be improved, the Government has established the Council for Excellence in Management and Leadership under the chairmanship of Sir Anthony Cleaver. The Council is due to report its interim findings in April 2001. The Government will consider the Council's conclusions and recommendations.

Tackling skills shortages

3.113 The Government is committed to ensuring that the UK competes for the best skilled workers in the world market. The arrangements for work permits have therefore been reviewed and the commitments made in Budget 2000 are being delivered.

3.114 The 'innovators' scheme was launched in September to attract budding entrepreneurs (especially those who plan to set up high-tech companies) to the UK. A range of IT jobs have been included in the shortage category list to make it easier for employers to obtain work permits for such workers.

Box 3.7: Adult basic skills and workplace training

A skilled workforce is essential to increasing the UK's productivity performance.

At present, however, the UK has significant comparative weaknesses in basic and vocational skills for adults. For instance:

- Sir Claus Moser's 1999 report on basic skills estimated that 20 per cent of the adult population had reading and writing skills below that of an 11 year old and considerably more might have similarly low numeracy; and
- the Skills Task Force found that the UK has just one third of the proportion of 25-28 year olds with level 3 vocational qualifications as Germany.

Addressing these weaknesses is crucial in a knowledge economy with a declining proportion of jobs for genuinely unskilled labour. A more skilled workforce will allow the advantages of new technologies to be exploited more effectively and will improve the introduction of new working practices. It will ensure that firms have flexibility to innovate and develop new products and services. A firm basis in numeracy and literacy is crucial to developing further skills.

Adult basic skills

The UK's weakness in adult basic skills is largely the legacy of social exclusion and historic failings in the education system. The Government's challenges are:

- to motivate those lacking basic skills to take the training opportunities available and to make an impact on their skills. Those with the lowest levels of skills can be difficult to engage, and the qualification rate needs to improve;
- to mobilise employers, in particular challenging the view that basic skills problems are solely the Government's responsibility. This is important in encouraging workplace training more generally; and
- to mobilise the public sector fully, as employers and as gateways to learning.

To start to meet these challenges, the Government is substantially increasing funding for adult basic skills. It has set a target, supported by over £240 million this year, rising to over £400 million in 2003-04, to reduce the number of adults without basic skills by 750,000 by 2004.

Workplace training

While figures suggest that the amount of workplace training undertaken in the UK has increased by 50 per cent since 1986, it is likely that both employers and employees under-invest in some areas of workforce development. For example employees with lower qualifications tend to receive far less training from employers than those with higher level skills. There are several reasons for this, which need to be overcome, including:

- both the actual cost of training and the opportunity cost of training time. This is especially important for small firms which also have less access to finance than their larger competitors. The Skills Task Force found that only 36 per cent of firms with fewer than 25 employees carry out some form of off-the-job training;
- firms' fears that trained employees will leave, thus depriving the firm of the benefits from the training in which they invested; and
- a lack of information for employers and employees of the returns from workforce development. Recent work by the Institute of Fiscal Studies[1] concludes that, in fact, there are considerable returns for both the employer and the employee from training. It estimates that increasing the number of workers trained by 5 percentage points would provide a 4 per cent increase in productivity and a 1.5 per cent increase in wages.

[1]'Who Gains When Workers Train?', Institute for Fiscal Studies, 2000.

3.115 It is now far easier for those overseas students whose skills are needed to obtain permission to work on graduation. The Overseas Labour Service has revised the definition of skilled workers to include all those with degrees allowing employers to obtain work permits for graduate recruits. The Home Office has recently changed its procedures so that prospective university students will not be denied student visas on the basis that they wish to switch into work permit employment on completion of their studies and applications from students to switch their immigration category will be normally be approved. The Government will be publicising these new measures widely to universities and employers.

3.116 Burdens on business have been reduced, with work permits now running for up to five years rather than four, and extensions and changes of employment are no longer subject to a labour market test.

3.117 Processing times for work permits have already gone down significantly and by April 2001, the Overseas Labour Service aims to process 80 per cent of completed applications within a week. Employers will soon benefit from electronic application forms which will be introduced in December 2000 and the Government is already piloting a scheme to allow employers to issue their own work permits.

3.118 At the turn of the year, the Government will launch a pilot scheme to attract people of outstanding ability from around the world. The scheme, which will seek applicants initially for up to six months, will allow particularly skilled individuals to enter the UK to seek work in their field of specialism. In order to gain entry, applicants will need to satisfy three of the following four criteria:

- a PhD or equivalent qualification;

- five years graduate level experience (three years if a PhD is held), of which two years should be at a senior level position;
- a salary of at least £40,000 in the last year (or the equivalent in their country of origin);
- evidence of significant achievement in their field of specialism.

Within a year of entry, each applicant will need to show evidence of employment at a level warranted by their skills base

PUBLIC SECTOR PRODUCTIVITY

The role of the public sector

3.119 The Government is working to provide the best framework and the right incentives for businesses to close the productivity gap with our international competitors. But it is also changing the way it works itself, ensuring similar disciplines are in place so that the public sector works to improve its own productivity[5].

3.120 The Government is seeking to bring this about in three complementary ways: by defining clearly the key outcome targets for each department and who is accountable for their delivery; by improving performance management based on clear strategies for delivery; and through a major investment for change programme supported by the right incentive structures and increasing managers' flexibility to innovate.

3.121 The Public Service Agreements (PSAs), first published after the 1998 Comprehensive Spending Review, and updated and improved as part of the 2000 Spending Review, are the single most ambitious attempt internationally to set targets for policy outcomes and service improvements that the Government is committed to. The new set, published in July, have been slimmed down to bring out more clearly the single-sentence aim, high-level objectives, and concrete targets that each main department and cross-departmental programme is working to. The 160 targets that result are an understandable, precise and accountable statement of the Government's priorities. Clear commitments have been made on key issues of concern. For example the Government will:

- reduce preventable deaths from cancer and heart disease;
- increase pupil attainment at GCSE level, especially in the most disadvantaged localities; and
- cut domestic burglary, especially focusing on the areas with the worst rates.

3.122 Many of these improvements can only be achieved by co-ordinated action by several parts of government. A feature of the 2000 Spending Review was the 15 cross-departmental reviews. As a result around 30 of the PSA targets are held jointly by more than one government department and they are jointly accountable for their delivery.

3.123 Setting clear priorities is only the first step towards delivery of improved services. The new Service Delivery Agreements (SDAs), published earlier this month, make clear the programmes and actions that departments will be working on in order to deliver the high level targets including the specific contributions departments are making to deliver joint targets. The SDAs also provide a guide to management priorities and value-for-money reforms in government departments. Parliament and the public will be kept informed regularly and in detail about performance against the targets, in departmental Annual Reports. The next reports are due in spring 2001. In addition the Government is preparing to provide more regular progress reports on PSA target delivery on the internet. The detailed public reporting provides a strong incentive to deliver the commitments contained in the PSAs, and the Cabinet Committee on Public Services and Public Expenditure (PSX), supported by the Treasury, rigorously monitors departmental performance, assessing progress against agreed milestones.

3.124 PSAs underpin the approach to clarifying accountabilities throughout public sector organisations. Being clear about expectations and putting the emphasis on results rather than procedures gives a sound foundation on which to build effective systems of public sector performance management. By targeting appreciable improvements in key services that the public value, the real enthusiasm of individuals within public sector organisations to serve the public can be tapped and engaged. In this way each individual can accept realistic but challenging objectives and be held accountable for them.

3.125 The Public Services Productivity Panel, a team of top private and public sector change management experts including chief executives and trade unionists, is a central part of the Government's strategy to improve public sector performance. One its first outputs was a new framework for performance management which has been adopted as the new business planning structure for the whole of central government as part of the Civil Service Reform programme. All departments are now required to establish independent quality assurance for their planning systems on a three year cycle.

Public investment

3.126 The Government is committed to significantly improving the public sector's capital stock as an integral part of improvements to public services. The 2000 Spending Review allocated £43 billion of additional funding to deliver significant improvements in key public services an investment for change underpinned by clear targets and a process of modernisation and reform. As part of this, net public investment is set to double to £18 billion a year by 200304. High quality capital investment in public services will make a valuable contribution to raising their productivity.

Chart 3.3

3.127 To ensure best use of this significant increase in investment, the Government has introduced a series of incentives to increase the productivity of the existing public sector asset base and new investment. The National Asset Register brings accountability to existing asset holdings. The Government has introduced resource accounting and budgeting, which ensures financial planning takes account of the annual cost of holding public assets, not just the purchase price. Departmental Investment Strategies, to be published shortly, set out how departments will deliver value for money in their investments. In addition, departments are allowed to recycle receipts from the sale of redundant assets to fund assets that are needed. As part of the Government's commitment to improve productivity in new capital investment, the Capital Modernisation Fund is a source of finance for innovative capital projects that look at new ways to enhance public service delivery such as delivering services on-line.

3.128 The public sector has not always been quick to innovate in the past, with the consequence that productivity is held back as systems fail to adapt sufficiently to changed circumstances. With clear accountabilities for outcomes and results, there is a case for reviewing inhibiting rules on systems and procedures. Under Modernising Government, steps are being taken to encourage innovation by increasing managers' flexibility to act. These include a requirement for all initiatives to undergo a regulatory impact assessment to minimise the level of bureaucracy experienced in implementation, greater 'bottom up' input into policy making through a regional co-ordination unit, over £230 million allocated for the first three rounds of the Invest to Save Budget allowing local managers to identify new ways of improving productivity, and a pilot of local PSAs (see Chapter 5) enabling central and local government to agree new freedoms and flexibilities to achieve new stretching targets in specific areas.

3.129 Accountabilities will be effective only if tangible consequences are associated with success and with under-achievement. Opportunities to innovate will only be taken up if there is a genuine entrepreneurial culture, where rewards are not reserved for those who play safe. Setting the right incentives is therefore the third interlocking piece of the Government's strategy.

3.130 The Government is committed to modernising public sector pay to ensure that it provides appropriate incentives for the delivery of PSAs, including a much greater use of performance-related pay. The four large national networks (the DSS, Inland Revenue, Customs and Excise and Employment Service), are preparing for the introduction of team-based performance awards directly linked to the delivery of PSA targets, a major recommendation of the Public Sector Productivity Panel in its report Incentives for Change. All other departments will review by April 2002 their current pay systems to determine how best to ensure that in future they underpin more effective service delivery and greater productivity.

3.131 The Public Sector Productivity Panel has, in its first year, recommended a wide range of ways to help deliver better services including improved team-based performance incentives, a new approach to the comparative measurement of police efficiency, ways to achieve greater customer focus in the delivery of services and a number of practical steps to improve NHS services. The Panel's joint report, Public Services Productivity: Meeting the Challenge, published in August 2000 stressed that a good performance management system embedded in the culture of an organisation is essential to deliver consistent top class performance.

3.132 The Panel has recently been expanded, and is currently developing its programme for the coming year. The Panel intends to focus its work on helping secure better ownership for the delivery of services through improved accountabilities, incentives and motivation of staff. As before, the Panel will be working on the ground to help the public sector deliver real change to improve the productivity and performance of public services for all users.

Partnerships UK

3.133 Public-Private Partnerships (PPPs) are a cornerstone of the Government's policy to modernise and improve the quality of public services. But PPPs bring with them new challenges which require specialist skills and expertise.

3.134 Partnerships UK has been established as successor to the Treasury taskforce. By combining private sector skills and disciplines with a strong public sector mission it will help the public sector to get the best deal from Private Finance (PFI) and PPP transactions.

Reforming government procurement

3.135 The Government is a major purchaser of goods and services. Making sure that it is a good purchaser not only improves value for money, but also encourages best practice amongst its suppliers.

3.136 To this end, the Government established the Office of Government Commerce (OGC), bringing together procurement from across Government. Following recommendations from a review of public procurement, the OGC is on track to save £1 billion across departments within three years through modernisation, skilling, e-tendering and strategic partnerships. All government procurement will be sent and received electronically by 2002.

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[1] The Government has published alongside this Pre-Budget Report a separate paper setting out its strategy for raising UK productivity: *Productivity in the UK: the Evidence and the Government's Approach*, HM Treasury, November 2000.

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[2]Comparative data on national productivity performance are collated by the Organisation for Economic Cooperation and Development, and adjusted by the Department of Trade and Industry to take account of the latest figures for the UK and US. Due to the introduction of the System of National Accounts there have been revisions to the GDP estimates for several countries, hence the data used in this Report are updates of those incorporated in Budget 2000.

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[3]For the US see 'Aggregate Productivity Growth: Lessons from Microeconomic Evidence', L Foster, J Haltiwanger and CJ Krizan , NBER Working Paper 6803, 1998; and for the UK 'Productivity in the 1990s: Evidence from British Plants', J Haskel and M Barnes, Department of Economics, Queen Mary, University of London, Draft Working Paper, 2000 available at http://www.qmw.ac.uk/~ugte153.

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[4]For instance *Executive Report*, Global Entrepreneurship Monitor, 1999.

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[5]The Government will be publishing a separate paper in due course on public sector productivity, to complement the week's paper on productivity in the wider economy published alongside the Pre-Budget Report.

4

Increasing employment opportunity for all

The Government's aim is employment opportunity for all the modern definition of full employment. The Government is working to ensure that there are job opportunities for all working age people, throughout their working lives. Increasing participation in the labour market will help to both raise the economy's long-term growth potential and reduce the poverty and social exclusion of which worklessness is often a key cause.

Achieving the Government's aim requires both an effective macroeconomic policy to deliver an environment of stability, and microeconomic reforms to improve the functioning of the labour market helping people to compete effectively for jobs, increasing work incentives and addressing the specific labour market problems of particular groups of people or local areas.

The key challenges which the Government is addressing in its efforts to increase employment opportunity for all are:

- **helping people to move off welfare and into work.** This involves not just helping those people who are currently unemployed to move back into jobs, but helping those who are currently inactive back into the labour market and reducing concentrations of worklessness in deprived areas;
- **ensuring that work pays.** The success of policies to reattach people to the labour market and help them into work relies on creating the right incentives. A modern tax and benefit system needs to make work pay more than benefits and ensure that once in work people are encouraged to stay there and progress;
- **easing the return to work and enabling people to work their way up once in work.** The short-term transition back into work can be a difficult time for many people. Government policy therefore needs to recognise that the prospect of making that transition can itself deter people from taking a job, and ensure that short-term support and advice is available to give them the confidence to take that step. The Government also wants to provide everyone with the opportunity to secure progression in work by having access to the education and training which they need to enhance their skills; and
- **building a new culture of lifelong learning:** In order to gain the vocational skills businesses require for higher paid work, many people first need to upgrade their basic skills. The new Learning and Skills Council will work in partnership with employers, Regional Development Agencies and the Small Business Service to deliver the right skills so people progress in work.

INTRODUCTION

4.1 The Government's aim is employment opportunity for all the modern definition of full employment. Macroeconomic stability is a prerequisite to achieving this aim, but is not enough to secure job opportunities for all. It needs to be backed up at the microeconomic level to ensure that individuals throughout the country are able to compete effectively for jobs, that there is a secure transition from welfare into work, that employment is financially rewarding and that people are able to secure progression in work. The Government has introduced radical reforms of the tax and benefit system backed up by active labour market policies to achieve these aims.

Achieving high and stable levels of employment across Britain

4.2 The past few years have seen a substantial improvement in Britain's labour market. Over 1 million more people are in work today than in spring 1997, and more people nearly 28 million are in work now than ever before. The employment rate, currently 74.7 per cent, has returned to levels typical of the 1960s and 1970s and substantially above those seen during most of the 1980s and 1990s.

Chart 4.1

4.3 Alongside record levels of employment, unemployment has fallen sharply. At 5.3 per cent, ILO unemployment is currently at its lowest rate since the 1970s. The claimant count measure currently stands at 1.04 million, down by nearly 630,000 since spring 1997 and the lowest rate since October 1975. The stock of unfilled vacancies at Jobcentres is at record levels: the ratio of jobseekers to vacancies currently stands at just under 3 claimant unemployed people to each Jobcentre vacancy, compared to around 10 jobseekers to each vacancy a decade ago.

4.4 Much of this improvement in the aggregate labour market has come about because of improved macroeconomic stability. Chapter 2 sets out the measures which the Government has taken to deliver economic stability with steady growth and low inflation. The sharp falls in employment experienced in the early 1980s, and again in the early 1990s, were the consequence of the cycle of boom and bust that has characterised the UK economy in the past. Each downturn left more people detached from the labour market, often giving up on finding a job and becoming economically inactive, sometimes permanently.

4.5 Beneath the aggregate picture, where the headline employment and unemployment rates have returned to levels last seen in the 1970s, there is a more complex picture. For some people and groups in society, employment opportunities have expanded significantly over the past 20 years. The employment rate of women has increased from about 60 per cent in 1980 to nearly 70 per cent today, with just over 55 per cent of mothers with children under the age of five in employment today.

4.6 However, for others, employment opportunities were sharply constrained during the 1980s and early 1990s, with increasing worklessness among the over 50s, lone parents and people with disabilities. These changing opportunities led to a polarisation of employment opportunity. For example, in 1996 the proportion of working age households with no-one in work was 14.1 per cent compared to 4.3 per cent in 1975 when the employment rate was broadly similar a threefold increase, while the proportion of households where all adults were working rose from 56.7 per cent in 1975 to 61.9 per cent in 1996.

4.7 This pattern of polarisation between the 'work-rich' and the 'work-poor' was also repeated geographically with increased employment opportunities in some areas, but sharply reduced opportunities in others.

4.8 The recession of the early 1980s opened up a large difference between the regions of Britain. While the recovery of the late 1980s saw unemployment fall these gaps between regions persisted. Following the recession of the early 1990s the subsequent recovery has seen falling unemployment and rising levels of vacancies in every region of Britain, creating a more balanced and sustainable recovery. Within all regions, however, there remain pockets of high unemployment and inactivity, where employment opportunities are denied to a large proportion of the local population. In addition many of the large cities as well as other areas experience extremes of severe disadvantage and relative affluence. For example:

- in Leicester, one ward in the south of the city has only 5 per cent of children living in households that are dependent on means-tested benefits, whereas in a nearby ward also in the south of the city, 79 per cent of children live in households dependent on means-tested benefits; and
- in Sheffield, there are four wards that are among the 100 most deprived wards in England, whereas in a different part of the same city there are two wards which are among the 10 per cent least deprived.

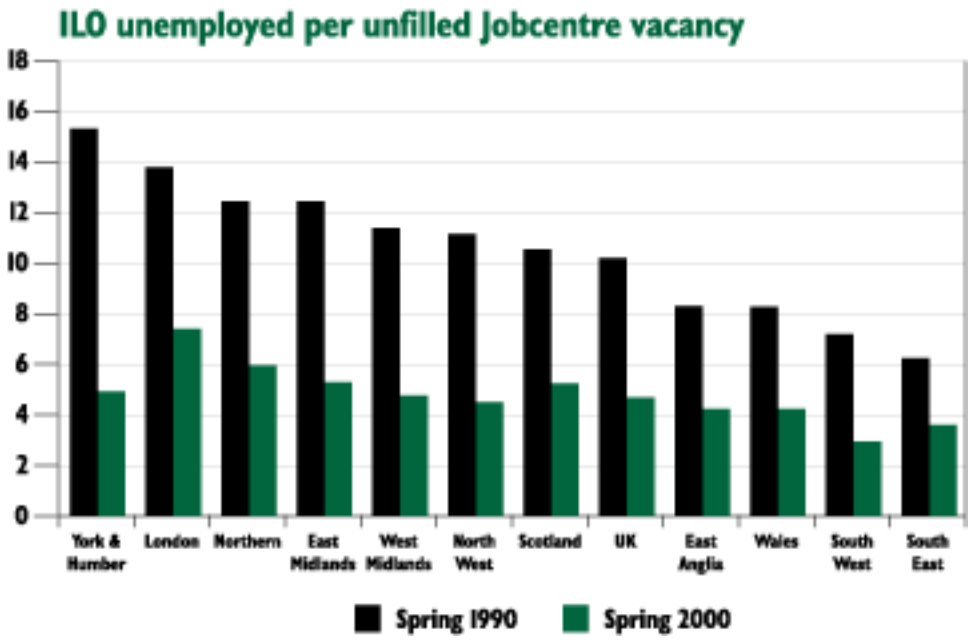
4.9 While the stable macroeconomic environment is delivering the levels of employment and unemployment of 20 years ago, these are still accompanied by far higher levels of poverty and deprivation than 20 years ago because those who are workless today are far less likely to share a household with people in employment, or to live in a neighbourhood where employment rates are high. Some of these concentrations of worklessness are being tackled the number of children in workless households has fallen by 250,000 since 1997 but significant problems remain.

4.10 These problems cannot be tackled through delivering economic stability alone. Vacancies are close to record levels in all regions. Unless those in disadvantaged groups or areas are able to take up these vacancies, policies to create further labour demand will not tackle these concentrations of worklessness. Instead, jobs will go to those already in work-rich households or areas, reinforcing polarisation within the labour market. So macroeconomic policies need to be complemented by microeconomic policies targeted on workless individuals and disadvantaged areas, to tackle the barriers preventing them from securing the vacancies which are continually being created in a healthy macroeconomic climate.

Box 4.1: Regional labour market patterns

Data on vacancies are an indication of the strength of labour demand. Vacancies are currently close to record levels. Across the country, there are around 360,000 vacancies currently registered at Jobcentres, with perhaps two others in the wider economy for every Jobcentre vacancy. Every month, more than 220,000 new vacancies are notified, so that over the last year, more than $2^1/_2$ million vacancies have been notified to Jobcentres alone.

The tightness of the labour market can be considered by looking at the ratio of unemployment to vacancies (the 'u/v ratio'). In a tight labour market, unemployment falls while the number of vacancies rises leading the u/v ratio the number of unemployed chasing each vacancy to fall. Conversely, in a downturn, unemployment rises and vacancies fall, so that the u/v ratio rises. The u/v ratio (based on ILO unemployment) is now lower than at any time since 1975. This reflects the overall strength of the economy, not least that whereas previously vacancies were concentrated in different areas to unemployed people, there are now vacancies throughout the country, as the chart below shows.



A strategy for achieving employment opportunity for all

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

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

WELFARE TO WORK

4.12 There are currently 1.04 million unemployed people claiming Jobseekers' Allowance (JSA), but every year there are around 3 million new claims for JSA. The labour market is dynamic and most of these claims end relatively quickly, with over 50 per cent of people moving off JSA within 13 weeks. There are a further 7.6 million people of working age receiving other out-of-work benefits, including sick and disabled people and lone parents.

4.13 Not all of the economically inactive will be able to work or want to work, because of, for example, caring responsibilities. But many of the economically inactive say that they would like to work. That is why the Government is providing enhanced support combining rights with responsibilities to help people to move from welfare into work through policies including ONE and the New Deal.

4.14 The New Deal is a key element of the Government's wider Welfare to Work strategy aimed at ending the waste of long-term unemployment. It is investing in the long-term employability of participants, giving them a greater chance to take control of their lives and recognising that for most peolple work is the foundation for independence and a sense of self-worth. The New Deal seeks to encourage people to utilise their talents and energy and equip them with the skills to compete for jobs. The key objectives of the New Deal are therefore:

- to help into jobs:
    - young and long-term unemployed people;
    - lone parents and people with disabilities who wish to work;
    - partners of the unemployed; and
    - those unemployed people aged over 50;
- to improve their prospects of staying and progressing in employment; and
- to increase their long-term employability.

This thereby makes a positive contribution to sustainable levels of employment and to a reduction in social exclusion.

New Deal

4.15 The New Deal is funded from the proceeds of the one-off Windfall Tax. Independent evaluations of both the New Deal for young people[1] and the New Deal for lone parents[2] suggest that these programmes are close to paying for themselves. Falling levels of unemployment, in part because of the New Deal's success, have reduced its costs and allowed the Government to extend provision, investing in further reductions in worklessness. **The 2000 Spending Review announced that the New Deal will become permanent, funded from a new Employment Opportunities Fund bringing together the remaining Windfall Tax receipts and additional resources.**

4.16 The New Deal for young people was launched nationally in April 1998 and the New Deal 25+ was introduced in June 1998. Since November 1998, the Government has also been running innovative pilots of an enhanced New Deal 25+ to test the effectiveness of applying the principles of the New Deal for young people to this wider group. The message the Government has received is clear: the New Deal is proving effective at getting unemployed people back to work.

New Deal for young people

4.17 The Government made a manifesto commitment in 1997 to move 250,000 young people into jobs during this Parliament. It is well on the way to honouring that commitment. Evaluation by the National Institute of Economic and Social Research[1] shows that the New Deal for young people is estimated in its first year to have reduced youth unemployment in Britain by around 40 per cent relative to what it would have been in the absence of the policy. Taken against international comparisons for programmes for young people, that is a very favourable result.

4.18 Long-term youth unemployment has fallen by 70 per cent since May 1997. The New Deal for young people helps young unemployed people to secure jobs as the most effective way of enhancing their earnings, increasing their skills and securing their future economic independence.

4.19 As of the end of August 2000, over 532,000 young people had joined the New Deal since the pathfinders were launched in January 1998 and almost 244,500 of these young people had found jobs. In addition, over 156,300 young people had gained work experience and training through the other New Deal options.

4.20 The New Deal for young people is not just about getting people into jobs today. It is also a programme designed to invest in a young person's long-term future. People who are unemployed for more than a year by the time they are 23 spend up to six times longer in unemployment over the following ten years than those who are unemployed for less than six months, and over 14 times longer than those who are not unemployed at all before 23. Securing employment is a fundamental building block of the New Deal. By helping young people into work, the New Deal is not just addressing their needs today but seeking to ensure that their long-term employment prospects are more secure.

4.21 The continuity and form of support offered by the personal adviser is providing a key element of the success of New Deal. Since June 2000, the Gateway stage of New Deal 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 communications skills. Up to 60 per cent of the young people on the programme believe that the New Deal improves their chances of getting a job.

New Deal for 25+

4.22 Budget 2000 announced that a comprehensive set of measures aimed at helping all unemployed people aged over 25

will be introduced from April 2001. This builds on the existing New Deal for 25+ which has already helped over 50,000 long-term unemployed people move into work. Since June 1998, people aged 25 and over who have been unemployed for two years or more have been eligible for a personal adviser service and, alongside a range of options, a £75 a week wage subsidy. Since April 2000, the New Deal 25+ Gateway has been enhanced with more intensive contact and greater access to support services.

4.23 A more intensive approach has been tested in some areas, and at earlier durations of unemployment, since November 1998. Building on these pilots and the experience of the New Deal for young people, as announced in Budget 2000, **the New Deal 25+ will be extended and intensified from April 2001, on a national basis**. For people aged over 25 who have been unemployed for 18 months, there will be a step change in New Deal provision, heralding a stronger emphasis on rights and responsibilities, comprising:

- a structured Gateway, lasting up to four months, with regular contact with a personal adviser, and access to a range of jobsearch support, including more specialised support for those with severe barriers to their employment prospects. Screening and assessment for basic skills needs will be a key element of the Gateway. For some, who would gain from it, there will be access to the Gateway to Work, the Intensive Gateway provision available through the New Deal for young people;
- for those aged 25-49, the Gateway will be followed by a compulsory Intensive Activity Period of between 13 and 26 weeks. Those aged 50 and over will be able to choose whether to participate. The Intensive Activity Period will include the following elements:
    - *support for self-employment*, including a period of test trading for up to 26 weeks. The participant's business starts to trade in its own right, during which time participants will continue to receive a weekly allowance equivalent to their benefit plus £15.38, but will not be able to draw on profits for personal use;
    - *basic employability training*, targeted at those with basic skills deficiencies or other serious basic employability problems. This will provide a mix of training over 26 weeks in soft skills, basic skills and occupational skills;
    - *focused and flexible packages of intensive support*, including work placements with employers or voluntary organisations, work-focused short training courses and help with motivation, soft skills and job search skills; and
    - in addition, at all stages, there will be *access to a wage subsidy* for those moving into employment. For a small minority who are likely to benefit from longer periods of full-time education or training, there will be opportunities to undertake employment-related courses; and
- at the end of the Intensive Activity Period, people who have not found a job will return to Jobseekers' Allowance and enter the follow-through period. This will last up to three months and will be focused on intensive job search, building on the skills and experience gained through the Intensive Activity Period.

4.24 In order to enforce the rights and responsibilities within this enhanced provision, the existing New Deal for young people sanctions regime will be extended to the 25-49 age group.

Innovation Fund

4.25 The New Deal Innovation Fund backs good ideas generated at the local level for improving the effectiveness of the New Deal and increasing knowledge about what works in helping people back to work. As announced last year, the Government is providing further funds from the receipts of the Windfall Tax to extend the Innovation Fund. £9.5 million has been allocated to extend the Innovation Fund to March 2003, £5 million of which has been ring-fenced for measures within inner cities to explore the use of intermediaries in helping disadvantaged people into jobs.

4.26 The November 1999 Pre-Budget Report announced a £3 million Innovation Fund within the New Deal for lone parents. This will allow private, voluntary and public sector organisations to bid for funds to improve outcomes for ethnic minorities, long-term benefit claimants and those who face geographical barriers, and to increase the number of lone parents moving into sustainable employment through increased employer engagement.

New Deal for the over 50s

4.27 For most of the 1980s and early 1990s, the employment rate of men aged over 50 fell. Over the same period women over 50 did not experience the same marked increases in labour market participation that younger women have enjoyed. In recent years, the overall employment position of the over 50s has improved. However, the employment rate of those aged between 50 and the state pension age, at 67 per cent in spring 2000, remains well below the employment rates of 80 per cent or more of people aged 25-49.

4.28 The New Deal for the over 50s was launched in nine Pathfinder Areas in October 1999, and was rolled out nationally in April 2000. This New Deal programme provides:

- personal advice;
- help with job search;
- an employment credit of £60 a week for full-time and £40 for part-time employment and self-employment; and
- in work training support.

4.29 This support is available to people aged over 50, where they or their partner have been on eligible benefits for more than six months, to help them return to work. The programme is voluntary and available to people who are economically inactive as well as the unemployed. In September 2000, the Government launched a major advertising campaign for the New Deal for the over 50s to ensure that all who can benefit from this initiative are aware of it.

Worklessness in deprived areas

4.30 Every region in Britain has experienced sharply falling unemployment and rising levels of vacancies. However, within regions there remain pockets of high unemployment, typically in individual local authority areas, wards within these areas and even down to particular housing estates. The majority of these areas are in inner cities, but seaside towns and former coal mining areas also feature. Often people from ethnic minorities, lone parents and people with disabilities are disproportionately concentrated within these small areas. They may suffer from poor housing, inadequate transport links and high crime rates, leading to social exclusion.

4.31 However, the problem of Britain's most deprived areas is not necessarily a lack of jobs in many cases, these areas are alongside, and within travelling distance of, labour markets with high levels of vacancies. People need to be equipped to take advantage of these opportunities. The Government's regional and area-based programmes are aimed at regenerating local communities but must also increase the employability of people in disadvantaged areas, so that they can access and fill vacancies that exist near to where they live. Otherwise such jobs will go to people outside the area, further reinforcing the problem.

Action Teams and Employment Zones

4.32 The Government is testing different approaches to tackling localised concentrations of inequality, through Action Teams and Employment Zones. By targeting the most disadvantaged areas a real contribution can be made to tackling some of the problems that have been identified. They can help people to find work and promote equality of opportunity, by:

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

4.33 Employment Zones offer the opportunity of tailoring programmes specifically to people's needs, with jobseekers and their personal advisers being able to set up Personal Job Accounts to use more flexibly funds that are available for support. In each case, the Government is looking for local solutions to local problems. Each will be unique to the area that it is serving. Action Teams, launched in autumn 2000, are working with the long-term unemployed and inactive people in the most deprived areas, identifying suitable vacancies in neighbouring areas and bringing the two together. Additionally, they are tackling barriers to employment, including funding for transport to enable people to access nearby vacancies.

4.34 The problems of deprived areas are often complex and long-standing. The Government will build on the lessons from Action Teams and Employment Zones in considering what possible further steps might be taken to tackle high levels of localised worklessness.

4.35 Action Teams and Employment Zones are complemented by a number of other area- based initiatives, such as the New Deal for Communities, Education Action Zones and Health Action Zones, all of which seek to address localised problems. In some instances these initiatives run co-terminously, enabling an assessment to be made as to whether these programmes deliver better outcomes than if they do not overlap.

Job Transition Service

4.36 Some of the most difficult employment problems have occurred when there were large-scale redundancies in areas dependent on one industry or one company. **The Government will introduce 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.

ONE

4.37 The Government's ONE service combines a one-stop shop for benefits and employment advice, a personal adviser service tc help people back into work, and work-focused interviews for all new benefit claimants: one place for work and benefits. It aims to forge an entirely new culture which puts work first, and provides a modern, integrated and flexible service for all. ONE is currently running in 12 pilot areas, including four using call centre technology and four led by the private and voluntary sectors. ONE represents a fundamental shift in the way that the Government supports people 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?" As announced in the 2000 Spending Review, the Government plans a substantial expansion of the ONE service, building on the lessons from the 12 pilots.

4.38 To deliver support for people of working age, during 2001 a brand new, modern agency will be established with a clear focus on work. The new agency will draw together the Employment Service and the parts of the Benefits Agency that support people of working age. It will deliver a single, integrated service to benefit claimants of working age and employers. 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.

New Deal for lone parents

4.39 Balancing work and family responsibilities is often difficult for parents, particularly when they are the sole carer of a child. But taking long periods out of the labour market while caring for children can put families at greater risk of poverty and can be damaging to long-term earnings potential.

4.40 Lone parent employment rates have risen from 44 per cent in 1997 to just over 50 per cent now, their highest level for over 20 years, and the number of lone parents on Income Support has fallen by over 100,000 since 1997. However, nearly half of lone parent households still have no-one in work, compared to only 7 per cent of couples with children. Children in lone parent households make up almost half of all children in poverty. There is still more scope for increasing employment opportunities for lone parents. The Government announced a new target for lone parent employment in the new Public Service Agreement targets in the 2000 Spending Review, including reducing the number of children in households with no-one in work over the three years to 2004, and reducing the number of children in poverty by at least a quarter by 2004 (see Chapter 5).

4.41 The New Deal for lone parents (NDLP) provides the opportunity for lone parents to receive help from a personal adviser to improve their prospects and living standards by taking up, and increasing, paid work. From the national launch of the programme in October 1998, over 158,000 lone parents have participated and over 60,000 have already moved into employment.

4.42 As announced in the November 1999 Pre-Budget Report, a package of improvements to NDLP has been introduced this year, including specialised resource centres and intensive help for lone parents soon to move onto Jobseekers' Allowance, an innovation fund and pilots of in-work training grants.

4.43 There are a significant number of lone parents, around 150,000, who are not working but who are not currently eligible for NDLP because they are not on Income Support. This includes lone parents who receive enough maintenance or Widowed Mother's Allowance to move them just out of Income Support, but which leaves them and their children in poverty. **Starting in autumn 2001, the offer of help and support from the NDLP will be made available to all lone parents who are not working, or who are working less than 16 hours per week.**

4.44 The Government recognises that for some lone parents, particularly those with young children, choices are constrained. Since April 2000, in the 12 pilot areas of ONE, all lone parents making a new benefit claim have been required to meet a personal adviser to discuss options for work and training. Building upon the lessons learnt, the Government will be providing information and guidance about opportunities to work, study or care for their children full time, through a specialist lone parent personal adviser. The opportunities on offer to lone parents include:

- work of 16 hours or more on the Working Families' Tax Credit, with a guaranteed minimum income and the childcare tax credit;
- the choice to try some work under 16 hours a week, with a **£20 a week earnings disregard**, and access to childcare help through advisers; and
- the opportunity to undertake education and training, with a **£15 a week premium on top of Income Support from**

April 2001, free access to Further Education courses and access to childcare funds.

4.45 These choices will be offered on a voluntary basis. **From October 2000 in pathfinder areas and nationally from April 2001, lone parents on Income Support with children over the age of five will be required to meet a personal adviser to discuss the opportunities available to them.**

Box 4.2: Helping lone parents into work

Employment rates of lone parents in the UK are low, both in comparison to lone parents in other countries and compared to mothers in couples in the UK.

The employment rate of lone parents has been falling over most of the past two decades: in 1979, two thirds of children in lone parent households lived with a working parent. By 199596, less than half of all children in lone parent households lived with a working parent. Female lone parent employment rates have not kept up with the general rise in female employment, and are significantly below the 70 per cent employment rate for mothers in couples.

More recently, the proportion of lone parents in work in the UK has begun to rise again. Today, lone parent employment rates are around 50 per cent the first time since the 1970s although the UK still lags substantially behind other industrialised countries. In the US, around 70 per cent of lone parents are in work, and in France over 80 per cent. The reasons for these differences are complex but may include the demographic characteristics of lone parents, health and education, the area in which they live, the availability and cost of childcare, work requirements and, historically, the gains to work. Yet the characteristics of lone parents in both France and, particularly, the US are broadly similar to those of lone parents in the UK.

Although the employment rate of lone parents is relatively low in the UK, many lone parents say that they would like to work. That is why help has been provided to facilitate work and make work pay, through the New Deal and the Working Families' Tax Credit (WFTC).

The WFTC provides support for low and middle income working families with children irrespective of whether there are one or two parents in a household. However, the WFTC has been of particular benefit to lone parents, helping to tackle poverty and support lone parents as they move off welfare and into work. In particular:

- **35 per cent (150,000) more lone parents are receiving WFTC compared to Family Credit;**
- **from April 2001, the WFTC guarantees lone parents in work for 35 hours a week £214 a week and £154 for lone parents in work for 16 hours a week; and**
- **over 100,000 lone parents are now receiving help with childcare, more than twice the number who benefited from the childcare disregard in Family Credit.**

The Government recognises that for some lone parents, particularly those with young children, choices are constrained. Help from specialist lone parent personal advisers and an improved package of choices through the New Deal for lone parents will provide lone parents with information about opportunities to work, study or care for their children full time and will help lone parents to plan for their future.

4.46 Chapter 5 sets out in more detail the Government's overall strategy for abolishing child poverty and for ensuring security for lone parents and their children, particularly when their children are young.

New Deal for partners of the unemployed

4.47 For couples where one partner is unemployed, the chances of the other partner being in work are much lower. This is especially the case for women: where the male partner is unemployed, only 40 per cent of female partners are employed. In contrast, where the male is employed, 75 per cent of female partners are employed. The large increases in female employment over the past 20 years have come in households where the partner is already in work. The New Deal for partners of unemployed people was launched in three pathfinder areas in February 1999 and was rolled out nationally in April 1999. It provides a personal adviser service aimed at helping partners of unemployed people to move into work. Partners aged between 18 and 24 are eligible to receive help through the New Deal for young people and from April 2001 will become joint JSA claimants - subject to the same rights and responsibilities as the main claimant.

New Deal for disabled people

4.48 People with disabilities have a particularly low level of participation in the labour market and low employment rates.

Whereas 79 per cent of the whole working age population is economically active, only 52 per cent of those with a work-limiting or Disability Discrimination Act-defined disability are, and even fewer just 11 per cent of those of working age on Disability Living Allowance are in work or looking for work. The goal of the New Deal for disabled people is to increase the labour force participation rate of this highly disadvantaged group.

4.49 Many people with disabilities say they wish to work. The Government has responded by:

- improving financial incentives through the Disabled Person's Tax Credit, which tops up in work incomes;
- improving work incentives in the benefits system. A new linking rule has been introduced into Incapacity Benefit to allow people who move into work but whose job does not work out to return to the same rate of benefit within one year (or two years if in receipt of DPTC). **In addition, from April 2001, people with disabilities on Income Support and Jobseekers' Allowance will be able to keep £20 a week of any earnings without losing any benefits.** This will boost their income and help them progress in work and move off benefits;
- introducing legal protection against discrimination through implementation of the Disability Discrimination Act; and
- introducing active labour market policies: the New Deal for disabled people in July 1997 and, in July 1999, work focused interviews through ONE pilots.

4.50 Recognising the need for innovative approaches in this area, the New Deal for disabled people tests a variety of measures and delivery mechanisms. There are:

- 12 regional pilots of a personal adviser service;
- 24 schemes testing new ideas; and
- services being delivered by the public, voluntary and private sectors.

By the end of September 2000, over 5,000 people with disabilities over 30 per cent of participants had found work through the New Deal.

4.51 In the 2000 Spending Review, the Government set aside additional resources for the extension of services for people with disabilities across the country under the New Deal for disabled people; and for retention and rehabilitation pilots.

4.52 The Pre-Budget Report announces further details of these policies. Both initiatives will continue to place great emphasis on testing experimental approaches in order to develop the most effective service possible to help people with disabilities into work. Continuing the focus on sound evidence-based policy-making, the NDDP will be evaluated using random assignment, learning what works best, to guide future policy-making:

- **the nationwide extension of the NDDP will test out the effectiveness of innovative Job Brokers,** whose role it will be to help people with disabilities become ready for work, and to put them in touch with employers. Organisations will be invited to bid for job broking contracts shortly; and
- **the Retention and Rehabilitation pilots will test integrated health and employment interventions.** The Government is seeking integrated and experimental approaches to maximising the retention in work of people at risk of losing their job through sickness or disability.

Funding Welfare to Work

4.53 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. **To make the New Deal a permanent deal, the 2000 Spending Review announced the creation of a new Employment Opportunities Fund to continue and expand New Deal programmes once Windfall Tax receipts become exhausted.** This Employment Opportunities Fund, worth £875 million in 2001-02, increasing to £1.4 billion in 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.

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

£million	1997-98	1998-99	1999-00	2000-01	**1997-2001**
Spending by programme[1]					
New Deal for 1824 year olds	50	200	320	440	1,000

New Deal for the over 25s[2]	0	10	90	170	270
New Deal for 50 plus	0	0	5	20	30
New Deal for lone parents	0	20	40	70	130
New Deal for disabled people[3]	0	5	20	30	60
New Deal for partners of unemployed people	0	0	5	20	30
New Deal for Schools[4]	90	270	260	850	1,480
Childcare	0	20	10	5	30
University for Industry[5]	0	5	0	0	5
ONE pilots[6]	0	0	0	5	5
Action Teams	0	0	0	20	20
Enterprise development	0	0	0	20	20
Total Expenditure	**140**	**530**	**750**	**1650**	**3070**
Windfall receipts allocated beyond 2000-01					**2130**
o/w 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 199798 and 199899, projected outturns for 199900 and allocations for 200001.*

[2] *Includes £10 million for skills development fund.*

[3] *Includes £10 million in 199900, an element of the November 1998 announcements on Welfare Reform.*

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

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

[6] *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 18-24 year olds	420	420	420
New Deal for the over 25s	190	230	180
New Deal for 50 plus	20	20	20
New Deal for lone parents	90	120	140
New Deal for disabled people[2]	50	60	60
New Deal for partners of unemployed people	20	20	20
Action Teams[3]	20	0	0
Job Transition Service	5	5	5
ONE pilots	5	0	0
Modernising the Employment Service	30	0	0

Unallocated[4]	**240**	**540**	**540**
Total WTW in EOF	**1040**	**1390**	**1370**
Enterprise in disadvantaged 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[5]	410	0	0

EASING THE TRANSITION TO WORK

4.54 For many people, especially those who have been out of work for long periods, the transition back into work can be a difficult period. Although they would be better off in work, the associated risks, especially managing until the first pay cheque and covering any additional expenditure such as buying clothes for work, can make many people prefer to stay on certain, but lower, benefit levels rather than make the move into work. Some groups also require additional support to overcome specific barriers to work for example families with children can be constrained by the cost and availability of childcare. The Government has therefore introduced a number of reforms to improve and simplify the schemes available to help ease the move into work. The new measures aim to provide people with additional financial support during the transition period in as straightforward and automatic a way as possible. This will give people security as well as encouraging them to take up employment.

Job Grant

4.55 As announced in Budget 2000, from spring 2001 a Job Grant of £100 will be available for people who move from welfare into work. This builds on the two-week Income Support run-on for lone parents, introduced in October 1999, which they will continue to receive. The Job Grant will replace the discretionary and narrowly targeted Jobfinder's Grant and Jobmatch, providing a single transitional payment, available much more widely and without the complex eligibility criteria of the previous schemes.

Income Support for Mortgage Interest run-on

4.56 Housing costs are a particular concern to many people moving back into work. Although Housing Benefit can be paid in work, the time taken to process claims can lead to rent arrears building up. Housing Benefit can already be paid, at out-of-work rates, for the first four weeks in work under the Housing Benefit Extended Payment scheme for recipients of Income Support and Jobseekers' Allowance. **As announced in Budget 2000, the rules of this scheme will be simplified from April 2001 to ensure that payments are as near automatic as possible**.

4.57 The Government is also providing help with housing costs for homeowners going back to work. Homeowners who have been out of work and on Income Support or Jobseekers' Allowance for nine months or more receive help in paying the interest on their mortgage through Income Support Mortgage Interest (ISMI). As announced in Budget 2000, **from spring 2001 the Government will extend the ISMI scheme to provide a four week ISMI run-on for those entering work**. The existing linking rules will also be improved so that everyone getting ISMI will be able to requalify for it directly if they return to benefits within one year of taking a job.

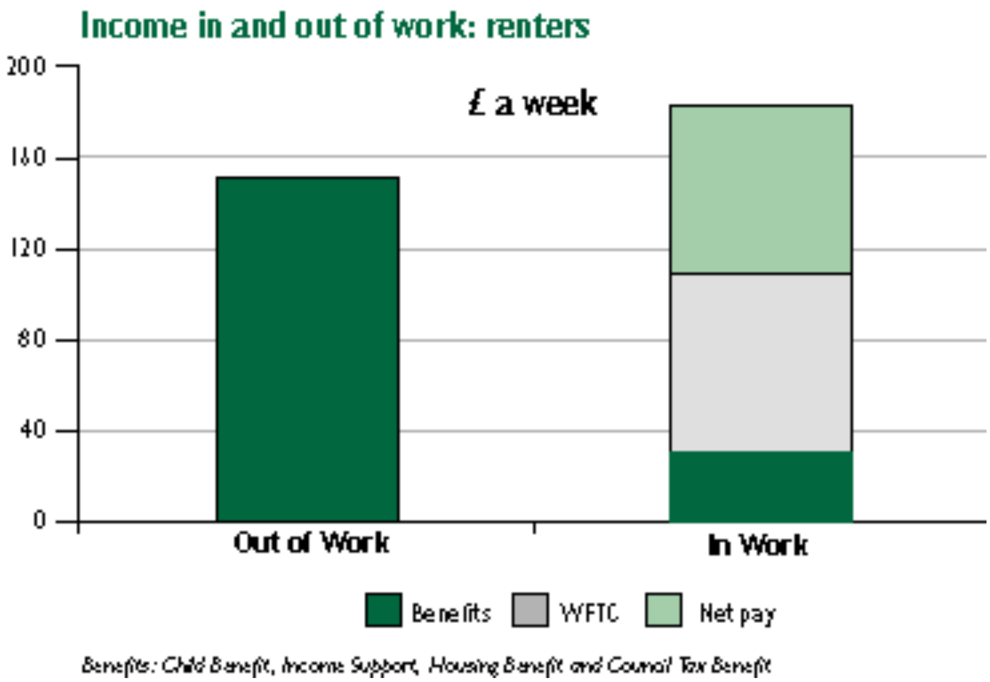
4.58 The Government is also making it easier for those in the benefit system to try out work by increasing the amount of earnings disregarded in Income Support and Jobseekers' Allowance by £5 to £20 a week for those groups facing restricted work choices, such as lone parents, carers or people with disabilities. As announced in Budget 2000, **from April 2001 these groups will be able to keep £20 a week of any earnings without losing their benefit**. This will boost their incomes and help them progress in work and move off benefits.

4.59 Budget 2000 also announced that **from April 2002 the Government will introduce measures to streamline the process for re-claiming benefit for people on Jobseekers' Allowance and Income Support returning to benefit after taking up full-time work for periods of up to 12 weeks**. **The Government will also consider the case for introducing a similar arrangement in Housing Benefit.** This should encourage benefit claimants to report starting work which may be temporary or insecure and help ensure that they are not deterred by the normal claims procedure. Together, these measures will help to reduce the barriers to trying legitimate work (see Box 4.3).

Box 4.3: Housing as a barrier to work

Housing costs are a particular concern to many people moving back to work. Evidence suggests that worklessness is concentrated among tenants, particularly in social housing.

The chart below illustrates how Housing Benefit, which helps low-income tenants with their rent, is affected by the transition into work. It shows the effect on weekly income before housing costs of a lone parent with one child aged under 11 moving from benefit to a part-time job working 20 hours a week at the National Minimum Wage and renting local authority accommodation.



The chart shows that because Housing Benefit is available for those in work, the lone parent tenant is better off in work. However, Housing Benefit does not meet the rent in full and a significant amount of net pay is needed to pay the remaining rent. The interaction of the Housing Benefit and Working Families' Tax Credit (WFTC) tapers can mean that the gains to work are small. However, the WFTC has already lifted 70,000 people off Housing Benefit this year by boosting in work income.

In practice, Housing Benefit administration is extremely variable and, at its worst, delays in claims can lead to arrears and debt. The Government has therefore announced action to smooth the transition to work:

- **simplifying the Housing Benefit Extended Payments scheme, which eases the transition to work for those on income support or JSA by continuing to pay the out-of-work rate of Housing Benefit for the first four weeks of work, to make payments as near automatic as possible; and**
- **looking at the case for replicating in Housing Benefit the rules that will allow Income Support and JSA claims to be suspended, rather than closed, for the first 12 weeks at work.**

The Government will consider what might be done to help local authorities improve Housing Benefit administration and what more might be done as new tax credits develop. The long-term case for further reforms to Housing Benefit is strong.

National Childcare Strategy

4.60 High-quality, affordable and accessible childcare will be a key factor in achieving the Government's objective to reduce the number of children living in workless households. The Government aims to support those already in work and promote the move into work for those on benefits. Evidence shows that childcare is a major barrier to parental employment, particularly for lone parents.

Childcare tax credit

4.61 The Government's strategy is to make childcare affordable for low-income parents by subsidising their childcare costs. The

Working Families' Tax Credit and Disabled Person's Tax Credit include a generous childcare tax credit element. Funding childcare in this manner ensures that the choice of childcare provider is where it belongs with the parents.

Box 4.4: Gender and opportunity

Good government requires a thorough understanding of the impacts of new and existing policies on different sectors of the population, including by gender. This means that women's interests must be properly met in the development of new policies and in the delivery of services.

Thirty years after the Equal Pay Act, women's full-time earnings are still only 84 per cent of those of men's, and for part-time workers only 58 per cent. This inequality is particularly marked among lower-skilled women. The Government has taken steps to improve the situation for the most vulnerable groups in the labour market. The introduction of the National Minimum Wage in April 1999 is estimated to have raised the wages of 900,000 women; and the Part-Time Worker's Directive will improve working conditions for part-timers, 83 per cent of whom are women, by giving them the same legal rights as full-timers. The Equal Opportunities Commission Taskforce on the gender pay gap will report in early 2001.

The Government believes that lack of working opportunities is a major cause of poverty for many women and their children. The Government's welfare reform and making work pay strategies seek to address this problem through policies including the New Deal for Lone Parents, the Working Families' Tax Credit and the National Childcare Strategy.

Good maternity provision is critical to providing financial support to women when a child is born and maintaining links with work for those who want to. Previously, many women have found it difficult to combine work and family responsibilities, and the Government has introduced a series of improvements to maternity arrangements, and is now undertaking a review of provision. It has also introduced new rights to four weeks additional parental leave, and to time off if a child or other close relative is sick.

Skills are critical to women's lifetime incomes in the 21st century. The Government's investment in education should improve women's choices. This is even more important for women with children. Currently for mothers with children below the age of five, 72 per cent of the women with high qualifications were active in the labour market compared to only 48 per cent of those with low qualifications. Hence the need to increase the opportunities for women to improve and update their skills and qualifications.

Girls are performing better than boys in school and more women than men are moving into further education. However, women are still getting less reward from their education and training, both in terms of job opportunities and incomes. Women start only 30 per cent of new businesses. The Government is aiming to raise the profile of female entrepreneurship through regional seminars, a national conference in February 2001 and the Small Business Service.

Women tend to be poorer in retirement. However, the income gap in retirement is slowly closing, as the proportion of women in employment has been increasing and more women are now covered by occupational pensions. Current Government reforms will help further and provide a more generous second-tier pension for low-earning employees, the majority of whom are women.

Support for childcare providers

4.62 To date, the National Childcare Strategy has created new childcare places that have helped 427,000 children across England In the 2000 Spending Review, the Government announced a major expansion of childcare, focused specifically on providing childcare facilities in disadvantaged areas for parents moving into work. This expansion will be funded by a threefold increase in annual expenditure on childcare from £66 million this year to over £200 million by 2003-04, and £155 million extra for childcare from the New Opportunities Fund between 2001 and 2004. The Government is offering:

- financial support for providers to encourage the setting up of childcare facilities for 0-3 year olds in the most disadvantaged areas. This includes resources for 900 new nurseries;
- start-up grants for childminders; and
- a business support package for childcare providers to minimise the difficulties in setting up and maintaining childcare facilities.

The new money from the 2000 Spending Review and New Opportunities Fund will ensure that the Government will have createc places for 1.6 million children by 2004. Taking into account turnover, that means a net increase in places for 1 million children in

England alone.

The informal economy

4.63 The review of the hidden economy, conducted by Lord Grabiner QC, and which reported to the Chancellor in March 2000, looked at the problems of unregistered businesses and self-employed people and employees in the hidden economy, and made a number of recommendations.

4.64 Lord Grabiner's report suggests that people can become trapped in the hidden economy because they are not aware of the legitimate opportunities that are available. The Government has already introduced a number of new incentives to encourage people to leave the informal economy and take up legitimate work. In June 2000, a confidential telephone line was launched to advise people in the hidden economy about how to put their affairs in order and how the tax and benefit rules apply to them. The Government also announced the introduction of a series of measures in Budget 2000 to help simplify the transition off benefits and into work, including the £100 Job Grant and increases in earnings disregards.

4.65 In addition, the Government will:

- extend the help which is given to people who start out in self-employment;
- introduce a requirement for new businesses to tell the Inland Revenue as soon as they start up, so that they can be offered early help and advice; and
- launch a campaign to publicise the existing incentives to join the legitimate economy, such as the Working Families' Tax Credit.

4.66 Lord Grabiner also recommended new measures to take action against those who persist in the hidden economy, especially employers who commit multiple tax offences and collude in benefit fraud. The Government:

- has legislated for a statutory offence of fraudulently evading income tax, which can be tried in the magistrates' court;
- will tighten procedures for allocating national insurance numbers;
- **from January 2001 will require people suspected of doing undeclared work while signing on as unemployed to attend the Jobcentre more frequently, at unpredictable times;**

- has legislated to give investigators the power to trace people who only give a phone number when they advertise for customers by making subscriber checks of the telephone directory; and
- will prepare to implement a "two strikes and you are out" approach for benefit fraud removing people's right to claim for a specified time if they have been caught twice.

MAKING WORK PAY

4.67 Evidence suggests that people who are out of work are reluctant to move into work if the financial gains are small. The situation where the difference between in-work and out-of-work incomes is too small to provide an incentive for someone to move into work is known as the "unemployment trap".

4.68 Those already in work can be discouraged from working longer hours or taking a better job because, as their earnings increase, their benefits are reduced and they must pay more income tax and national insurance contributions. Where this happens it is often referred to as the "poverty trap".

4.69 Policies aimed at helping individuals better compete in the labour market, such as the New Deal, therefore need to be supported by policies that reward work. In the past, it was often the case that the financial incentives were insufficient to encourage people to take work, or to take a better paid job:

- many people were caught in the unemployment trap: in 1997, a couple with two children needed to earn nearly £260 a week to be £40 a week better off in work. For someone working 35 hours a week, this meant finding a job paying £7.50 an hour more than twice the current National Minimum Wage; and
- others were caught in the poverty trap: nearly $^3/_4$ million families lost more than 70 per cent of every extra pound they earned as taxes increased and their benefits were withdrawn in 1997.

4.70 The Government is therefore committed to tackling the unemployment and poverty traps by making sure that work pays more than welfare and by providing incentives to move up the earnings ladder.

National Minimum Wage

4.71 The National Minimum Wage ensures fair minimum standards of pay and underpins the Government's tax and benefit reforms. It was introduced in April 1999 and the rates were recently increased to:

- £3.70 an hour for workers aged 22 and over; and
- £3.20 an hour for workers aged 18-21.

4.72 Trainees (workers aged 22 and over in the first six months of employment and receiving training leading to a recognised qualification) are also entitled to a minimum wage of £3.20 an hour.

4.73 The Low Pay Commission's Second Report, which assessed the initial impact of the National Minimum Wage, found that the National Minimum Wage has been a success and has not had any harmful effects on employment or the economy. The Low Pay Commission has been asked by the Government to continue to monitor the impact of the National Minimum Wage and consider the case for a further increase, and to report its findings by July 2001.

Equal pay

4.74 Women's earnings continue to lag behind those of men, 30 years after the Equal Pay Act. The Government recognises that there are major problems in the equal pay tribunal procedures. It can take years for women to gain redress for pay discrimination; delays and complexity deter many more women from bringing claims. The Government is committed to tackling these problems and ensuring equity for women. The Department for Education and Employment and the Department of Trade and Industry will shortly bring forward for consultation proposals for overhauling the system, with the specific aim of speeding up and simplifying tribunal procedures.

Making work pay for all

4.75 The Government has embarked upon a series of reforms to help make work pay at all levels of the labour market, including for those on low incomes. The basic rate of income tax was reduced to 22p from April 2000 the lowest level for 70 years. The introduction of the 10p starting rate of income tax in April 1999 halved the marginal tax rate for 1.8 million people in low paid work.

4.76 In addition to reducing income tax, the Government's reforms to employees' national insurance contributions (NICs) have helped to ensure that jobs at the lower end of the earnings distribution now pay better. Following a report into work incentives by Martin Taylor[3], published at the time of the 1998 Budget, the NICs entry fee was abolished, removing the situation where employees could face a drop in net pay as a result of a one penny increase in gross earnings. In addition, as previously announced **from April 2001 the threshold above which employees pay NICs will be increased to align it with the income tax personal allowance**.

4.77 The Government has also simplified NICs payments for employers, introducing a single employer rate and aligning the point at which employers begin to pay NICs with the personal tax allowance. Additionally, **there will be a reduction in employer NICs of 0.3 percentage points from April 2001 and a further reduction of 0.1 percentage points from April 2002**, thereby ensuring that all revenue from the climate change levy and the aggregates levy is recycled back to business (see Chapter 6 for details of the climate change levy and the aggregates levy).

Box 4.5: The income tax personal allowance, NICs threshold and WFTC/DPTC rates for 2001-02

The threshold above which employees begin to pay NICs will be aligned with the income tax personal allowance from April 2001. **The income tax personal allowance for 2001-02 will be £4,535 and the NICs threshold will be £87 a week.** Increasing the point at which employees begin to pay NICs from the 'lower earnings limit' to the new 'primary threshold' means that around 1 million people no longer have to pay NICs. At the same time, the entitlement to contributory benefits for those earning between the lower earnings limit and the primary threshold has been protected.

In addition, the main Working Families' Tax Credit and Disabled Person's Tax Credit rates and income thresholds will be increased in line with indexation from April 2001.

Additional targeted support

4.78 Martin Taylor's report highlighted the particular work incentive problems faced by families with children. To address these problems, the Working Families' Tax Credit (WFTC) was introduced in October 1999. Already, more than 1.1 million families are receiving the WFTC, around 300,000 more than received Family Credit at its peak. Families are, on average receiving around £30 a week more compared to Family Credit.

4.79 The WFTC includes a generous childcare tax credit component, which helps many families for whom the cost of childcare is a barrier to work. The credit is worth 70 per cent of eligible childcare costs up to £100 a week for a family with one child and £150 for a family with two or more children. Over 100,000 families are benefiting from the childcare tax credit, more than twice the number that received the Family Credit disregard at its peak. In addition, as a tax credit rather than a disregard, it is of particular help to those on the lowest incomes.

Box 4.6: Extending the principle of the Working Families' Tax Credit

While the WFTC has helped to make work pay for working families with children, the gains to work from low-paid jobs for those without children can still be low. For example, a single earner couple without children living in rented accommodation with earnings of £160 a week is only £15 a week better off than on benefits, compared to around £40 better off if they had children.

They 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 below is 60 per cent of the median.

The March 2000 Budget announced that the principle of in-work support through tax credits will be extended to people without children[1]. This will complement reforms to the way the tax and benefit system support children, with the introduction of a single integrated credit for children. Precise details of how far to extend support to adults without children are being carefully considered. However, detailed analysis shows:

- **the over 45 age group often face the greatest unemployment trap. The wages of people in this group on returning to work tend to be low compared to their previous job, and have declined relative to other workers;**
- **for young people, low wages tend to be transitory and are less likely to be associated with low household incomes and poverty. The Government's commitment to high quality education and training opportunities for all, backed up by policies such as the New Deal, may be more effective at treating the causes of low wages for this group;**
- **part-time employment is also a contributory factor in working poverty for households without children, alongside low wages; and**
- **couples without children face a greater work incentive problem compared to single people, since out-of-work benefits for couples are higher. They are also more likely than single people to live in low-income households.**

As an illustrative example, if an employment tax credit for people without children was based around the adult credit in the WFTC, and were made available to single people and couples with someone over the age of 25, combined with a 30 hour eligibility rule and with a higher rate for couples, it could reach between 300,000 and 400,000 low-income working households without children. Such a credit would:

- **deliver a minimum income guarantee of around £165 a week for couples without children and with someone working 35 hours, compared to £117 a week now;**
- **double the gain to work for couples in rented accommodation at the National Minimum Wage, and increase it by a third for single people; and**
- **increase the incomes of the poorest households in work by on average around £20 a week for couples and £15 a week for single people.**

The Government will consider carefully the detailed design issues surrounding an employment tax credit to make sure that it effectively and efficiently delivers the Government's aims of providing work incentives and tackling in-work poverty.

1*The Modernisation of Britain's Tax and Benefit System, Number Six, "Tackling Poverty and Making Work Pay tax Credits for the 21st Century*". HM Treasury, March 2000.

4.80 Recent increases in the Working Families' Tax Credit for children, combined with the increase in the National Minimum Wage to £3.70 an hour, now guarantee a minimum income of £208 a week, rising to £214 a week from April 2001 for a family with children eligible for WFTC and with someone working 35 hours or more a week.

4.81 The Disabled Person's Tax Credit (DPTC), launched alongside the WFTC, helps to provide support for workers with disabilities. In August 2000, over 25,000 disabled workers were benefiting from DPTC 37 per cent more than were receiving Disability Working Allowance in July 1999 by an average of £72 per week. DPTC is open to people who work for 16 hours or more a week, have an illness or disability which puts them at a disadvantage in getting a job, and who are either receiving one of a range of incapacity or disability benefits at the time of their application or have been receiving certain benefits within the previous six months. From October 2000, a new fast-track to DPTC was introduced to help people who have been sick for 20 weeks or more, but can do some work, to remain in their job.

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

Tackling the unemployment trap

4.82 The reforms outlined above are helping to ensure that work pays more than welfare, thereby addressing the unemployment trap. The gain to work has increased while security for those out-of-work has been maintained and enhanced.

4.83 The Government's making work pay package highlights clearly the rewards of work over welfare, **and by April 2001 guarantees**:

Weekly Minimum Income Guarantee

	Working 35 hours a week	Working 16 hours a week	Weekly income below which no net income tax is paid
Family receiving WFTC	**£214**	**£154**	**£255**
Family receiving DPTC	**£246**	**£186**	**£309**

4.84 There is some evidence that unemployed people may be reluctant to take a job if they will be less than £40 a week better off in work. As a result of measures announced in previous Budgets over the current Parliament, the weekly wage before tax needed to be £40 a week better off in work has fallen from nearly £260 to £160, for a couple with two children under 11. This amount is very close to the average wage this group would command when moving into work. This is illustrated in Chart 4.2.

Chart 4.2

Tackling the poverty trap

4.85 The Government's reforms to the tax and benefit system have also helped to counter the poverty trap. Low-income families, who often face the highest marginal deduction rates and therefore the greatest poverty trap, now keep more of each additional pound that they earn. This means they have more incentive to take a better paid job or increase the hours they work. As a result of tax and benefit reforms, the number of families facing marginal deduction rates[4]of more than 70 per cent will fall to around a third of the 1997 level a reduction of nearly half a million during this Parliament.

Increasing labour supply

4.86 One of the key aims of the Government's tax and benefit reforms is to boost labour supply by increasing the number of workless people who are seeking work.

4.87 The Government has also estimated the impact of the whole package of measures to make work pay, including the reductions in income tax and NICs. On cautious assumptions, the initial package of reforms[5] is estimated to increase labour supply by 160,000 people. If this result was translated into jobs, it would mean:

- a four per cent reduction in the number of households without work;
- a five per cent fall in the number of children in workless families; and
- a six per cent reduction in the number of workless lone parent households.

4.88 Further details of these estimates are contained in *"The Modernisation of Britain's Tax and Benefit System, Number Six, Tackling Poverty and Making Work Pay Tax Credits for the 21st Century", HM Treasury, March 2000.*

SECURING PROGRESSION IN WORK

4.89 Moving from welfare into work is the first step in moving out of poverty. But the Government also wants to enable people to progress up the earnings ladder once in employment. The Government has introduced policies to promote lifelong learning to ensure that everyone in work is equipped with the training and skills necessary to progress in work.

New Deal providing skills

4.90 Both the New Deal for young people and the New Deal 50 plus 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.

Life long learning

4.91 In order to gain the vocational skills businesses require for higher paid work, many people first need to upgrade their basic skills. Only by building a new culture of lifelong learning can this be achieved. The new Learning and Skills Council will work in partnership with employers, Regional Development Agencies and the Small Business Service to deliver the right skills to progress in work.

4.92 The Government has also invested £25 million to make opportunities available for up to 50,000 more people to get the ICT skills they need to increase their employability, and if they need it, to improve their basic literacy and numeracy. This measure complements the ICT learning centres announced in Budget 99. Nineteen pilot projects are testing innovative ways of enabling people to overcome barriers to their acquisition of basic ICT skills.

4.93 Lifelong learning is not just about basic skills. There will also be increased means through individual learning accounts, and increased opportunities through the learndirect centres, for individuals to take responsibility for their own futures, and to continue to increase their knowledge and skills, thereby improving their employability. Currently over 700 learndirect centres are operating nationally, offering over 400 courses including ICT, Basic Skills, Multimedia and Retail & Distribution. Over 85 per cent of these courses are available on-line. More details are provided in Chapter 3.

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[1] *New Deal for young people: first year analysis of implications for the macroeconomy*, National Institute of Economic and Social Research, December 1999.
[2] J Hales et al '*Evaluation of the New Deal for Lone Parents: Early Lessons from Phase One Prototypes Synthesis Report*' - Department of Social Security Research Report, March 2000.

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[3] *The Modernisation of Britain's Tax and Benefit System number two* "*Work Incentives*: A report by Martin Taylor." HM Treasury, March 1998.

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4 The marginal deduction rate measures how much of every extra pound that someone earns is lost as they pay more tax and have their benefits reduced.

5 All tax and benefit reforms excluding those measures announced in Budget 2000 and the childcare tax credit.

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. In particular, this means tackling child poverty and its causes, providing security in old age, rewarding work and saving, and concentrating extra help on the people and communities that need it most.

The key challenges the Government faces in its efforts to build a fairer society are:

- **finding effective ways to support families and children**. The Government wants to ensure that every child has the best possible start in life, by combining financial support for all families - especially those with lower incomes - with targeted interventions to assist the most vulnerable families and communities;
- **developing a long-term strategy for supporting pensioners**. As the proportion of senior citizens in our society grows, it becomes ever more important to create a system of support which ensures that all pensioners share in the rising prosperity of the country, is sustainable in the long-term, rewards those who have saved for their retirement, and targets extra financial support on the poorest pensioners;
- **delivering world-class public services**. To support an inclusive, safe and fair society, the Government wants to maintain its drive for ever better public services by combining prudent management of the economy and the public finances with focused, carefully-chosen spending plans; and
- **creating a modern and fair tax system** which encourages work and saving, raises sufficient revenue to pay for high quality public services, and tackles tax abuse and avoidance.

INTRODUCTION

5.1 The previous chapters set out how the Government is helping to build a strong and stable economy for the long-term, based on high and stable levels of growth and employment. But Britain's prosperity cannot be measured by these factors alone. A strong and productive economy must be underpinned by fairness and inclusion, enabling every individual to fulfil their potential - regardless of gender, disability, ethnicity, age, family circumstance, or the area in which they live.

5.2 The Government believes that where work is an option, it remains the best route out of poverty and social exclusion. Work brings with it independence for workers and their families. Chapter 4 sets out the Government's strategy to provide employment opportunity for all.

5.3 Social inclusion and the spread of opportunity to all are therefore at the heart of the Government's economic agenda. The Government recognises that while those who can work have a responsibility to do so, those who cannot have a right to security and support. But it also believes that opportunity has to be viewed dynamically, so that opportunity is not one-off but repeated and continuous. Support must be available at the right time in people's lives, to tackle problems before they take root, and to prevent opportunities being denied.

5.4 In particular, this means tackling child poverty, which is still at an unacceptably high level. The Government is committed to the eradication of child poverty within a generation, ensuring that people's life-chances are no longer unfairly determined by their childhood circumstances. This is why the Government is targeting financial help on those families, with children, who need it most, and developing new services to support children from particularly deprived backgrounds.

5.5 A fair society is also one that guarantees security for people in their old age. The Government is committed to ensuring that all pensioners share in the country's rising prosperity, creating a system of support for pensioners that is sustainable in the long term and targets most resources on those pensioners who need them most. For many people, savings - however modest - are a good way of ensuring security and independence. The Government wants to promote the right environment for supporting those who make provision for the future by saving some of their income.

5.6 Excellent public services, accessible to all, are essential to the development of a society that is fair and just. The availability of high quality education and health services, and the standard of public infrastructure, are key determinants of quality of life. The Government is committed, through the 2000 Spending Review, to a large programme of increased investment in Britain's key public services, with the long-term aim of bringing standards up to those of the very best.

5.7 The opportunity for the Government to make sustained increases in investment in public services depends partly on maintaining high and stable levels of economic growth. But it also requires prudent management of the public finances, based on a tax system in which everyone pays their fair share.

5.8 This chapter describes how the Government is applying these principles to help deliver a fairer society and a better quality of life for all. It describes 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

5.9 Over the past two decades, while the economy has grown, the proportion of children living in low-income households has more than doubled. This has denied opportunities to many in society and has also restricted the economy from growing at its full potential.

5.10 Alongside the rise in the number of children in low-income households, families with children overall have taken a decreasing share of national income. Between 1979 and 1995-6, average incomes after housing costs rose by 35 per cent for working households with children, and by 43 per cent for those without.

The challenge of child poverty

5.11 The Government's aim is for every child to have the best possible start in life. A substantial body of evidence suggests that children who grow up in low-income households experience disadvantage and lack of opportunity that affect not only their own experience as adults but also the life chances of their children.[1]

5.12 Lack of opportunity is of greatest concern when it persists between generations - when an individual's life chances are determined by their family background, rather than by their own skills and aspirations. Children's outcomes as adults are clearly related to their families' economic circumstances. For example, evidence shows that:

- the sons of the lowest paid are more than five times as likely to be in the lowest income quartile than the sons of the highest paid. Between 40 and 70 per cent of a child's earnings in adulthood can be related to his or her parents' earnings; and
- although children frequently do end up in a different economic position from their parents, for most people the movement is limited.

5.13 The influence across generations is strengthened further as children who grow up in disadvantaged families are more likely as adults to be dependent on benefit and unable to afford their own home. Daughters from disadvantaged families are also more likely to become teenage mothers.

5.14 Educational development over the first ten years of a child's life is linked to a range of factors that are more likely to occur in disadvantaged families, such as large family size, housing overcrowding and unemployment of the father. Even after allowing for such characteristics, low income has an additional adverse impact on educational outcomes. Children who grow up in poverty have poorer school attendance records, are less likely to remain in school at or beyond 16, and are up to ten percentage points more likely to have no qualifications. The effect of poverty on education may explain around half of the impact of childhood disadvantage on adult economic and social outcomes.

5.15 It is unacceptable that children's life-chances are affected by their family circumstances in this way. This is why the Government has set a long-term commitment to halve child poverty within ten years and to abolish it within a generation. A new milestone along the way is the 2000 Spending Review Public Service Agreement to reduce by at least a quarter by 2004 the number of children living in households with an income of less than 60 per cent of the median.

5.16 Child poverty is a complex problem. It 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;
- **targeted interventions** such as the Sure Start programme for those with additional needs and at key stages in life, particularly where there are very young children;
- **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; and
- **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.

5.17 The Government's second annual report on tackling poverty and social exclusion[2]sets out progress the Government has made in these areas and the scale of the task ahead. The report sets out a range of child poverty indicators, including a set of five headline indicators covering low income, worklessness, education, housing and health to monitor progress towards eradicating child poverty in 20 years. The report makes the commitment to improve the lives of children in all of these key areas.

5.18 The Government is making progress in tackling the high levels of poverty that built up over the past two decades:

- over 1.1 million families are currently claiming the Working Families' Tax Credit, around 300,000 more than received its predecessor, Family Credit, at its peak;
- families receiving the Working Families' Tax Credit are receiving on average £30 a week more than under Family Credit;
- couples on Income Support with two children under 11 are now nearly £30 a week better off in real terms than in 1997; and
- in the three years to spring 2000, the number of children living in households where no-one is in work fell by more than 250,000.

Financial support for families with children

5.19 The Government's approach to tax and benefit reform for families with children is underpinned by two principles:

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

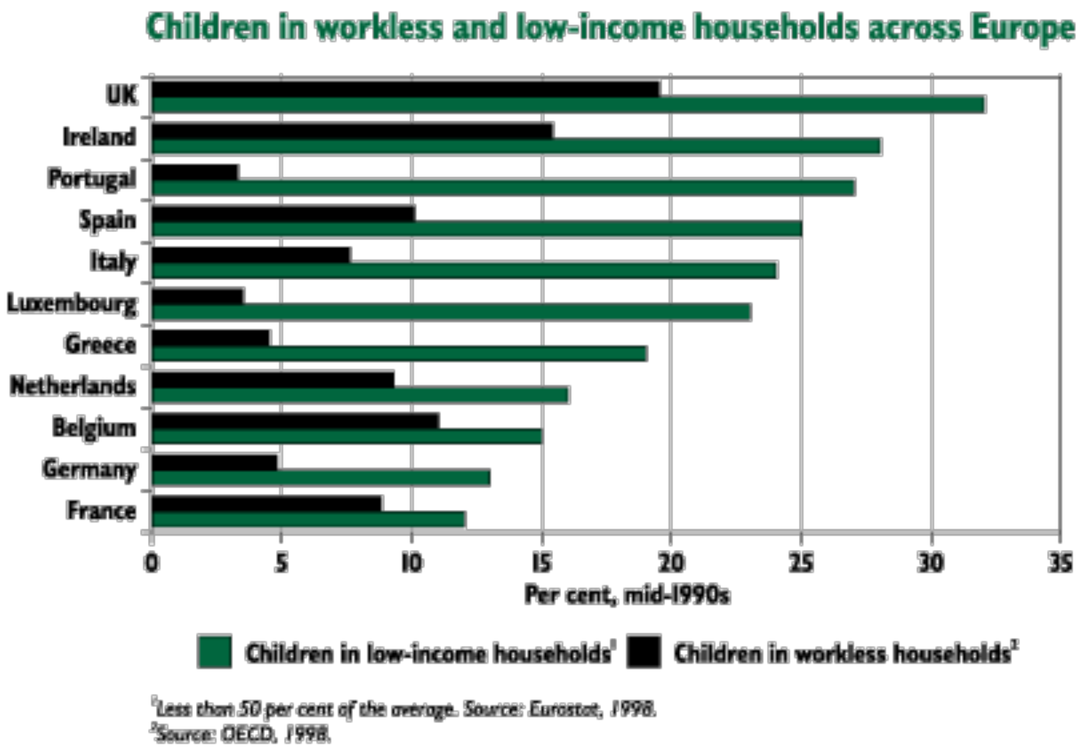
5.20 With these principles in mind, the Government has introduced the following changes over the Parliament so far:

- **record increases in Child Benefit, with a 26 per cent real increase in the rate for the first child since 1997.** By April 2001 Child Benefit will be worth at least £15.50 a week for the first child and at least £10.35 a week for subsequent children;
- **replacing the married couple's allowance with a new Children's Tax Credit, to be introduced in April 2001.** The Children's Tax Credit will be worth up to £442 a year and will give extra help to around 5 million families with children under 16;
- **the introduction of the Working Families' Tax Credit** in October 1999, to make work pay for low and middle-income working families with children; and
- **increases in Income Support and other income-related benefits.** Rates for children under 11 have been increased by 72 per cent in real terms since 1997. With the latest increases, from October this year, a lone parent on benefit with two

children under eleven is now at least £1,300 a year better off and a couple £1,500 a year better off compared with 1997.

Box 5.1: Workless households and low incomes

The UK has one of the highest proportions of children living in workless households in the EU. In spring 2000 the total number of children living in workless households was around 1.9 million. Worklessness is the biggest single cause of low-income for households with children. In 1998-9 around 60 per cent of children in low-income households were in households with no adult in work. The chart below shows the percentage of children in workless households and low-income households among European countries in the mid-1990s.



One of the key features of worklessness in the UK is the high proportion of lone parent workless families. In spring 2000, lone parent families accounted for two out of three workless families. Box 4.2 discusses the Government's measures focused on lone parents.

The problems of worklessness in Britain today are not due to a simple lack of jobs. The challenge is two-fold: to maintain high and stable levels of employment so that vacancies are available throughout the country, and to equip those people who have missed out on growing employment opportunities to take up those vacancies, so that growing prosperity reaches into every community. The 2000 Spending Review announced an increase in the resources available to help people move from welfare to work, and the tax and benefit reforms introduced in this Parliament will continue to ensure that work is financially rewarded.

Over this Parliament, the Government has started to see real progress in tackling the problem of worklessness. The number of children living in households where no-one is in work fell by more than 250,000 from 17.9 per cent of all children in working age households in spring 1997 to 15.8 per cent in spring 2000. The fall over the last year alone was more than 180,000, with over half of this occurring in lone parent families.

5.21 Chart 5.1 shows that the Government has increased support for all families with children. It also shows that the greatest increases have been targeted on families on lower incomes.

Chart 5.1

5.22 As a result of measures announced so far in the current Parliament, by 2001:

- a family with two children and gross earnings of £12,500 will be £2,600 a year better off in real terms; and
- a family on average earnings of £25,000 and with two children will be £370 a year better off, as well as having the lowest direct tax burden since 1972.

Chart 5.2

Box 5.2: A better-integrated system of support for children

While reforms so far in the current Parliament have achieved significant progress in securing the Government's aims, there is still a lot more to be done. However, progress is constrained by the nature of the tools the Government has at its disposal. Looking to the longer term, the Government wants to create a tax and benefit system for the 21st century that will enable it to deliver on its child poverty and employment ambitions.

As set out in Budget 2000, the Government therefore intends to introduce a new system of support, which will bring together payments for children currently made through the tax and benefit systems. A single tax credit will integrate the different strands of support for children available through the Working Families' Tax Credit, the Disabled Person's Tax Credit, Income Support/Job Seekers' Allowance and the Children's Tax Credit, building on the foundation of universal Child Benefit. This tax credit will be paid directly to the main carer in families in and out of work. It will be complemented by an employment tax credit for people in work (as set out in Chapter 4). The new tax credits will be administered by the Inland Revenue, and, subject to the legislative timetable, will be introduced from 2003.

This better-integrated system for supporting children will have the following advantages:

- transparency: bringing together all the income-related payments supporting children will make it simpler for parents to understand how much they can expect to receive. Currently, child elements of income-related benefits and tax credits are mixed with adult elements into a single payment;
- security: the integrated system will provide a secure income bridge to support children that covers families in and out of work, and helps people in the important transition from welfare to work;
- a combination of universal and targeted support: building on the foundation of universal Child Benefit, a single framework for assessment and payment of income-related support will allow extra resources to be directed at those most in need;
- payment: all support for children will be paid to the main carer; and
- simplicity: a single mechanism will produce efficiency gains for government and reduce hassle for parents.

This approach is similar to that adopted by a number of other countries. The Canada Child Tax Benefit, for example, provides support for children regardless of whether their parents are in or out of work. This is an important element in a wider series of reforms aimed at reducing child poverty, tackling the unemployment trap and promoting attachment to the labour market.

5.23 Over the Parliament as a whole, the tax and benefit measures introduced will lift around 1.2 million children out of poverty. Chart 5.2 above shows that all families have gained from the Government's measures to support children, but that the largest gains have been by those on the lowest incomes.

Support for families in the early years of a child's life

5.24 Around two fifths of children are born into poverty. Mothers on low incomes face particularly difficult and restricted choices about how they help 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 - some of the lowest-paid women have not been entitled to maternity pay or to tax credits when their child is first born.

5.25 During this Parliament, a number of reforms have been introduced to address these problems, and better reflect the needs of new parents on low incomes:

- **extending maternity pay:** entitlement to the Maternity Allowance has been extended to around 16,000 low-earning women who were previously unable to claim it (those earning at least £30 a week but less than the lower earnings limit). The allowance has also been increased for self-employed women, benefiting around 11,000 women by an extra £7.95 a week;
- **introducing a new maternity grant:** the new Sure Start Maternity Grant replaced the Maternity Payment from April 2000, and, as announced in Budget 2000, will be increased to £300 from December 2000. The grant is linked to contact with a healthcare professional to ensure expert advice on child development and services. It will be available to over 200,000 mothers in low-income families every year. **By October 2001, the £500 capital limits in the Sure Start Maternity Grant will be abolished to ensure that families on low incomes receive help to cover the costs associated with the birth of a new baby.** This will benefit up to an additional 15,000 low-income families every year; and
- **making tax credits more responsive when a child is born:** reforms announced in Budget 2000, and to be implemented in April 2001, **will allow mothers to qualify for the Working Families' Tax Credit when they are on**

maternity leave (claiming 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 renew their WFTC claim as soon as a new child is born, rather than having to wait until their old claim expires. This gets the extra support for the new baby - plus any increase in payments because their income has dropped - to the family more quickly.

5.26 In making these reforms, the Government is ensuring that more help is directed towards the poorest families, to give these mothers more choice about how they support their family around the birth of a child and whether and how to plan a return to work.

5.27 In Budget 2000, the Chancellor announced a review of what further improvements might be made to maternity pay and parental leave. The review is being led by the Secretary of State for Trade and Industry, and the intention is to publish a formal consultation document before the end of this year. The Government will bring forward firm proposals in the light of the responses it receives.

Public services to tackle child poverty

5.28 The Government is committed to tackling the causes of poverty and social exclusion, not just the symptoms. This principle formed the basis for many of the announcements in the 2000 Spending Review.

Children's Fund

5.29 The 2000 Spending Review announced resources of £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 itself, for children of all ages.

5.30 Problems facing children and their families are often multi-dimensional. To make a real difference, support needs to be integrated, for example through learning mentors, out of school activities and parenting support. The preventative stream of the Children's Fund will aim to develop services so that children at risk of social exclusion and failure are identified early and provided with a package of support which enables them to overcome barriers and disadvantage, and start to meet their aspirations.

5.31 The Children's Fund will engage voluntary and community groups both through the network of local funds and by ensuring that they are closely involved in drawing up and delivering proposals for increased preventative services. The Government is hosting a conference in November 2000 to help develop the Children's Fund and engage the views of key players including the voluntary and community sector, private sector, local government and young people themselves.

Sure Start

5.32 Sure Start is a central part of the Government's campaign to eradicate child poverty by 2020. The programme is committed to tackling the causes of poverty and social exclusion by working with parents and children to promote the physical, intellectual and social development of pre-school children. Initially, the Government committed funds to the creation of 250 local programmes by 2001-02. Of these, 129 programmes are already in place. Sure Start programmes are managed by local partnerships between local parents, private and voluntary organisations and statutory services, to offer a coherent, joined-up service that addresses local needs.

5.33 Significant further investment in the 2000 Spending Review demonstrates the Government's determination to ensure wider coverage for the Sure Start programme. **The new money includes provision for a major geographical expansion of Sure Start - doubling the number of programmes to at least 500 by 2004 and more than doubling planned expenditure to almost £500 million by 2003-04.** By 2004, Sure Start will reach one third of poor children under four years old. The Government is currently looking at ways to integrate Sure Start practice into all services for under-5s as part of its overall strategy for halving child poverty by the end of the decade.

5.34 Sure Start is an evidence-based policy, drawing on the results of numerous studies conducted in the US and elsewhere. This research shows that the environment a child is exposed to, both during pregnancy and in the first years after birth, is crucial to later development. Focused intervention in early childhood can significantly improve the development and life opportunities of a child. For example, Sure Start is committed to developing local services for pregnant women: Budget 2000 increased the Sure Start Maternity Grant, and the 2000 Spending Review includes additional resources for local services for pregnant women, setting a new public service agreement target of a 10 per cent reduction in the number of mothers in Sure Start areas who smoke during pregnancy by 2004.

The importance of a good start in education

5.35 Education is an important influence on a child's life chances. It is critical to employment opportunity and to the well being of people throughout their lives. Together with extra resources provided in Budget 2000, the 2000 Spending Review allocated resources that will result in average real growth in education spending of 6.6 per cent a year across the UK over the four years from 1999-2000 to 2003-04.

5.36 Strong numeracy and literacy, together with good communication and technology skills, are essential prerequisites for making the most of the opportunities offered by the modern economy. Good progress has already been made, particularly in primary schools. For example, between 1998 and 2000 the number of pupils achieving the standard expected for 11 year-olds in maths rose by 13 percentage points, to reach 72 per cent; while in literacy there was an improvement of 10 percentage points, to 75 per cent. Schools across the country are well on course to achieve the existing targets for 2002 of 75 per cent in maths and 80 per cent in literacy.

National e-Learning Foundation

5.37 Learning through ICT boosts attainment, with the greatest gains often experienced by the most disadvantaged children. **The Government has decided to allocate £5 million additional money from the windfall tax reserve to help establish the National e-Learning Foundation.** Building on pilots run over the last two years, this will lever-in significant private sector funding to provide portable ICT equipment offering Internet access. It will be targeted at the most disadvantaged areas first, where the digital divide is greatest.

Connexions

5.38 The 2000 Spending Review provided for the progressive introduction of the Connexions personal adviser service to support young people aged between 13 and 19 to remain in education or undertake training. As a young person's vulnerability increases, more help will become available. Alongside Connexions, there will be an expansion of other services for vulnerable young people, such as the treatment of drug and mental health problems.

Educational Maintenance Allowances

5.39 Educational Maintenance Allowances (EMAs) are enabling young people from poorer families to pursue education beyond the age of 16. Budget 2000 announced an extension of the pilots to enable local education authorities in 56 of the most disadvantaged areas across England to provide EMAs from September 2000. As set out in the 1998 Comprehensive Spending Review White Paper, "if successful, EMAs would replace Child Benefit after 16 for those staying in education beyond their GCSEs".[3]

5.40 Although it is too soon to reach a judgement about the success of EMAs, evidence from early evaluation of the pilots is encouraging. This includes an estimated increase in participation rates during the first year of around five percentage points. In addition, there have been significant improvements in attendance, effort and quality of coursework. The approach of linking payment of EMAs to delivery of the student's 'learning agreement' has proved particularly successful.

FAIRNESS FOR PEOPLE WITH DISABILITIES

5.41 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 set out in Chapter 4, increases the gains to work for people with disabilities and removes the administrative complexity of a separate benefit claim and cheque. 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.

Disability Income Guarantee

5.42 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 £134 a week for single people, and £176 a week for couples. **The Secretary of State for Social Security will be announcing a further £200 million a year package of measures to help disabled people and carers in the coming days.**

5.43 Also from April 2001, children aged three to four with severe disabilities will receive an additional £37.40 a week through the extension of the Disability Living Allowance. Reforms to Incapacity Benefit will provide up to £26.70 a week more for people who were disabled before the age of 20.

5.44 From January 2000, the maximum earnings disregard in the Independent Living Fund was increased from £30 to £106.50 per 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.

5.45 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 21 years.**

FAIRNESS FOR PENSIONERS

5.46 Over the past 20 years, the gap between rich and poor pensioners has grown so that pensioner incomes are now as divergent as those of the population as a whole. The Government is committed to developing policies which enable all pensioners to share in the country's rising prosperity, and which tackle this growing inequality. This means:

- acting to end 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 retirement; and
- treating pensioners in the tax system fairly, and paving the way to further tax-benefit integration.

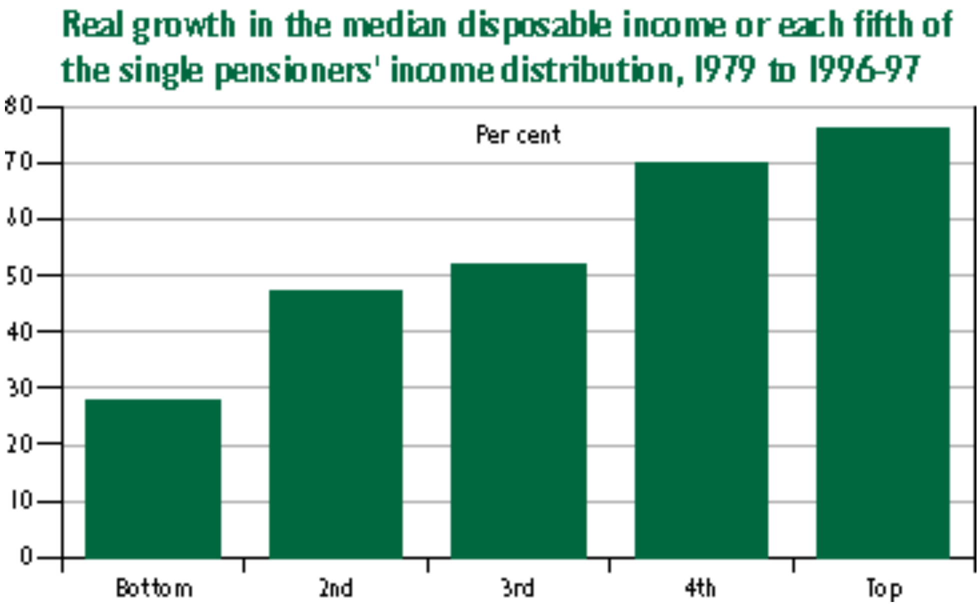
Box 5.3: Pensioner incomes

Over the last 20 years, the gap between rich and poor pensioners has grown dramatically wider. In this period, the incomes of the richest fifth of pensioners rose by 80 per cent, but the incomes of the poorest grew by only 30 per cent. By comparison, during the same period, average earnings grew by 36 per cent.

The first reason for this growing inequality in pensioner incomes is that more people have been retiring with good occupational pensions, and more pensioners have investments and savings. In 1998-99, average disposable income was £141 a week for single pensioners and £272 a week for pensioner couples - more than double the level of the basic state pension. One in six pensioner couples now retires on an income of £20,000 a year or more.

State pensions and benefits have also served to increase inequality. Over the last 20 years the growth in average benefit income has been significantly higher for better-off pensioners than for the poorest. This is largely due to SERPS, the state earnings-related pension, which pays more to those who earned more during their working life and which matured in 1998. By the 1990s, the progressive effect of state support for pensioners was negligible. The poorest pensioner couples received lower levels of benefit income and state pensions than middle-income couples.

This is why the Government believes that the first priority was to target resources on the poorest, followed by those on low and modest incomes. Planning for the future on the basis of the earnings link in the basic state pension would not do enough to help those pensioners in most need, or to tackle and reduce these inequalities. This is why the Government is spending substantially more on the Minimum Income Guarantee and introducing a Pension Credit from 2003.



Tackling pensioner poverty

5.47 The Government's first priority has been to help those in greatest need. The pattern of pensioner incomes now reflects that of earners. Like earners, the top fifth of pensioners are now three times better off than the lowest fifth. As this gap between the richest and poorest has widened, too many pensioners have not shared in the rising prosperity of the country.

Minimum Income Guarantee

5.48 To address this first priority quickly, the Government built on the existing structure of 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 the incomes of these pensioners have kept pace with the incomes of the wider population. Around 2 million pensioners now benefit from this extra support, and the Government has been running the largest ever advertising campaign and simplifying the claims process to promote further take-up of the MIG.

5.49 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. As a result, half a million pensioners will gain an average of £5 a week.**

5.50 To help protect future pensioners from the poverty and inequality today's pensioners have had to endure, the Government is giving today's workers a real 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 lower paid workers, and for carers and the disabled. Some 18 million people stand to gain from the introduction of the **State Second Pension**; and
- **Stakeholder pensions** which will provide a safe, flexible, low-cost way to save for retirement for moderate and higher earners.

Security for all pensioners

5.51 The Government is also committed to ensuring security in retirement for all pensioners, not just the poorest, so it has introduced:

- **winter fuel payments**, paid to every household with someone over 60 - 8.5 million in total - each winter. When introduced in 1997, this payment was worth £20, and was then increased further to £100 last winter. Budget 2000 increased the winter fuel payment, and set this at £150 for future years;
- **from November 2000, concessionary TV licences for households with someone aged 75 or over.** Over 3 million households will benefit - 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; and

- as set out in Chapter 6, measures to combat fuel poverty through the Home Energy Efficiency Scheme, the Government's Affordable Warmth Programme, a reduced VAT rate of five per cent to grant-funded installation of heating systems, and a reduced rate of VAT on domestic fuel.

5.52 The Government is also determined to ensure that pensioners who pay tax are treated fairly. Six out of ten pensioners aged 65 and over do not have any income tax to pay. But for those who do, the Government has made a series of changes to the tax system to ensure that pensioners who have provided for their retirement continue to enjoy this security:

- over 4 million pensioners benefited from the introduction of the 10 pence starting rate of income tax on pensions, savings income and earnings from April 1999;
- almost 3 million older people who pay income tax benefited from the reduction in the basic rate to 22 per cent from April 2000; and
- for 2000-01, the personal tax allowances for people aged 65 or over increased to £5,790 for someone aged 65 to 74, and to £6,050 for someone aged 75 or more. These increases built on the above-indexation increases in the allowances for 1999-2000, so no-one aged 65 or over need pay any income tax until their income reaches at least £111 a week.

5.53 In order to simplify the tax system for older taxpayers, the Government has decided to announce changes to the levels of the age-related tax allowances in the preceding Pre-Budget Report for the years 2001-02 and 2002-03. This will mean that people see the benefit of increases in the allowances from April and will help to make their tax affairs easier to understand. **The age-related personal allowance will rise in 2001-02, in line with prices, to £5,990 for people aged 65-74 and to £6,260 for people aged 75 or more. The income limit for these and other age-related allowances will also rise in line with prices.**

'Taxback' campaign

5.54 The Government has also recently launched a 'Taxback' campaign to encourage pensioners and other savers to claim back any tax due to them. It is estimated that there is around **£100 million to be claimed by some 1.5 million pensioners**.

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

5.55 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 just for the very poorest, but also for those on low and modest incomes.

Need for radical reform of the current system

5.56 The Government's priority for the next Parliament is therefore to reward savings for those on low and modest incomes. Too many pensioners work hard to provide for their retirement, building up second-tier pensions or other savings, only to find that they get little or no benefit from them. The current system has been successful in getting more help more quickly to those in greatest need. But it still:

- sets a savings trap. It penalises those on the MIG for every pound of pension they have built up. And those with incomes just above the MIG feel let down because they are so little better off: an 80-year-old with £20 a week of occupational pension and full basic state pension will find herself just one or two pounds a week better off than someone who has saved nothing. It also excludes some pensioners, through unfair capital rules, from extra support because they have built up a small amount of savings; and
- involves an intrusive weekly means test, which contrasts with the less burdensome annual cycle for wealthier pensioners in the tax system, making some pensioners reluctant to claim their entitlement. The six different rates in the current MIG, ranging from £78.45 a week for a single pensioner to £131.05 a week for a couple, also add to the complexity that deters many pensioners from claiming.

The Pension Credit

5.57 The Government is determined to tackle the inequalities and unfairness of the current system. Budget 2000 said that the Government intended to examine for the longer term whether, through an income taper or other measures, the MIG could provide extra help to people who have provided for themselves. **The Secretary of State for Social Security is therefore publishing, for consultation, detailed proposals for a Pension Credit to be introduced from 2003.** The Pension Credit 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-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.**

5.58 By linking the guaranteed minimum income and maximum Credit rate to earnings, the Pension Credit will ensure that **low and modest income pensioners on the Credit will get, year on year, an increase in support greater than they would receive from an earnings link in the basic state pension.** So, based on trend forecasts, an 80-year-old with a basic pension of £77.00 a week and a Pension Credit of £20 a week will get £4.30 a week more the following year, more than the £3.45 a week delivered by linking the basic state pension to earnings.

Increases for pensioners who pay tax

5.59 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.

5.60 Most pensioners have no income tax to pay. But for those who do, **the Government proposes, subject to consultation, 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 £6560 for those aged 65 to 74 and to £6850 for those aged 75 or more.** The Government then proposes to increase the allowances by reference to the rise in earnings rather than prices throughout the remainder of the Parliament. In the same way that a pensioner on an income of £130 a week will be entitled to a Credit of £2 a week extra, so a pensioner paying tax at 22 per cent on income of £170 a week would receive £1 extra a week in 2003-04 through this more generous tax allowance. Over 3 million pensioners aged 65 or more would benefit from the increase.

5.61 In designing the Credit, the Government is seeking ways to build upon the progress made since 1997 in bringing the tax and benefit systems closer together. That progress is set out fully earlier in this chapter and in Chapter 4. This programme of tax-benefit integration has been informed by the following principles:

- **to tackle poverty,** minimum levels of income should be guaranteed for the most vulnerable groups in society - the elderly, families and the sick and disabled;
- **to promote incentives to work and save,** the tax burden and high marginal tax-benefit withdrawal rates at the lower end of the income distribution should be reduced;
- **to maximise take up,** the stigma and hassle of claiming support should be reduced;
- **to ensure that support is targeted at those who need it most,** new credits should be assessed on a household basis where possible, while respecting the principles of independent taxation that each person should be taxed on their own income and have their own income tax allowance and rate bands; and
- **to improve customer service and increase efficiency** in Government, the administration of tax and benefits should be brought closer together.

5.62 The Pension Credit and associated changes build on these principles and represent a further step towards tax and benefit integration. The consultation document to be issued by the Secretary of State for Social Security will explain these changes in more detail. 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.

Moving towards a Pension Credit

5.63 The new Pension Credit will deliver substantial gains to all pensioners on low and modest incomes from 2003. But ahead of this, the Government is determined to deliver benefits to them straight away. The Government will therefore:

- **increase the winter fuel payment, which is set at £150 for future years, to £200 this winter.** So this winter, 8.5 million pensioner households will be eligible for a payment of £200 - almost £4 a week - double the amount of last year's payment;
- **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 of a further £4.80 to £120.70 a week in April 2002; and
- **increase the lower rates of the MIG** to equal its highest rate, raise this by earnings and further, by the real increase in the basic state pension, so that all pensioners gain fully from the increase in the basic state pension. **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 forecasts, from 2003, when the Pension Credit is introduced, the earnings-linked guaranteed minimum income will be at least £100 a week for single pensioners, and for couples at least £154 a week. By then, reflecting the return to normal price uprating, the basic state pension will be at least £77 a week for single pensioners and £123 a week for couples.

5.64 As Chart 5.3 shows, all pensioners will have gained from the Government's measures during this Parliament, with those in greatest need benefiting the most. Next year, around
2 million of the poorest pensioner households will be at least £15 a week, or £800 a year, better off in real terms as a result of the Government's measures since 1997.

Chart 5.3

5.65 The Government's tax and benefit reforms will mean that next year the average pensioner household will be £580 a year - £11 a week - better off. Virtually all pensioner households will be better off as a result of the Government's measures than they would have been with an earnings link in the basic state pension. Next year, the Government will be spending over £2 billion more on the poorest third of pensioners - five times more than an earnings link in the basic state pension would have given them.

SUPPORTING SAVING

The Government's savings strategy

5.66 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. The Pension Credit will ensure that people who have saved for their retirement are not unfairly penalised. The Government is 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.

5.67 These measures fit within the Government's overall strategy to encourage saving, which is to:

- **create the right environment for saving:**
    - a stable macroeconomy with low inflation;
    - employment opportunity for all;
    - a well-regulated and efficient market in financial services;
    - flexible and accessible savings products; and
    - an integrated and coherent approach to saving;
- **create the right incentives for people to save:**
    - a tax system with greater incentives to save, particularly for low-income savers;
    - a tax and benefit system that does not unfairly penalise savers; and
    - lower charges to enhance the rewards to saving; and
- **provide information and education to help people make the right saving choices:**
    - clear, impartial information; and
    - greater financial literacy.

5.68 Further details of the Government's strategy are set out in the Treasury paper *Helping People to Save*[4], published alongside the Pre-Budget Report.

Individual Savings Accounts (ISAs)

5.69 Individual Savings Accounts (ISAs) were introduced in April 1999 to encourage tax-free saving, particularly among lower-income savers. In the first year, 9.3 million accounts were opened and over £28.4 billion invested - 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. More than £9 billion has been invested in ISAs during the first quarter of 2000-01.

5.70 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 per year, compared with around one in five TESSAs and one in six PEPs[5]. **To build on the success of ISAs, the Government will retain the £7,000 contribution limit for a further five years until April 2006.** Keeping a higher £3,000 limit for cash will particularly help those low-income and younger savers who have saved in mini cash ISAs. **From April 2001, this will include 16 and 17-**

year olds, who will be able to save in a cash ISA for the first time. There are 100,000 16 and 17 year-olds who work and pay tax and could benefit from the opportunity to save tax free.

Encouraging small savers

5.71 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 will continue to look at ways of encouraging people on low and moderate incomes to save.

Fair treatment for savings

5.72 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. **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.

An integrated approach to saving

5.73 People have wide-ranging saving needs for the short and longer term. ISAs and stakeholder pensions provide simple, flexible products that meet those needs. The Government is also making the savings system more integrated by improving transferability between vehicles. New tax rules for pensions will allow someone to contribute at least £3,600 a year regardless of earnings, allowing them to start saving in an ISA and transfer the money into a pension when they are ready to save for the longer term. Also, anyone who builds up substantial shareholdings in a new All-Employee Share Ownership Plan will be able to transfer shares directly into an ISA or a stakeholder pension. The Government wants to increase flexibility where possible and is currently investigating with the pensions industry whether it would be useful in practice to allow certain eligible ISA collective investments to be transferred directly into a stakeholder pension and to be placed in an Individual Pension Account.

Transparent savings products

5.74 To give people confidence to take out ISAs and other financial products, the Government developed CAT standards as voluntary benchmarks for **c**harges, **a**ccess and **t**erms. A study of the ISA market, carried out for the Treasury by McKinsey's, has found that CAT standards have helped ISA savers achieve value for money. They have set an interest rate floor for cash ISAs, while a typical saver investing in a CAT-standard equity ISA would pay £35 a year less in charges than someone investing in a non-CAT ISA.

Competitive financial services

5.75 The Government wants to promote effective competition in the financial services industry. **The Treasury has therefore endorsed proposals from the Financial Services Authority (FSA) to work towards modernising the regulations on how retail investments are sold** (see Box 5.4).

Box 5.4: Polarisation

Since 1988, the market for retail investments has been polarised. That is, FSA rules have insisted that retail sales firms must either offer the products of only one group of firms, or be fully independent and offer their customers access to the whole market.

The Director-General of Fair Trading reported in 1999 that aspects of these rules were significantly anti-competitive and should be reformed. Independent research for the FSA, published in July 2000, foresaw that liberalisation of the rules would improve market competition, with scope for lower prices and greater variety of choice for consumers, without undermining the role of independent financial advisers.

The FSA is now planning proposals to update polarisation in two stages. Subject to consultation, the first phase, aimed for spring 2001, will reform the rules covering investment in stakeholder pensions, potentially CAT-standard ISAs, and direct sales offers including new developments such as Internet fund supermarkets. These are all areas where consumers often feel confident to select for themselves.

The second phase will extend reform to the full range of retail investment products, with scope for radical change, drawing on work the FSA plans on improving disclosure arrangements for a wide range of retail investments. This stage of reform will take longer to bring into effect but could have a significant effect on the structure of the market for retail investments. The aim is to deliver a better choice for consumers through more effective competition and enhanced transparency.

Information on financial products

5.76 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 published first, in early 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. The Government will work with the FSA to consider ways of increasing access to good, impartial information and advice for low-income savers.

HIGH QUALITY PUBLIC SERVICES

5.77 By ensuring that tough fiscal rules are met and economic stability is maintained the Government has been able to free significant resources to strengthen Britain's public services. The Government is committed to improving frontline public services in order to achieve its priorities.

5.78 The 2000 Spending Review provides for a doubling of net investment in infrastructure over the next three years (see Box 5.5) to deliver integrated transport and modern schools and hospitals, while current spending will increase by 2.5 per cent a year in real terms. Three-quarters of this increase will be spent on the Government's priorities of health, education, transport, housing and law and order.

5.79 On a consistent basis, £43 billion of additional funding has been allocated to Departmental Expenditure Limits by 2003-04 (see Table B15). This provides for average real growth for the three years from 2000-01 of 5.2 per cent a year for education (UK); 5.6 per cent a year for health (UK); 20 per cent a year for transport; 12 per cent a year for housing; and 4.2 per cent a year for the criminal justice system. The Government is able to afford these increases to deliver improvements in key public services because of prudent management of the public finances, its success in reducing unemployment and by dealing with fraud and unnecessary bureaucracy.

Chart 5.4

Box 5.5: Investment in public services

The Government is committed to boosting the public sector's capital stock as an integral part of improvements to public services.

Net public investment is set to more than double, from £7 billion in 2000-01 to £18 billion in 2003-04. This will deliver:

- a two-and-a-half fold increase in transport investment;
- a further £1.5 billion for education to enable several thousands of schools a year to receive renovation and modernisation;
- a further £1.4 billion for the NHS, building on the 38 major hospital plans already approved since May 1997;
- a £1 billion programme of investment in science laboratories; and
- £1 billion of investment to ensure public services can be delivered online.

This is enhanced by Private Finance deals anticipated to be worth around £12 billion over the three years from 2000-01. Investment is accompanied by rigorous Departmental Investment Strategies setting out how government departments will deliver concrete outcomes. These will be published by each department, along with a summary White Paper, later this month.

Public Service Agreements

5.80 The quality of public services, however, depends not only on how much the Government spends but also on how effectively it spends it. Following the Comprehensive Spending Review in 1998, the Government introduced a new system of performance management for public expenditure. The 2000 Spending Review allocates spending and sets out in Public Service Agreements (PSAs) the outcomes that every part of government will deliver to the public. It details the improvements in public services the public can expect over the next three years and describes how the Government will allocate its funds to achieve these improvements.

5.81 The publication of PSAs is an important step in improving democracy, transparency and accountability. PSAs are agreements with the public, showing the taxpayer exactly what the Government will deliver in return for his or her investment. By publishing clear and measurable targets, the Government is making it possible for everyone to judge whether it meets them.

5.82 This is the most ambitious attempt internationally to set explicit goals for outcomes across the whole of Government. On 3 November, departments published their plans for the good management of their resources to achieve these objectives in new Service Delivery Agreements (SDAs).[6]

A modern National Health Service

5.83 In Budget 2000 the Government announced a substantial increase in health funding, with growth averaging 6.1 per cent a year in real terms over the four years to 2003-04. This is the longest period of sustained high growth in the history of the NHS, and will fund extra investment in NHS facilities such as new hospitals and increases in numbers of doctors and nurses. The 2000 Spending Review also increased social services funding significantly in real terms to provide resources for the elderly, children and other vulnerable groups. Challenging new PSA targets include:

- to reduce the maximum wait for an outpatient appointment to three months, and the maximum wait for inpatient treatment to six months by the end of 2005; and
- to reduce substantially by 2010 the mortality rates from major killers - from heart disease by at least 40 per cent in people under 75, and from cancer by at least 20 per cent in people under 75.

5.84 The Government needs to look further ahead to ensure that the NHS will always have access to the level of public funding that it needs to provide a comprehensive, high-quality service available on the basis of clinical need and not on ability to pay. Budget 2000 announced that the Chancellor is commissioning a long-term assessment of the technological, demographic and medical trends over the next two decades that will affect the health service, to report to him in time for the start of the next spending review in 2002.

Education

5.85 The extra funds for education announced in the 2000 Spending Review will add over £10 billion to spending on education and training in England by 2003-04. A 33 per cent real increase in spending is projected for UK education between 1996-97 and 2003-04. These funds will enable schools, colleges and universities to achieve even higher standards. PSA targets from the 2000 Spending Review include:

- to increase the overall percentage of pupils obtaining five or more GSCEs at grades A* to C, with at least 38 per cent to achieve this standard in every local education authority by 2004; and
- to increase the participation of 18-30 year olds in Higher Education towards 50 per cent by the end of the decade.

Extending the New Deal for schools

5.86 To tackle further the backlog of repairs in schools, and to ensure that our children are learning in a suitable environment, **the Government will invest a further £200 million in school buildings across the UK in 2000-01.** These resources have been released from the revenue raised by the windfall tax, due to lower unemployment, and will be additional to those made available for schools in the 2000 Spending Review.

Transport

5.87 The Government is committed to transforming the country's transport system with public investment rising to over £6 billion a year by 2004, a doubling in real terms. The Ten-Year Plan for Transport will reduce road congestion, produce better and more reliable trains, and deliver a renaissance in local public transport. New PSA targets include:

- to increase rail use in the UK from 2000 levels by 50 per cent by 2010, while at the same time securing improvements in punctuality and reliability; and
- to reduce congestion in the road network in England below current levels by 2010, by promoting integrated transport solutions and investing in public transport and the road network.

Tackling crime

5.88 To build a safe, just and tolerant society the Government is tackling crime and strengthening communities by raising police spending to record levels, making major investment in local crime prevention and setting challenging targets for reduction in vehicle crime, burglaries and robberies. Key PSA targets include:

- reducing vehicle crime by 30 per cent by 2004, domestic burglary by 25 per cent by 2005, and robbery in our principal cities by 14 per cent by 2005; and
- halving from 142 to 71 days by 2002 the time taken from arrest to sentence for persistent young offenders.

STRENGTHENING COMMUNITY LIFE

5.89 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 have to put up not only with a rundown physical environment and limited opportunities, but often also the poorest public services.

Government intervention in deprived areas

5.90 The 2000 Spending Review set for the first time specific PSA targets to start narrowing the gap between our poorest communities and the rest of the country on education, health, worklessness, crime and housing. This will ensure that the new resources announced in the 2000 Spending Review go to the places that need them most. Further details of the Government's response to the longer-term challenge will be set out in the National Strategy Action Plan to be published shortly. This will be taken forward by the new Neighbourhood Renewal Unit announced by the Prime Minister in September this year.

Neighbourhood Renewal Fund

5.91 The Neighbourhood Renewal Fund will channel £800 million over the next three years to the most disadvantaged areas to help local authorities and others make early progress in improving services in poor neighbourhoods. The Fund will provide extra money to enable more spending on teachers, police officers, crime prevention programmes, social services or other services that can deliver real improvements for the community. Local people, councils, those who provide local services, business and the voluntary sector will form Local Strategic Partnerships to decide how the money can best be spent to meet the individual needs of their communities.

The New Deal for Communities

5.92 There are now 39 neighbourhoods benefiting from the New Deal for Communities - with investment totalling around £2 billion over ten years. To help learn the emerging lessons, the next phase of the New Deal will focus on supporting more, smaller schemes, including additional support for helping local people influence public services, promoting community involvement at local and neighbourhood level, establishing a National Centre for Neighbourhood Renewal and providing better neighbourhood-level data.

Urban renewal

5.93 The Government has also taken further action to encourage enterprise and business growth in disadvantaged communities within a clear framework bringing regions, cities, districts and neighbourhoods together to deliver higher prosperity for all. Box 3.4 describes the Government's strategy for urban renewal and summarises further proposals to help transform disadvantaged communities and make the most of successful towns and cities. The forthcoming Urban White Paper will set out a comprehensive strategy for improving the performance of all the UK's towns and cities.

Strengthening rural communities

5.94 The Government recognises the challenges the countryside is facing, and will work with rural people to overcome them. In the forthcoming Rural White Paper the Government will set out its vision for a vibrant and living countryside with thriving rural communities. It will focus, among other things, on how best to involve local people in the decisions that shape their communities; how market towns can be rejuvenated; and how best to support the delivery of vital services that are at the heart of village communities. Chapter 6 describes the steps being taken by the Government to reduce pressure on the rural environment.

Modernising local government

Local PSAs

5.95 The 2000 Spending Review announced a new initiative to strengthen links between local and central government and improve the delivery of services through:

- a concordat for local services agreed between the Government and the Local Government Association and the establishment of a national-level Local Government PSA drawing together in one place the targets which local authorities and their local partners are expected to deliver; and
- the piloting of local PSAs - which the Government will develop jointly with local authorities and the Local Government Association.

5.96 Local authorities will commit to enhanced targets covering key national and local priorities, while rules and regulations that are unnecessarily getting in the way of better performance will be removed and improved performance rewarded. The Government aims to reach agreements with 20 pilot local authorities for 2001-02, ahead of a planned wider rollout in 2002-03. Local PSAs will focus on key local services such as education, social services and transport, and cross-cutting issues such as social exclusion, linking to other locally-based initiatives such as the Neighbourhood Renewal Fund.

Charity taxation: getting Britain giving

5.97 Budget 2000 introduced a number of measures from April 2000 to encourage and simplify giving to charity:

- the minimum limit of £250 for Gift Aid donations was removed, so that the scheme now applies to all donations - large or small, regular or one-off;
- the £1,200 limit on payroll giving donations was abolished;
- a new income tax relief was introduced on gifts to charity of most shares and securities, in addition to existing capital gains tax relief; and
- a *de minimis* exemption was introduced to allow charities to engage in small-scale trading activities, without the need to set up a subsidiary company.

5.98 The Government remains committed to developing a thriving voluntary sector. It wants to develop a culture of giving, of both time and money, and to continue to work together in partnership with the voluntary sector to achieve this.

Promoting payroll giving

5.99 In October 2000, the Government launched a national publicity campaign to promote awareness of the income tax relief attracted by payroll giving. The campaign stresses the simplicity of payroll giving and encourages larger employers to provide a payroll giving scheme to their staff or to improve their existing scheme.

5.100 To help meet its aim of achieving a sustained increase in charitable giving, **the Government has also agreed to support a voluntary sector-led publicity campaign to encourage donations of both money and time, and to improve awareness of existing tax reliefs**.

5.101 Volunteering and helping each other out are central to healthy, democratic and socially inclusive communities. The 2000 Spending Review set out a package of measures to deliver substantial progress by 2004 towards one million more people being actively involved in their communities.

A FAIR AND MODERN TAX SYSTEM

Modernising the tax system

Stamp duty

5.102 The Government is modernising the administration of the tax system to help facilitiate e-commerce and make electronic dealings with government easier. A new system for electronic conveyancing, enabled under the Electronic Communications Act, will remove the need for paper documents. **It is intended that the legislation required to modernise stamp duty to deal with the new system will be published before Budget 2001.**

Construction Industry Scheme

5.103 Building on the review of the Construction Industry Scheme (CIS) undertaken since Budget 2000, the Government has decided to extend the scope of electronic data exchange starting at the end of November 2000. As a first step, **more sub-**

contractors will be able to qualify for the CIS5 certificate, which removes the requirement for them to present a certificate in person, and which allows contractors to provide details of payments electronically to the Inland Revenue. The change to CIS will help around 8,000 businesses and save over £1 million, in administration costs across the industry. The Government believes that, in the longer term, big savings can be achieved through a more fundamental shift to electronic data exchange, and will continue to consult with the construction industry on the precise steps required to achieve that shift.

Self-Assessment enquiries

5.104 The Chartered Institute of Taxation and the Inland Revenue will publish a joint report on enquiries into Self-Assessment tax returns in the next few days. The report will make some suggestions for improvements in the law and practice relating to enquiries. The Government will announce its response to the report at the same time.

Tobacco

5.105 The Chancellor will continue to base Budget judgements on the future level of tobacco taxes on a wide range of factors, including the Government's health objectives. The Government believes that there is a strong case for year on year real terms increases in the price of cigarettes. A vital part of the Government's strategy is to reduce the supply of cheap smuggled tobacco.

Smuggling

5.106 Tobacco smuggling not only undermines the Government's objective of reducing the levels of smoking in the UK as cheaper cigarettes become available, but brings with it widespread and serious criminality. Smuggling cost the Exchequer £2.5 billion in lost revenue in 1999. The Government has demonstrated its determination to tackle this threat by investing £209 million over three years in deploying almost 1,000 more Customs and Excise staff and establishing a nationwide network of the latest x-ray scanning technology, increasing substantially the amount of freight which can be examined.

Fiscal marks

5.107 In the 1999 Pre-Budget Report, the Government announced its intention to introduce a legal requirement for cigarette packs and hand-rolling tobacco pouches sold in the UK to carry a fiscal mark showing that UK duty has been paid on them. **From 1 April 2001 the fiscal mark will be introduced allowing anyone buying or selling tobacco to know immediately whether they are dealing with legitimate goods.**

Forestalling

5.108 Forestalling is a tax avoidance practice whereby manufacturers and importers build up large stocks of cigarettes in the months leading up to a Budget change and pay duty on their accumulated stocks just before the Budget increase takes effect. The November 1999 Pre-Budget Report announced that steps would be taken to put an end to this practice, which cost the Exchequer around £280 million in 1999-2000. There will be restrictions on clearances of cigarettes from duty-suspended warehouses in the months immediately preceding a Budget. These will be in place in time for the run-up to Budget 2001.

Betting

Reform of General Betting Duty

5.109 In March 2000, the Government launched a consultation exercise on the scope for modernising general betting duty. The Government's objective in considering the response to the consultation has been to assess the scope for a modernisation of General Betting Duty that would 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.

5.110 The Government believes there is scope for a modernising reform of General Betting Duty to deliver this objective. The Gross Profits Tax reform outlined in the consultation document is one such approach. The Government intends to hold further discussions with interested parties in the coming months, including with the betting industry, on how to ensure that the benefits of any change are fairly shared, with a view to an announcement at the time of Budget 2001.

PROMOTING FAIRNESS INTERNATIONALLY

5.111 The Government continues to apply the principles of economic reform and social justice to its work abroad. It supports the challenging targets set by the international community for 2015, such as

- halving the numbers of people living on less than $1 a day; and
- giving universal access to primary education.

5.112 Among the greatest barriers to achieving these targets are the world's killer diseases, particularly HIV/AIDs, malaria and TB. Together these diseases kill 5 million people a year - most in the developing countries. AIDS alone has already created 13 million orphans. The Department for International Development and others are already undertaking a wide range of projects, but a particular problem is that drugs and vaccines are not likely to be available in the immediate future. But research on vaccines suitable for developing countries remains minimal, with only a tiny fraction of new patents addressing diseases in developing countries. This is mainly because those who might be able to develop vaccines fear they would not be able to recoup the significant research expenditures that will be needed.

5.113 The Government has therefore set in hand urgent work to investigate the problem and come forward with new proposals. Working alongside and feeding into a wider review being conducted by the Performance and Innovation Unit, the Treasury will look at a range of tax options, focusing on creating the right incentives and tackling the scale of the perceived risks. This will build on the consultations already underway with the pharmaceutical industry, and will depend heavily on developing a shared commitment to tackle this issue. Throughout, the Government will keep closely involved with international efforts to solve the burden of infectious diseases.

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[1] The evidence and sources are summarised in: *Supporting Children Through the Tax and Benefit System*, HM Treasury, November 1999.

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

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[3] *Comprehensive Spending Review: new public spending plans 1999-2002*, HM Treasury (Cm 4011), July 1998.

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[4] *The Modernisation of Britain's Tax and Benefit System, Number Seven, "Helping People to Save*", HM Treasury, November 2000.

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

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[6] *Spending Review 2000: Service Delivery Agreements 2001-2004: A Guide*, HM Treasury (Cm 4915), November 2000.

6

Protecting the Environment

The Government's aim for sustainable development is to ensure a better quality of life for everyone, today and for generations to come. Although a high and stable rate of economic growth is vital for delivering a better quality of life and rising economic prosperity, it should be achieved while protecting and, where possible, enhancing the environment, and ensuring that the benefits are shared by everyone.

This chapter sets out the strategy the Government has put in place to ensure that growth is sustainable environmentally, as well as socially and economically. Key elements of the Government's environmental strategy include:

- **tackling climate change**: taking action to reduce greenhouse gas emissions to meet the UK's legally-binding Kyoto target and move towards the Government's domestic goal for reducing carbon dioxide (CO_2) emissions;
- **improving air quality**: reducing local air pollution that poses risks to human health;
- **regenerating Britain's towns and cities**: addressing the legacy of derelict and under-used urban land in Britain and the need to bring it back into use as part of an urban renaissance, and promoting enterprise and growth in cities and disadvantaged areas, making them better places to live and work; and
- **protecting Britain's countryside**: reducing pressure on the rural environment by reducing waste, encouraging use of less damaging agricultural methods, and reducing environmental costs of aggregates extraction.

WHY THE ENVIRONMENT MATTERS

6.1 The Government is committed to achieving high and sustainable levels of growth and employment. But this alone will not guarantee the improvements in the quality of life that people expect. Everyone should have a fair chance to share in the benefits of growth, and growth should not come at the expense of the environment. The environment affects everyone, directly through the quality of air and water, and also through longer-term influences such as climate change.

Climate change

6.2 Climate change is already beginning to affect the environment. Global temperatures are increasing, causing the oceans to become warmer and sea levels to rise (see Chart 6.1). This has led to an increased risk of flooding in some areas and water shortages in others. The 1990s saw four of the five warmest years in England according to records going back 340 years. Average global temperatures rose by 0.6 degrees celsius over the twentieth century. The Intergovernmental Panel on Climate Change (IPCC) has estimated that unless further action is taken to reduce greenhouse gas emissions, temperatures could rise by a further 3 degrees celsius during the twenty-first century.

Chart 6.1

6.3 It is not possible to attribute extreme weather conditions purely to climate change, but it may be expected to lead to an increase in their intensity. Extreme weather is becoming more frequent, and contributing to increased flooding, which is causing severe hardship, disruption, and loss of life in the UK and around the globe.

Local air quality

6.4 Although there is a general downward trend in the average number of days when the level of air pollution in the UK is above acceptable levels, poor air quality still poses risks to human health, the quality of life, and the natural environment. 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. Evidence is beginning to emerge which suggests that long-term exposure to air pollution could have more significant health effects than those associated with short term episodes. Urban air pollution can expose motorists by up to three times as much pollution as pedestrians and cyclists since they effectively travel through a "tunnel" of pollution.

The challenges faced by towns and cities

6.5 Although there is increasing pressure for development in the countryside, the National Land Use Database shows that, in England today, 58,000 hectares of brownfield land are either vacant, derelict or available for redevelopment. Failure to make the most of this land and buildings in urban areas wastes a precious resource and continues to create pressure for greenfield development. The Government is committed to regenerating Britain's towns and cities, stimulating enterprise and employment, and making them better places in which to live and work.

Pressures on the countryside

6.6 The demands of an increasingly affluent population for new housing and infrastructure have inevitably put pressure on the rural environment, as have the landfilling of waste, modern agricultural methods, and aggregates quarrying.

6.7 Industry and commerce in England and Wales produce around 80 million tonnes of waste each year. Local authorities collect a further 30 million tonnes. Disposing of this waste places further pressure on scarce land due to the UK's heavy reliance on landfill as a means of waste disposal - one of the highest rates in the EU. As the biodegradable element of the waste decomposes, it releases methane, a powerful greenhouse gas.

6.8 While they have improved crop yields, modern agricultural methods have also tended to reduce biodiversity. There has been a 35 per cent decline in the population index for 20 farmland bird species since 1970. There is also increasing evidence that pesticide use is associated with significant environmental impacts on biodiversity and water quality.

6.9 The extraction and transport of aggregates imposes significant environmental costs on local communities. These include noise, dust, visual intrusion, loss of amenity and adverse effects on nature.

A STRATEGY FOR PROTECTING THE ENVIRONMENT

6.10 The Government has put in place a clear strategic framework for tackling the environmental costs described above whilst achieving a high and stable level of growth and employment and promoting social justice. This strategy rests on four main pillars:

- identifying the problems and risks;
- setting objectives and targets where appropriate;
- appraising, selecting, consulting, and implementing the most appropriate set of policy instruments for the circumstances; and
- evaluating the success of policies, modifying them where appropriate, and applying experience from one area of policy to another.

Identifying the problems and risks

6.11 The Government's climate change programme has taken into account the growing scientific consensus on the potential impacts of increasing concentrations of greenhouse gases in the atmosphere. The Government has also commissioned a number of independent studies to assess the environmental impact of particular economic activities, such as the extraction of aggregates and pesticide use.

Setting objectives and targets

6.12 Once environmental problems and risks have been identified, the Government can put in place a corresponding strategy to address the environmental concerns. This strategy must be consistent with the Government's economic and social objectives, to ensure sustainable improvements in the quality of life. The strategy may involve setting objectives, such as reducing the environmental impact of pesticide use and aggregates extraction. In some cases, quantitative targets may be appropriate, as in the case of climate change, where the Government has signed up to legally binding commitments to reduce greenhouse gas emissions by 2008-2012. Other targets include increasing both waste recycling and the amount of energy coming from renewable sources by 2010.

The Government's policy instruments

6.13 The Government has a range of policy instruments it can use to meet its environmental objectives. This includes regulation, public spending, information campaigns, voluntary agreements, and economic instruments such as taxes, charges, and permit trading. The use of these measures is assessed on a case-by-case basis, taking into account the wider economic and social consequences. In many cases, a mixed package of policies will be needed, as in the case of the Government's strategy to combat climate change. This includes energy efficiency funding, the climate change levy, the Pollution Prevention Control regulations, and projects aimed at energy improvements in homes.

6.14 Economic instruments such as taxes, charges and trading can offer the scope for tackling environmental costs in the most cost-effective way. By making use of the price mechanism, economic instruments make those involved in environmentally-damaging activities face the true costs of their actions and respond according to their own circumstances. In this way, economic instruments integrate effective protection of the environment and prudent use of natural resources into the heart of economic decision-making.

6.15 The Government first set out its principles on environmental taxation in the July 1997 Budget, indicating that it wanted to shift the burden of tax over time from "goods" like labour, to "bads" like pollution. The November 1999 Pre-Budget Report restated those principles, and made it clear that:

- should face the true costs which their actions impose on society;
- the social consequences of environmental taxation must be acceptable;
- economic instruments must deliver real environmental gains cost-effectively;
- environmental policies must be based on sound evidence but uncertainty cannot necessarily justify inaction; and
- environmental policies must not threaten the competitiveness of UK business.

6.16 Economic instruments will not always be the best solution to environmental problems. Regulations are often more appropriate where minimum standards need to be maintained to protect the environment or the public. Public spending can also deliver environmental benefits. Government-funded environmental campaigns can be used to alert business and individuals to the true environmental consequences of their actions, and encouraging them to change their behaviour accordingly. Box 6.1 describes some of the public spending initiatives announced in the 2000 Spending Review which are aimed at protecting the environment.

Box 6.1: The 2000 Spending Review and the environment

The 2000 Spending Review supported the Government's environmental objectives by announcing a number of new measures including increased funding for public transport, energy efficiency, renewable energy, waste recycling and sustainable agriculture:

- the 10 Year Plan for Transport invests heavily in providing high quality public transport alternatives to road travel. Investing in modern public transport will reduce traffic levels and the associated emissions of the main greenhouse gas, carbon dioxide, and improve local air quality by reducing emissions of pollutants such as nitrogen dioxide and particulates;
- new funds for renewable energy will reduce greenhouse gas emissions further. A Carbon Trust will give energy efficiency advice to business and encourage low carbon technologies. There will be financial incentives for businesses to join a domestic emissions trading scheme;
- new money for local councils will ensure that at least 17 per cent of household waste is recycled or composted by 2004; and
- better protection of the countryside through a shift from production subsidies to deliver environmental improvements in agriculture.

Evaluating and modifying policies

6.17 An appraisal of all the Government's environmental tax reforms is provided in Table 6.2 at the end of this chapter. This table shows the impact on the environment of each measure, while Table 6.1 shows how these measures complement other policy initiatives. This allows the Government to monitor progress towards its environmental aims, and apply experience from one area of policy to another. For example, the success of duty differentials to encourage the take up of ultra low sulphur diesel informed the decision to introduce a new duty differential for ultra low sulphur petrol, which will generate further local air quality benefits[1].

IMPLEMENTING THE ENVIRONMENTAL STRATEGY

6.18 The Government's strategic framework for tackling the environmental costs of economic growth, alongside its economic and social objectives, can be described under three broad headings:

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

6.19 The remainder of this chapter reviews the progress that the Government has already made towards achieving these goals, and the further steps now being considered.

TACKLING CLIMATE CHANGE AND IMPROVING AIR QUALITY

Frameworks for action

6.20 The Government's strategic frameworks for tackling climate change and improving air quality are set out fully in the *Climate Change draft UK programme* and the *Air Quality Strategy for England, Scotland, Wales and Northern Ireland*. The first of these documents explains how the Government and the devolved administrations aim to ensure that the UK moves towards a low-carbon economy by putting in place policies that give clear signals about the changes that need to be made. The final programme will be published shortly. The Government's Air Quality Strategy sets targets to be achieved between 2003 and 2008 for eight air pollutants that can have significant effects on health. These targets are derived from standards recommended by independent health experts.

6.21 The Government believes that all sectors should play their part in tackling the UK's environmental problems, and has put in place a wide range of policies that will generate environmental improvements across the UK, including the business, domestic, and transport sectors.

Business

6.22 The Government has introduced a number of measures to ensure that the business sector contributes to meeting the UK's climate change targets, including:

- **economic instruments** such as the climate change levy and associated negotiated agreements, enhanced capital allowances for energy saving investments and the emissions trading scheme;
- **public expenditure**, including the energy efficiency fund; and
- **regulations** such as the Pollution Prevention and Control regulations.

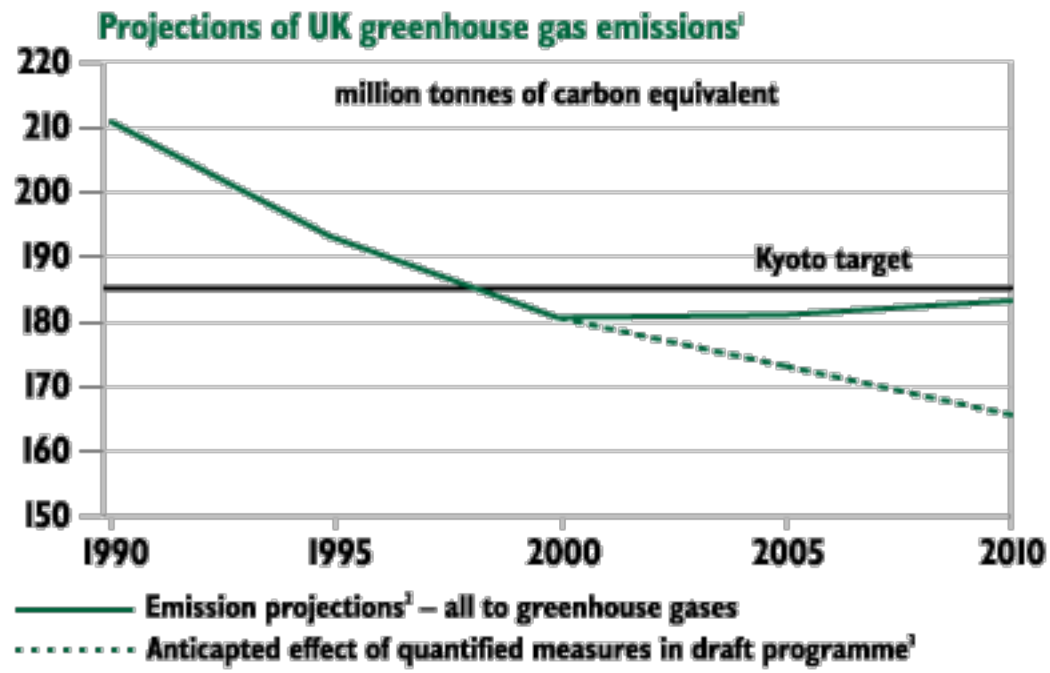
The climate change levy

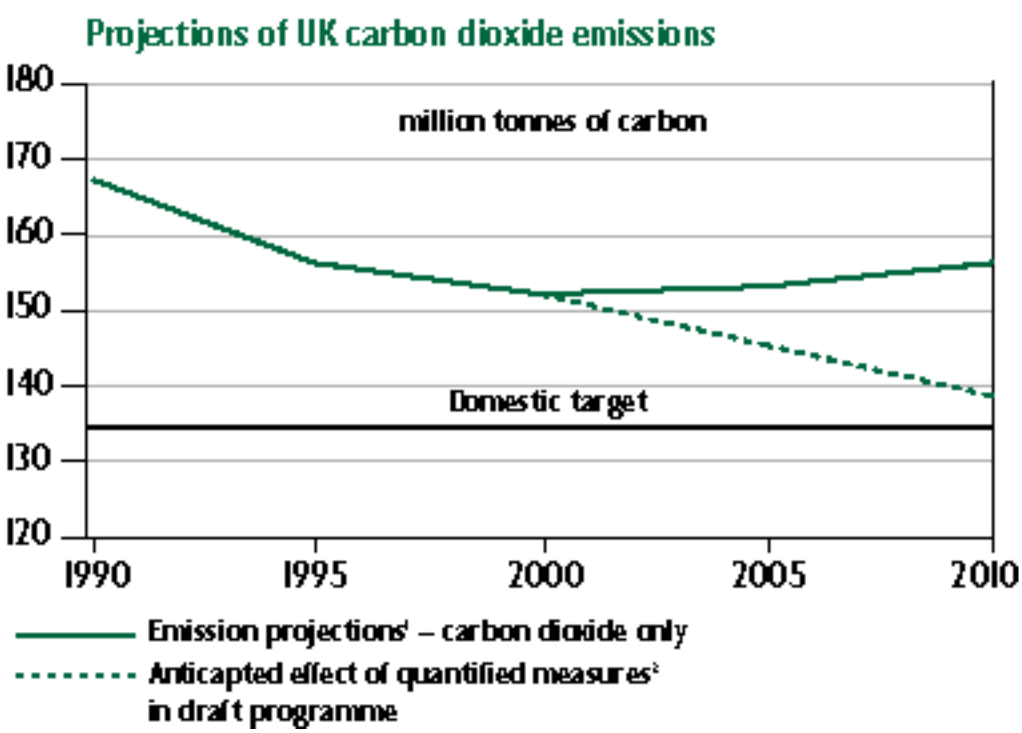
6.23 In 1998, the Government asked Lord Marshall to explore how business and industry might play its part in meeting the UK's emission reduction targets. His report, *Economic Instruments and the Business Use of Energy*, noted considerable scope for cost effective energy saving and greenhouse gas abatement measures in business. He concluded that there was a role for a tax, alongside negotiated agreements and emissions trading, to deliver these savings.

Box 6.2: Emission projections and targets

The UK has already made good progress in reducing its greenhouse gas emissions. With emissions in 1998 around $8^1/_2$ per cent lower than in 1990, the UK will be one of the few OECD countries to meet the target set in Rio in 1992 of returning emissions to 1990 levels by 2000. The action already taken, together with that planned, means that the UK is on course to go beyond its Kyoto target to cut greenhouse gas emissions by $12^1/_2$ per cent below 1990 levels by 2008-2012, and to move towards its domestic goal to cut carbon dioxide emissions by 20 per cent by 2010.

The charts below shows the predicted effect by 2010 of all the measures set out in the draft 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. Revised estimates will be published shortly in the final programme.





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 renewables), 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 draft UK climate change programme.

6.24 Acting on the Marshall recommendations, in Budget 99 **the Government announced that it would introduce the climate change levy - payable on the business use of energy - in April 2001.** All the revenues will be recycled back to business through:

- a 0.3 percentage point cut in employers' National Insurance Contributions;
- additional support for energy efficiency measures; and
- enhanced capital allowances for energy saving technologies.

The negotiated agreements

6.25 The Government's aim in designing the climate change levy has been to deliver effective emissions savings while protecting the competitiveness of UK industry. Eligible energy-intensive industrial sectors exposed to international competition will be able to benefit from an 80 per cent reduction in the rate of the climate change levy, in return for agreeing to and meeting challenging energy efficiency or emissions reduction targets.

6.26 More than 40 energy intensive sectors have been in negotiation with the Government to identify and agree energy efficiency or emissions reduction targets. Negotiations with most of the major sectors have now been completed and most others are expected to be concluded within the next few weeks. The process of signing individual site agreements is now well under way.

Capital allowances

6.27 As part of the climate change levy package, firms will qualify for 100 per cent first year capital allowances for making investments in selected low carbon technologies. The technologies eligible are combined heat and power, boilers, motors, variable speed drives, lighting systems, refrigeration equipment, pipe insulation, and thermal screens. Stringent energy saving criteria must be met in order for a specific product or technology to be included on the list - criteria which resulted from detailed consultation with business. The list of qualifying products will be published by the Department for the Environment, Transport and the Regions shortly. The cost will depend on take-up, and is expected to be around £100 million in 2001-02 (the first year of the scheme), and £140 million in 2002-03.

Energy efficiency fund

6.28 The 2000 Spending Review announced a new £50 million a year energy efficiency fund to promote energy saving and reduce greenhouse gas emissions by providing an additional:

- £100 million over three years to provide energy efficiency advice to business, and accelerate the research, development and take up of low carbon technologies and measures through a new body called the Carbon Trust; and
- £50 million over three years to promote the development of new sources of renewable energy.

The Carbon Trust

6.29 The Government believes that a new, UK-wide independent company limited by guarantee - called the Carbon Trust - is the most effective way of accelerating the take up of low-carbon technologies, both on the timescale for the Kyoto Protocol and into the long term. The Carbon Trust will take the lead on low carbon technology and innovation in the UK. It's main aim will be to run an integrated programme of measures to support organisations paying the Climate Change levy. The Government is currently working with the devolved administrations, the Research Councils, and the Advisory Committee on Business and the Environment to set up the Trust and ensure that it delivers effectively across the UK.

State aids

6.30 Several aspects of the climate change levy package (most notably discounts for those eligible energy-intensive sectors) will require European state aids clearance, and the appropriate applications have been made. The most recent draft of the new EU state aid guidelines for environmental measures was published in early October. The revised draft is encouraging, particularly in extending the timescale allowable for environmental measures to 10 years. The Government is continuing to work with the Commission to ensure a timely approval of its application.

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. Lord Marshall recommended that there should be a business-led initiative to design a "dry run pilot" domestic trading scheme for greenhouse gas emissions. The CBI and Advisory Committee on Business and the Environment then set up the UK Emissions Trading Group (ETG) to take forward the design of a domestic trading scheme.

6.32 There are important advantages from making an early start to emissions trading in the UK. Trading will deliver significant reductions in greenhouse gas emissions and provide a long-term signal to help firms move towards a low-carbon economy. Trading will offer UK business and the City of London vital early experience in advance of the schemes expected at an international level.

6.33 The ETG was supported in the first instance by 25 major UK companies. Support from the business sector has subsequently grown to include over 100 major companies and trade associations, together with academics and environmental organisations. The Government is grateful for the work of the ETG. The 2000 Spending Review announced **that £30 million in 2003-04 would be available to provide a financial incentive for firms to take on binding emissions reductions targets.**

6.34 A DETR consultation paper published alongside the Pre-Budget Report includes outline proposals and options for the basic rules of the Emissions Trading Scheme. The Government is seeking views on proposals for the Scheme so that the broad framework can be in place. This would allow the first group of firms to sign up to emissions reductions targets in 2001 and begin in trading in 2002.

Households

6.35 Encouraging greater energy efficiency in the home is a key part of the Government's policies towards reducing fuel poverty and carbon emissions. A number of measures have been introduced to ensure that households play their part in meeting the UK's emission targets whilst protecting the most vulnerable in society. These include:

- **economic instruments** such as extending the reduced rate of VAT for the installation of energy saving materials, and capital allowances to support affordable warmth;
- **public expenditure** such as the Affordable Warmth programme, the Home Energy Efficiency Scheme, and the corresponding energy efficiency programmes in the devolved administrations; and
- **regulations,** such as energy efficiency standards of performance.

VAT on energy saving materials

6.36 From April 2000, the rate of VAT on installations of certain energy saving materials in all homes was reduced from 17.5 per cent to 5 per cent. The energy saving materials that qualify for the reduced rate when installed in homes by a contractor are:

- insulation for walls, floors, ceilings, roofs, lofts, water tanks, pipes and other plumbing fittings;
- draught stripping for windows and doors;
- central heating system controls, including thermostatic radiator valves;
- hot water system controls; and
- solar panels.

Home Energy Efficiency Scheme

6.37 The Government's New Home Energy Efficiency Scheme (New HEES) was launched in England in June 2000. It is designed to provide comprehensive packages of heating and insulation improvements to ensure that the most vulnerable households (those including people over 60, children, people with disabilities, and chronically sick people) need not risk ill-health due to a cold home. Similar schemes operate in the devolved administrations. In addition, all grant funded supplies made under HEES qualify for the reduced rate of VAT.

Affordable Warmth

6.38 The Government's Affordable Warmth programme has been developed in conjunction with Transco. It aims to facilitate the introduction of new, energy-efficient central heating systems in up to 1 million homes by the end of 2005. The programme will benefit social housing, as well as some private sector homes. Many of those helped are likely to be households with members aged 60 and above, who will benefit from warmer homes and lower fuel bills. There will also be an environmental benefit of reducing emissions of greenhouse gases. Budget 2000 announced plans to introduce capital allowances to underpin the programme.

Transport

6.39 A safe, clean, convenient, and efficient transport system is crucial to sustaining economic growth, promoting social inclusion, and safeguarding the environment. Increased economic activity and growing incomes have generated higher demand for personal travel and the transport of goods and services over recent decades. Between 1968 and 1998, passenger travel and freight moved almost doubled. Without the measures outlined in the Government's 10 Year Plan for Transport, road traffic in England (in vehicle kilometres) was forecast to increase by over 20 per cent over the next 10 years. The key challenges faced by the Government are the implications that this growth has for congestion, pollution, and social exclusion.

Congestion

6.40 Increased volumes of car and goods vehicle traffic have led to increasing congestion on the road network, particularly in urban areas. Without the measures set out in the Government's 10 Year Plan for Transport, congestion could grow by 15 per cent across the network as a whole, and by 28 per cent on the inter-urban trunk road network, by 2010. Time delays caused by congestion, both on roads and public transport, represent a substantial direct cost to business and an inconvenience to the public.

Pollution

6.41 The transport sector is the third largest source of greenhouse gas emissions in the UK, with emissions of carbon dioxide (CO_2) from this sector accounting for over a fifth of total emissions. Road transport also impacts on air quality, especially in urban areas. It is a significant source of particulates and contributes to emissions of nitrogen oxides, a key air pollutant and precursor to ground-level ozone.

Social exclusion

6.42 Rural communities are typically more dependant on the car. Low population densities often make providing public transport in rural areas relatively uneconomic. Only 36 per cent of households in rural areas are within a 10 minute walk of a regular bus service, compared with 94 per cent in urban areas. As a result, those without use of a car may suffer poor access to employment opportunities and basic services.

Ensuring sustainable transport

6.43 The Government has put in place an effective package of measures to make sure that the transport system supports growth and employment, enhances social inclusion, and protects the environment. These measures include:

- **economic instruments** such as fuel duty differentials to promote cleaner fuels, reforms to vehicle excise duty (VED) and company car tax to promote cleaner vehicles, and green travel plans to promote more environmentally friendly modes of transport;
- **public expenditure:** as indicated in Chapter 5, the 2000 Spending Review announced that public investment in transport will rise to £6 billion by 2003-04, more than doubling in real terms. The Government's 10 Year Plan for Transport is a long-term investment plan to modernise the transport system, and put right the results of years of under-investment and stop-start funding. 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.
- **voluntary agreements:** the European Commission and European car manufacturers (ACEA) have agreed to reduce average carbon dioxide emission levels from their new cars from 186g per kilometre to 140g per kilometre by 2008. The agreement has recently been extended to Korean and Japanese car makers; and
- **regulations:** tighter European vehicle emission standards have substantially reduced emissions of key air pollutants over the last decade, by effectively mandating the fitting of catalytic converters to new petrol cars. More stringent standards agreed in 1998 are expected to reduce emissions further by 50 per cent from 2005.

Box 6.3: The 2000 Spending Review and sustainable transport

The Government's reforms to vehicle taxation form only part of an overall package of measures aimed at ensuring a more sustainable transport system. The Government's 10 Year Plan for Transport will tackle congestion, reduce pollution and promote social inclusion by providing funding for:

Cleaner technologies

- a doubling of resources by 2003-04 for cleaner vehicles initiatives to accelerate the take up of new and cleaner technologies. These include Powershift - to encourage fleet managers to operate gas and electric vehicles; the Cleaner

Vehicles Programme - fitting pollution reduction equipment to existing fleets; and increased support to encourage the early introduction of hybrid fuel-cell vehicles.

Public transport

- a large scale expansion in rail passenger and freight traffic which is expected to contribute to a significant reduction in inter-urban trunk road congestion;
- a further £30 million a year to extend the Rural Bus Subsidy Grant to services into market towns and provide for an expansion of flexible services such as taxi buses; and
- improving rural transport to bring about a one-third increase in the proportion of rural households living within a ten minute walk of an hourly bus service;

The road network

- targeted increases in the capacity of the strategic road network, together with better network management to reduce delays and improve reliability. The Plan provides sufficient funding for 30 bypasses, widening some 5 per cent of the network and associated junction improvements, and 80 major schemes to improve safety and traffic flow at other junctions; and
- around 200 major local road improvements, including over 70 bypasses, as part of local transport plans, providing for safer and cleaner town centres.

Fuel duties

6.44 Fuel duties have played an important role in helping the UK meet its Kyoto target for reductions in greenhouse gas emissions. Increased fuel duties between 1996 and 1999 are estimated to produce carbon savings of between 1 and 2.5 million tonnes by 2010. However, the environmental benefits of higher fuel prices must be balanced with the Government's social and economic objectives. Hence in the November 1999 Pre-Budget Report, the Government decided to move away from the fuel duty escalator introduced by the previous Government in 1993, and announced that decisions on future changes in fuel duty would be taken in the light of environmental, economic and social objectives.

6.45 At the time of the November 1999 Pre-Budget Report, the price of oil was around $22 a barrel. By the time of Budget 2000, it had risen to $30 a barrel. As a result, the Chancellor froze duty in real terms in Budget 2000. The price since Budget 2000 has averaged over $28 a barrel. The Department for Trade and Industry will shortly be publishing a paper which will look at the possible impacts of world oil prices on carbon emissions.

6.46 Taking account of these factors, and of the other measures being taken to tackle climate change, **the Government has decided to freeze duties on petrol, diesel, other road fuels, and non-road fuel oils (such as red diesel) in cash terms in Budget 2001.** This will lower taxes on petrol and diesel in real terms by around $1^1/_2$ pence per litre, to the benefit of business and all motorists. This is likely to cost about £560 million in 2001-02, and has been included in the fiscal projections in Annex B.

Ultra-low sulphur fuels

6.47 Duty differentials have an important role to play in encouraging the use of environmentally-friendly fuels. As explained in an HM Customs and Excise paper published immediately before the Pre-Budget Report, ultra-low sulphur fuels offer significant environmental advantages over conventional fuels.

6.48 Between 1997 and 1999, the introduction and widening of the duty differential in favour of Ultra-Low Sulphur Diesel (ULSD) over conventional diesel encouraged oil companies to supply and produce ULSD and achieved an almost complete conversion of the UK diesel market to ULSD. This cleaner fuel is available to all diesel motorists, and has delivered a number of emissions savings, including an 8 per cent reduction in urban particulate emissions, and has stimulated the development of new pollution-reducing technology.

ULSP

6.49 Ultra-Low Sulphur Petrol (ULSP), which can be used in any car that takes unleaded petrol, potentially offers significant environmental advantages over unleaded petrol, by:

- reducing nitrogen oxide emissions;
- enabling the introduction of new petrol engine technologies such as Gasoline Direct Injection (GDI) that improves efficiency and reduces carbon emissions; and

- helping to prolong the life and efficiency of catalytic converters.

6.50 In order to encourage the use of ULSP, in Budget 2000 the Chancellor announced that he intended to introduce a duty differential of 1 penny per litre in favour of this fuel. The duty reduction came into effect on 1 October 2000 and ULSP is now coming on to the market. Given the environmental benefits of this fuel, the Government wants to encourage and speed up its take up. **The Government therefore intends to cut the duty on ULSP and widen its differential with standard unleaded petrol by a further 2 pence per litre in Budget 2001. This would be conditional on the oil companies guaranteeing nationwide access to its environmental benefits.** In these circumstances, the duty on ULSP would therefore have been cut by a total of 3 pence per litre since Budget 2000. Reducing the duty on ULSP by this further 2 pence per litre would cost around £385 million in 2001-02.

ULSD

6.51 In these circumstances, the Government believes that it would be appropriate to reconsider the level of duty on the fuel that makes up virtually all diesel sold in the UK, ULSD. Taking account of the role of diesel in determining the transport costs of British business and since ultra-low sulphur fuels offer significant environmental benefits over conventional fuels, the **Government would bring the duty rate of ULSD down by 3 pence per litre in Budget 2001 to maintain the existing balance between duty rates on the most commonly available petrol and diesel.** This would cost £615 million in 2001-02.

Lead-replacement petrol

6.52 Lead-replacement petrol (LRP) was introduced to replace leaded petrol for those older cars unable to run on unleaded. LRP is currently subject to a 2 pence per litre duty premium over standard unleaded petrol. However, there is an argument that LRP is generally no worse for the environment than standard unleaded petrol. Furthermore, many people driving older cars are often unable to afford newer vehicles and become locked-in to buying LRP.

The Government has therefore decided, subject to a full and proper assessment of the environmental implications, to remove the duty premium on lead-replacement petrol. This would cost around £40 million a year.

Road fuel gases

6.53 In Budget 99 the Government cut the duty on Road Fuel Gases by 29 per cent and froze the rate of duty on them in Budget 2000. The UK now has the widest duty differential between road fuel gases and other types of fuel of any country in the EU. Individuals and companies continue to have a significant incentive to convert to road fuel gases, and car manufacturers and fuel suppliers are continuing to respond to increasing demand by increasing the production of gas-powered vehicles and the availability of road fuel gases at filling stations.

Green fuel challenge

6.54 In the longer term, the challenge will be to achieve cleaner, greener road transport. Ultimately it will be for industry to rise to the challenge of developing profitable alternative fuels and related technologies. Therefore, in the run up to Budget 2001, **the Government will invite British industry to develop proposals for practical alternative fuels. Following consideration of these proposals the Chancellor will announce major reductions in duty rates for the most promising environmentally-friendly alternative fuels.**

VED for cars

6.55 As set out in Budget 2000, VED for cars will be subject to significant changes from March 2001. These changes will ensure that VED more closely reflects the environmental impact of cars.

6.56 The introduction of the four banded graduated VED system for all new cars bought from March 2001 will mean that the level of VED payable will be 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 measure will encourage the purchase of:

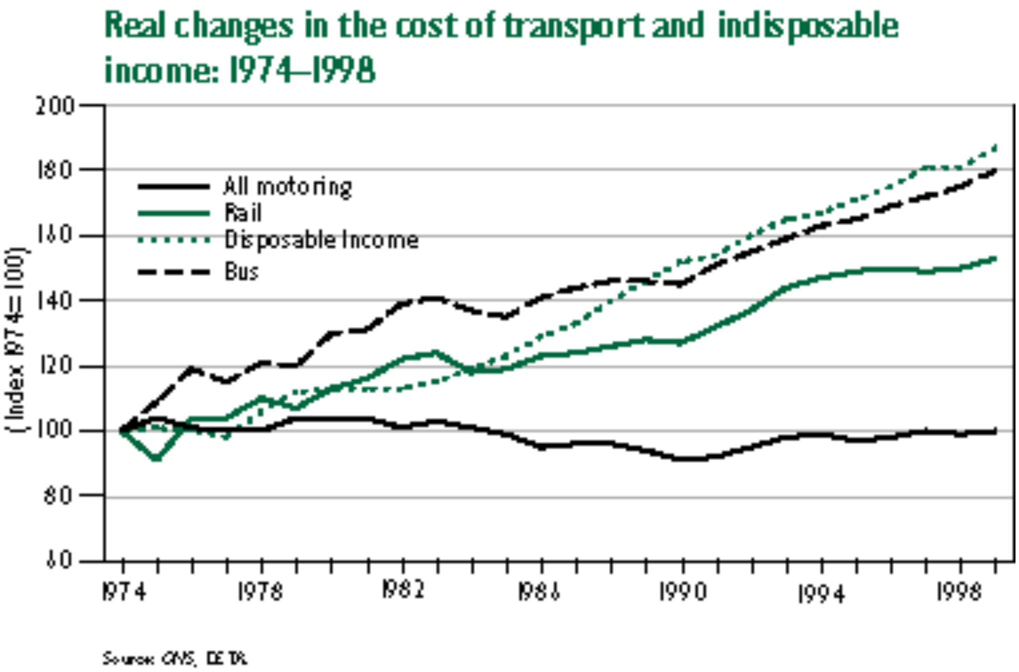
- new cars as opposed to older cars;
- cars with lower carbon emissions and better fuel efficiency; and
- cars using fuels and technology which are better for local air quality.

6.57 Budget 99 introduced a reduced rate of VED for cars with engines up to 1,100 cc. This was designed to encourage people to drive smaller, less polluting cars. Budget 2000 announced that this reduction in the rate would be extended to existing cars with engines up to 1,200 cc in March 2001 and owners of cars with engine sizes from 1,100 cc to 1,200 cc would receive a rebate of up to £55. This will mean that a further 2.2 million cars will benefit.

6.58 The Government has now decided to introduce in Budget 2001, subject to consultation with motoring organisations, a further extension of the "small car" engine capacity threshold to 1,500cc. This change would cut VED by £55 for a further 5 million car owners initially, providing further options for cheaper motoring and meaning that around a third of cars in total will benefit from the lower rate of VED. This would cost around £250 million a year over the next three years. It is intended to backdate this arrangement to November 2000, at a further cost of about £100 million.

Box 6.4: Costs of Motoring

The cost of motoring has remained broadly constant in real terms since 1974, whilst disposable income (up 87 per cent) and the cost of using public transport (buses up 80 per cent, rail up 50 per cent) have risen significantly.



Central to keeping the cost of motoring roughly constant between 1974 and 1999 has been the 29 per cent fall in the real cost of car purchase. This has offset real increases in the cost of maintenance of 44 per cent, tax and insurance increases of 59 per cent, and petrol and oil increases of 11 per cent.

Company car tax

6.59 Budget 2000 announced a major revenue-neutral reform of company car taxation. From April 2002, the 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 (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. **The Government will shortly introduce regulations to waive this diesel supplement for clean diesel cars achieving Euro 4 emission standards, which is the cleanest available technology**. Drivers and their employers will now face an incentive to choose cars with lower emissions both of carbon dioxide and local air pollutants.

6.60 The Government intends to provide further incentives to choose more environmentally-friendly company cars to compensate for the higher cost of new technologies and encourage the take up of environmentally friendly vehicles:

- **electric cars will only have to pay tax on 9 per cent of a car's price;**
- **hybrid petrol/electric cars will receive a 2 per cent discount to compensate for the higher cost of the technology and a further discount for every 20g/km their CO_2 emissions are below the 165 g/km level attracting 15 per cent;**

and

- **all cars running on gas will get at least a 1 per cent discount for their lower CO_2 emissions, more for every 20g/km their CO_2 emissions are below the 165 g/km level.**

Authorised mileage rates

6.61 To complement these reforms to company car taxation, the Government intends to restructure the administrative system of authorised mileage rates. This two stage reform will cost the Exchequer £45 million per year by 2002-03. **To provide an early incentive to use cleaner cars for business trips, drivers of small cars will benefit from an increase in the current two lower bands to 40 pence for the first 4,000 miles and 25 pence for further miles from April 2001. The rates for the two higher bands will be frozen.**

6.62 For the second stage of reform, the Government will be consulting with interested parties on the introduction of a new statutory system of mileage rates from April 2002. The proposed statutory system 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 single lower rate of 25 pence per mile for any additional business miles above the first 10,000.**

Green travel

6.63 Budget 99 introduced a package of measures to promote green travel plans. The Government will build on these reforms in Budget 2001 by :

- removing VAT from the purchase of cycle helmets with effect from 1 April 2001 to encourage 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;
- introducing a new passenger rate of 2 pence per mile per passenger to encourage car-sharing on business trips in private cars from April 2002; and
- lowering the threshold for works buses qualifying for tax exemptions from 12 passenger seats to nine 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.

Reforming car taxation

6.64 The measures that the Government is announcing and consulting on today will further encourage the use of cleaner fuels and technologies as well as more efficient cars. And for those who have no alternative to car ownership there is an option of using cars that qualify for lower rate of VED. If all the measures, including those that the Government is consulting on, are implemented then the tax on motorists will fall by the equivalent of about 4 pence per litre in real terms.

Improving the transport industry

6.65 Efficient freight transport plays a key role in a sustainable economy. The UK economy - from high technology sectors to agriculture - relies on having efficient transport for raw materials, manufactured components and final products. Freight transport itself needs to be environmentally sustainable. As described above, the Government has created incentives for the haulage industry to switch to less environmentally-damaging ULSD and to fit low-emissions technology. Its 10 Year Plan for Transport will also increase the efficiency of freight transport and reduce its environmental impacts compared with those forecast.

6.66 However, the Government has decided to go further in recognising the need for British industry to be competitive while continuing to protect the environment. **It therefore intends to consult on and introduce a series of environmentally-principled measures set out below that will increase the competitiveness of British industry. The total cost of these measures will be about £350 million a year, depending on the detailed arrangements. It will develop these measures to be finalised in Budget 2001 in consultation with the haulage industry, including the Road Haulage Forum, and other interested groups.**

VED for lorries

6.67 The Government announced in Budget 98 that it would reform VED for lorries. It commissioned a report from independent experts on the environmental and track damage caused by lorries, that was published in April 2000. **It can now announce that it**

will introduce a reformed system of lorry VED in Budget 2001, subject to consultation on the details of the reform, to reflect better the environmental and track costs of different lorries. The reform is intended to reduce by approximately £300 million a year (equivalent to over 50 per cent) the cost of VED on lorries for British industry. The reduction in VED itself is in accordance with the Government's principle of shifting taxes away from vehicle ownership. The new scheme will continue to reward lorries meeting lower emissions and the Government will consider using new Euro emissions standards in the future. It will also be a simpler, more flexible system. The Government is publishing a consultation document alongside the Pre-Budget Report.

6.68 The Government intends to implement transitional arrangements as a first stage of this reform. Up to £265 million will be available to rebate VED fees for this financial year, in keeping with legal constraints. This will mean cuts of fifty per cent for many of the largest vehicles, worth up to £4,000 each. The Department of the Environment, Transport and the Regions will announce, within a few days of the publication of the Pre-Budget Report, the detailed arrangements for this scheme. The Government intends that the first payments will be made before the end of the year and all payments before the end of January 2001.

6.69 Many other European countries operate "vignette" or "user charge" schemes that charge foreign as well as domestic hauliers. **The Government intends to introduce such a scheme in the UK, to ensure that foreign hauliers start to contribute towards the costs of maintaining the UK road network and the environmental costs that they impose.** The Government would intend that UK hauliers would face no additional costs as a result of introducing such a scheme. The Government will consult on the operational implications of introducing a user charge scheme, such as a vignette. This scheme should mean that typical UK VED rates would be less than in Sweden and broadly the same as in Germany, the Netherlands, Ireland and Belgium. Furthermore, for those lorries that qualify for the reduced pollution discount, the Government would expect typical UK VED rates to be less than in all these countries and comparable with those in France.

Modernising UK road haulage

6.70 Efficiency and environmental improvements can go hand-in-hand. More efficient routes, more careful driving and making more efficient use of lorries (by for example ensuring that lorries are full for return as well as outward journeys) all improve the efficiency of haulage firms and British industry, but also have environmental benefits. Training programmes can help improve many of these aspects of the industry. **The Road Haulage Forum has already initiated a review of training and the Government will help develop this scheme with a view to improving the quality of training, especially for small haulage firms.**

6.71 The reformed lorry VED system will offer encouragements to drive newer, cleaner, less-damaging lorries. **In addition, the Government intends to set up a £100 million ring-fenced fund to offer further incentives or allowances for scrapping older, more-polluting lorries or encouraging cleaner lorries and technology,** to secure environmental benefits and help the haulage industry modernise, consulting industry on the detailed arrangements.

6.72 Together with the reduction in duty in ULSD proposed and the freeze in fuel duties, these measures would represent a reduction for freight transport of around £750 million a year in real terms, equivalent to a reduction of about 8 pence per litre for diesel used in road haulage.

VED for tractors

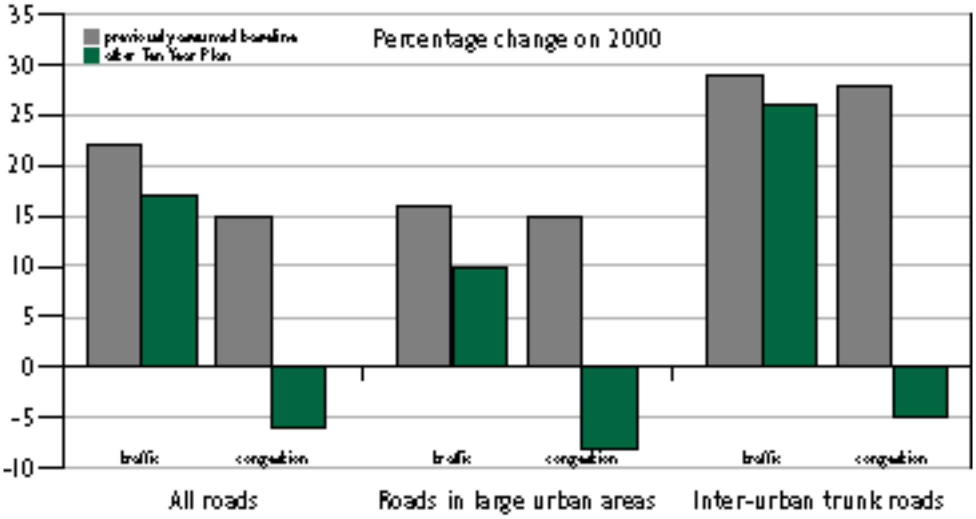
6.73 VED on tractors will be abolished, subject to consultation, especially with the National Farmers' Union and the police about ensuring that controls over insurance, maintenance and theft remain. This will save farmers in total over £9 million a year, or £40 for every agricultural vehicle and comes on top of a number of other measures that the Government has announced in recent months to support farming. This change will be introduced as soon as possible after Budget 2001 and is consistent with the Government's principle of switching tax away from vehicle ownership.

Box 6.5: Tackling congestion

Tackling congestion is one of the key Public Service Agreement (PSA) targets of the Ten Year Plan. The spending measures in the Ten Year Plan will lead to a 5 per cent reduction in overall traffic growth compared with the baseline previously forecast, and an absolute reduction in overall congestion compared to today. Large reductions in congestion are forecast in those areas where congestion is currently worst: 15 per cent in London, and 8 per cent on average in other large cities. On inter-urban trunk roads, where congestion has been growing fastest, a reduction of 5 per cent is forecast.

Reducing congestion will cut business costs by making journeys faster and more reliable.

The change in 2010 traffic and congestion forecasts resulting from the Ten Year Plan



Lower congestion also means less pollution from stationary and slow moving vehicles. Improvements to the transport network will open up new and expanded markets for business, stimulating competition and potentially contributing to faster economic growth. Better infrastructure can play a major role in supporting regeneration programmes and access to new jobs, at both regional and local levels.

REGENERATING BRITAIN'S TOWNS AND CITIES

6.74 The Government's vision of an urban renaissance is one of ensuring towns and cities build on their potential and become places where people want to live, work, and spend their leisure time. They must also offer attractive locations for business. A comprehensive strategy for achieving this aim will be set out in the forthcoming Urban White Paper. Chapter 3 sets out proposals for encouraging an enterprise and innovation culture. Towns and cities need to provide an attractive physical environment for enterprise to grow, local communities to become vibrant, and to reduce unsustainable development in the countryside.

6.75 The Urban Task Force Report of June 1999 looked at the causes of decline in English towns and cities and recommended solutions to bring people back into urban neighbourhoods. Amongst the issues it addressed was the legacy of derelict and underused urban land in Britain and the need to bring it back into use as a contribution towards an urban renaissance. The Government whole-heartedly supports the vision set out by the Urban Task Force. A full response will be set out in the Urban White Paper.

6.76 The Government is taking steps to encourage more productive use of brownfield land and empty property, building on the recommendations of the Urban Task Force Report:

- **economic instruments:** a package of measures to bring derelict land and empty property back into productive use and regenerate the most disadvantaged communities will be introduced in Budget 2001;
- **public expenditure:** the 2000 Spending Review announced significant increases in regeneration budgets and resources for Regional Development Agencies; and
- **regulations:** including radical new guidance on planning for housing (PPG3) and regional and local targets for brownfield redevelopment.

6.77 The Government is introducing a package of tax measures worth a cumulative £1 billion over five years to contribute to its objective of regenerating Britain's towns and cities. These will build on the proposals for reducing business rates in disadvantaged areas, introducing a supplementary business rate, and introducing a new local tax re-investment programme, as set out in *Modernising Local Government Finance: a Green Paper,* which are currently under consultation. The package of measures considered below are aimed at bringing empty properties back in to use, developing brownfield land, and bringing life back in to Britain's urban areas by targeting help at our most disadvantaged communities. This package of measures to help regenerate towns and cities will also reduce the pressures for unnecessary development in Britain's rural areas and represents a substantial response to the recommendations made by the Urban Task Force report.

Stamp duty relief for disadvantaged urban areas

6.78 Budget 2000 announced that the Government was attracted to the idea of offering relief from stamp duty for new developments on brownfield land. Since then the Government has consulted with interested parties on how this measure might be best targeted to help meet the Government's objectives and how it could work in practice. In light of the representations made, the Government intends to target the relief at Britain's most disadvantaged wards. **Budget 2001 will introduce a complete exemption from stamp duty for all property transactions in Britain's most disadvantaged communities from April 2001 at a cost of around £100 million a year by 2002-03.** This will bring benefits to both households and enterprises in these areas and will encourage the refurbishment and return to use of existing properties as well as new developments. This measure will help stimulate this poorly performing segment of the property market, attracting enterprise and business into local communities. The Government will work with the devolved authorities in the run up to Budget 2001 in identifying the communities that will benefit.

Tax relief for cleaning up contaminated land

6.79 Contaminated sites in Britain can have significant negative impacts on households and businesses in the local area. They are also a wasted resource and can and form a significant barrier to regeneration. **The Government intends to encourage the clean up of contaminated land by introducing an accelerated payable tax credit for the costs incurred in cleaning up these sites in Budget 2001. This measure is estimated to cost £30 million in 2001/02 and £55 million in 2002/03.**

6.80 Too many properties have been vacant for too long. In England alone, approximately 1.3 million residential and commercial buildings are currently empty. Bringing such vacant and under-utilised properties back into use will help relieve pressure on greenfield development and provide a more diversified use of land at the heart of our towns and cities. To help bring back into use derelict and abandoned property, **the Government intends to introduce a £80 million package of measures to encourage property conversions in Budget 2001, including:**

- **a reduced rate of VAT for the cost of converting residential properties into a different number of dwellings; for example, houses 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;**
- **an immediate tax relief to property owners for the costs of converting redundant space over shops and other commercial premises into flats for letting.**

Tax relief for Urban Regeneration Companies

6.81 The Urban Taskforce recommended that the Government enable 'arms length' Urban Regeneration Companies (URCs) to co-ordinate and deliver area regeneration projects. The Government has been encouraged by the work of the first three URCs - Liverpool Vision, New East Manchester, and Sheffield One - in developing a clear vision and strategy for key areas of these cities. They work with a range of private and public sector partners with the aim of bringing private investment back into the disadvantaged areas within towns and cities.

6.82 The Government is carefully monitoring and evaluating the process of the 3 pilot companies. The results so far show that the URCs have had considerable success in putting together strategies and helping to pull together the many regeneration initiatives operating in their areas. The Urban White Paper will set out the Government's plans for building on these pilots. In areas where URCs exist they will play a key role in taking forward the City Growth Strategies detailed in Chapter 3. **The Government will continue to monitor the URCs carefully, and will consider how a tax relief could help to promote their development.**

Box 6.6: The 2000 Spending Review and urban regeneration

The 2000 Spending Review settlement made a significant contribution towards addressing the problems of urban decline and dereliction. Regeneration budgets will grow in real terms by an average of 15 per cent each year. Spending in 2003-04 will be £932 million higher than in 200001. The economic role of Regional Development Agencies has been strengthened and their budgets will increase by £0.5 billion by 200304 with additional money for their programmes to restore land and bring it back into economic use (see Box 3.4). Public Service Agreement targets have been set to improve the economic performance of all regions and to bring back into use 17 per cent of current brownfield land to help deliver the Government's target that 60 per cent of new housing should be built on previously developed land.

VAT on listed buildings

6.83 The Government is keen to preserve Britain's rich built heritage for both current and future generations. Places of worship can play a focal point in rural and urban communities. **The Government is attracted to the idea of offering a reduced rate of VAT for the repair and maintenance of listed buildings** which are used as places of worship, and has written to the European Commission today to make clear its position.

State Aids

6.84 Several aspects of the urban regeneration package will require EU state aids clearance, and the appropriate applications will be made to the European Commission in due course. Progress on implementing this package of measures will be considered in Budget 2001.

6.85 This package of measures, worth £1 billion over five years, forms only one part of the Government's vision of an urban renaissance, which will be set out in the forthcoming Urban White Paper. **The Government intends to review the contribution that this package of measures has made to Britain's urban renaissance after five years.**

PROTECTING BRITAIN'S COUNTRYSIDE

6.86 The Government is committed to reducing the pressures that economic growth puts on the rural environment. The forthcoming Rural White Paper will put in place policies which guide the path of change towards a countryside that is sustainable - economically, environmentally and socially - and strengthen the role farmers play as stewards of the traditional rural landscape. Measures aimed at protecting the country-side include:

- **economic instruments** such as the landfill tax increases and aggregates levy, as well as a package of measures to relieve the pressures on greenfield land by regenerating Britain's towns and cities, as discussed in the proceeding section;
- **public expenditure** on land and project based measures in the form of the aggregates Sustainability Fund, and the measures contained in the Rural Development Programme (launched in October 2000); and
- **regulations,** such as new minerals planning guidance, and planning guidance on housing which promotes urban brownfield development.

The aggregates levy and the Sustainability Fund

6.87 Budget 2000 announced that the aggregates levy would be introduced from April 2002 to address the environmental costs of aggregates extraction and encourage the use of recycled materials. This levy will bring about environmental benefits by making the price of aggregates better reflect their true social and environmental costs, and encouraging the use of alternative materials which would otherwise have to be landfilled, thus reducing the amount of extraction. A recent survey undertaken by the Environment Agency, the results of which are to be published later this year, shows that there is still scope for additional use of construction and demolition wastes. There is also significant scope for using more materials such as china clay waste and colliery spoil which scar the landscape. The levy will also encourage the development of a range of other alternatives including the use of waste glass and tyres in aggregate mixes.

6.88 Budget 2000 announced that the revenues raised from the levy would be matched by a 0.1 percentage point cut in employers' NICs and a new Sustainability Fund aimed at delivering local environmental benefits to areas subject to the environmental costs of aggregates extraction. The Government has recently consulted on how this Fund could best be used, and a summary of responses is published alongside the Pre-Budget Report. On the whole, the consultation was well received. The majority of the options set out in the document were supported, but many respondents emphasised that the Fund should not be used to pay for activities which are properly the site operators responsibility. In light of the representations made, **the Government has decided to allocate £35 million to the new Sustainability Fund that will be introduced alongside the aggregates levy in April 2002.** In the run up to Budget 2001, the Government will hold discussions with the devolved administrations on whether there is scope for setting up a UK-wide Fund with shared objectives that maximise the environmental benefits of the Fund and complements the objectives of the aggregates levy.

Waste

6.89 *Waste Strategy 2000: England and Wales* sets out the Government's vision for delivering a more sustainable use of resources via increases in reuse, recycling and energy recovery. Targets set by the Landfill Directive apply only to biodegradable waste. To deliver further improvements, the Government and the National Assembly for Wales have established targets to recover value from 40 per cent of all municipal waste by 2005, rising to 67 per cent by 2015. Local authorities will play a major role in meeting these goals and have already been set targets which will nearly triple the recycling and composting of household waste by 2005.

6.90 The Governments's Waste Strategy involves using a number of instruments to reduce waste and increase recycling and composting of all waste streams, thereby diverting waste from landfill. These include:

- tradeable permits limiting the amount of waste local authorities can send to landfill;
- the Waste and Resources Action Programme (WRAP) which aims to secure a significant increase in more sustainable management of wastes, and an expansion in the markets for secondary materials;
- the landfill tax escalator;
- raising awareness of the need to recycle and reduce waste through the *"Are you doing your bit?"* advertising campaign; and
- a pilot scheme to require public procurement of certain recycled products.

Landfill tax credit scheme

6.91 The landfill tax credit scheme, which has already raised £300 million for approved projects, was extended in January 2000 to include "research and education on market development for recycled waste" and to make explicit that recycling related research and development was eligible for funding under the scheme.

6.92 Waste Strategy 2000 set out the Government's strategy to use the scheme to deliver sustainable waste management. But so far in 2000, the proportion of credits being allocated to sustainable waste management have been falling. In line with the commitments made in the waste strategy, the Government intends to explore how resources going through the scheme could be better used to increase recycling rates, particularly of household waste.

Capital allowances for oil rigs

6.93 In order to further reduce the amount of demolition waste, the Government has announced that **capital allowances will be available for the costs of preparing oil rigs and other offshore oil installations for reuse on the same basis as they are currently available for the costs of demolition.** Reuse is the more environmentally friendly option, and this will stop the tax system discriminating against it.

Pesticides

6.94 The Government is committed to minimising the adverse environmental impact of pesticides use, consistent with adequate crop protection. The statutory approval system and the activities of the Pesticides Forum have made important contributions to this objective.

6.95 In March 1999, DETR published a report by ECOTEC consultants, *Design of a tax or charge scheme for pesticides*. This showed that a carefully designed tax or charge scheme could be used to address the environmental impacts of pesticide use. As the Government stated in the November 1999 Pre-Budget Report, it believes that a tax could, in conjunction with other measures, be a useful tool in addressing the environmental impacts of pesticides.

6.96 Since the November 1999 Pre-Budget Report, the Government has been exploring with the agrochemical industry whether its objectives could be better achieved through a partnership approach. As part of this process, the Crop Protection Association (CPA) published a formal set of voluntary proposals in April 2000. The Government invited interested parties to comment on the proposed measures and their effectiveness in tackling the environmental impacts of pesticide use. A summary of the responses are available on the DETR web page www.environment.detr.gov.uk.

6.97 The Government agrees with the concerns raised by respondents to the recent consultation exercise that the measures proposed by the CPA in April were not sufficient. The Government therefore welcomes the revised proposals submitted by the CPA in October and the involvement of other stakeholders, but believes that the proposed measures still fail to meet a number of concerns raised. The Government would like to see further improvements to this package and will be holding discussions with the CPA on developing a more substantial package in the run up to Budget 2001.

Water

6.98 In April 2000, the Government published a consultation paper, seeking views on how economic instruments - in particular, abstraction licence trading - might be introduced or facilitated. This paper is available on the DETR website[1]. The Government is considering responses and will announce the outcome in early 2001.

ENVIRONMENTAL APPRAISAL OF POLICY MEASURES

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

6.100 There are large uncertainties involved in trying to estimate behavioural responses to Budget measures. It is not always easy to quantify the individual environmental effects of individual Government policies, especially when they are introduced as part of a package of measures. Wherever possible, an attempt has been made to separate out the effects of individual measures, as in the case of company car tax, but it should be noted that these estimates are subject to large margins of error. Estimates are not included where the precise details of a policy measure are not yet finalised.

6.101 The Government has made available documentation about the environmental appraisal methodology underlying its estimates including those set out in the draft climate change programme, the associated paper on the derivation of carbon savings, the DTI 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.

Table 6.1 and Table 6.2

A

The economy

Monetary and fiscal stability, together with improved underlying labour market performance, has created a foundation of steady growth and low inflation in the UK economy. The challenge ahead lies in maintaining economic stability, and improving productivity and employment opportunity for all, so delivering stronger sustained growth in output:

- The UK economy has witnessed continued strong growth combined with low inflation in 2000. The number of people in work has risen by more than one million since spring 1997, and the employment rate is now close to its previous record high.
- Underlying pay pressures have, nevertheless, remained subdued. This signals a fall in the sustainable rate of unemployment over recent years, boosting trend output growth and helping to keep interest rates historically low.
- The Monetary Policy Committee has raised interest rates pre-emptively, noting that domestic demand growth needed to slow. As in Budget 2000, GDP is forecast to grow by 3 per cent in 2000, easing to its assumed sustainable rate of $2^1/_4$ to $2^3/_4$ per cent in 2001 and later years.
- RPIX inflation is now expected to rise gradually back to $2^1/_2$ per cent by mid-2001, remaining at the Government's target thereafter. The short-term risk of excess growth in demand is balanced by the possibility of continued favourable developments in costs and margins.
- There is considerable scope for stronger non-inflationary growth through seizing opportunities to step up the pace of productivity gains and further moves towards full employment.
- Real oil prices remain significantly below late 1970s to mid-1980s levels, and global oil dependency has fallen significantly since then. But higher oil prices, if sustained, pose a clear risk to global inflation and growth.

Introduction[1,2]

A1. This annex discusses economic developments since Budget 2000, and provides updated forecasts for the UK and world economies in the period to 2003. The overview section sets out the key points, summarising UK economic prospects in the light of the recent underlying improvement in labour market performance and its implications for trend output growth. More detailed forecast issues and risks are discussed in the second half of this annex, followed by a summary of the world economy outlook.

UK ECONOMY OVERVIEW

Table A1: Summary of forecast

			Forecast		
	1999	2000	2001	2002	2003
GDP growth (per cent)	$2^1/_4$	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)	$2^1/_4$	$2^1/_4$	$2^1/_2$	$2^1/_2$	$2^1/_2$

The economy in 2000

A2. The UK economy has experienced continued strong growth in output and employment combined with low inflation since Budget 2000. The preliminary estimate of GDP showed total output rising by 0.7 per cent in the third quarter and by 2.9 per cent over the past year, exceeding its estimated trend rate. Growth had strengthened rapidly during the course of 1999, as buoyant domestic demand drove the economy out of a temporary slowing that was partly associated with the slowdown in global activity. Helped by low inflation, proactive policy responses, and a sharper than expected improvement in external demand, this was one of the most rapid recoveries in UK growth since the 1960s.

A3. The labour market remains buoyant, with activity further strengthening in the period since March. The Labour Force Survey (LFS) measure of employment has risen to a series of record highs, and in the three months to August was 330,000 higher than a year earlier. International Labour Organisation (ILO) and claimant count unemployment have fallen to their lowest rates since the 1970s. Underlying growth in average earnings has, nevertheless, edged below $4^1/_2$ per cent, and the headline measure eased significantly during the second quarter as the impact of bonuses and one-off millennium-related payments dissipated.

A4. Growth in unit labour costs has fallen following a strong cyclical recovery in whole economy productivity growth, and continued competitive pressures have contributed to a further compression of producer and retail margins. RPIX inflation therefore remained just over 2 per cent in the third quarter, despite stronger upward pressure from import prices, and has fluctuated in a very narrow range throughout 2000. On the Harmonised Index of Consumer Prices (HICP) measure, UK inflation was 1.0 per cent in September, remaining the lowest in the EU. Performance over recent years contrasts sharply with the UK's historical record as a relatively high and volatile inflation country.

A5. Latest data suggest that the softening in economic activity in the first quarter of 2000 was a temporary reaction to exceptional strength in demand in the run up to the new millennium. There was no run down of inventories as had been widely expected, but growth in final demand fell back. GDP rose by a modest 0.5 per cent overall, though partly reflecting an erratic decline in energy-related output. However, this pattern was quickly reversed with rapid growth in domestic demand driving a 0.9 per cent increase in GDP in the second quarter.

A6. Overall, GDP rose by 1.3 per cent in the first half of 2000 compared to the previous half year, closely in line with the Budget forecast, and with final domestic demand growth easing from the strong rates of expansion seen in 1999. Household consumption growth has shown some further moderation, though it still exceeds longer-term sustainable rates. Lower than expected growth in total domestic demand has largely reflected some temporary weakness in government spending. This was broadly offset by surprisingly robust growth in goods export volumes, due to rapid growth in UK export markets. The contribution of net trade to GDP growth therefore has remained much more neutral than in previous years, continuing the clear improvement seen since mid-1999.

A7. Service sector activity remains strong, with output rising by 3.3 per cent in the year to the third quarter. Industrial production and construction output have also firmed and so divergence in performance between sectors has narrowed markedly over the past year. Manufacturing output rose by 0.6 per cent in the third quarter and was 0.9 per cent higher than a year earlier. While sterling's strength has had a disproportionate impact on manufacturing activity over recent years, variation in performance within the sector has been marked. A number of export-intensive businesses such as engineering and chemicals have recorded relatively strong gains in real output, as have some industries typically exposed to a high degree of foreign competition in the home market.

The labour market

A8. Strong and stable economic growth has led to a marked improvement in labour market performance over recent years. LFS employment has increased by more than one million in total since spring 1997, pushing the working-age employment rate to just below its previous 75 per cent peak reached in 1990. Unemployment has also fallen markedly, on the ILO measure from 7.2 per cent in spring 1997 to 5.3 per cent currently.

Chart A1

A9. Growth in LFS employment looks to have strengthened in the period since Budget 2000, rising 80,000 in the three months to August compared to the previous three months. Growth in the alternative workforce jobs series has been more erratic, rising by 69,000 between June and March but showing little change in the first quarter. This may partly reflect sampling methods, but also continuing falls in the number of people with second jobs[3]. The proportion of temporary or part-time employees not able to find permanent or full-time employment has fallen significantly over the past year.

A10. Buoyant survey indicators and record numbers of vacancies suggest that labour demand will remain robust. With unemployment reaching new lows, it has become increasingly important that rising demand is matched by increased labour market participation. Working-age participation continues to rise modestly, though by less than in previous cycles, and so remains below the last peak recorded in 1990. In addition to the 1.6 million ILO unemployed, there are a further 2.3 million people of working age who are economically inactive but want a job. As set out in chapter 4, the challenge ahead lies with expanding the effective supply of labour, helping the economy to grow more rapidly without encountering skill shortages and excess cost pressures.

A11. The headline measure of whole economy earnings growth has fallen from a peak of 6.0 per cent in the three months to February to 3.9 per cent in the three months to August, driven by a deceleration in private service sector pay. This recent trend owes much to a sharp decline in the contribution of bonuses to overall pay growth, which turned sharply negative in the months after April. However, growth in underlying earnings (excluding bonuses) has also edged below $4\frac{1}{2}$ per cent during the course of 2000, with stronger first quarter outturns probably boosted by one-off payments associated with the millennium.

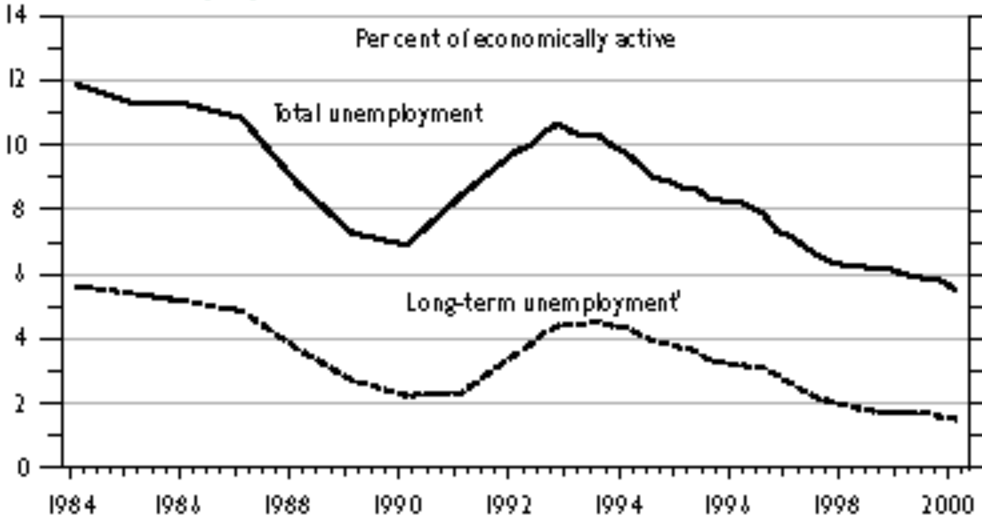
A12. Underlying pay settlements - which exclude so-called 'drift' elements of total earnings such as overtime payments and bonuses - have, nevertheless, been rising recently. The Industrial Relations Services (IRS) measure of 3-month median whole economy settlements has risen by around $\frac{1}{2}$ percentage point to 3 per cent currently, with Confederation of British Industry (CBI) data showing a similar upturn. This may provide a clearer indication of underlying labour market tightness, though rising headline RPI inflation has probably also been a factor. This suggests that that real wage bargaining is still partly backward-looking despite some further decline in workers' expectations of future inflation in recent years. Greater credibility in the inflation target, nevertheless, will have helped to contain labour cost pressures, even with the economy operating just above trend.

A13. Whole economy productivity growth recovered to 2.4 per cent in the second quarter of 2000, driving a fall in unit wage cost growth to just 1.1 per cent. Although volatile shorter-term movements in productivity and unit costs can be misleading, underlying earnings growth of around $4\frac{1}{2}$ per cent recently appears sustainable given estimated trend productivity growth of 2 per cent a year. The absence of any upturn in wage inflation or trend unit wage costs growth[4] since the first half of 1997 signals an underlying improvement in the trade-off between unemployment and inflation over recent years. Box A1 examines some possible explanations for this apparent fall in the non-accelerating inflation rate of unemployment (NAIRU). The implications for trend output growth are set out in the next section.

Box A1: The sustainable rate of unemployment

Higher levels of unemployment, indicating an excess supply of labour, can be thought of as exerting downward pressure on pay, resolving the competing real wage aspirations of workers and firms. Greater responsiveness of real wages to unemployment therefore allows stable inflation to be achieved with lower levels of unemployment and hence higher output. Similarly, a sustained reduction in unemployment can be achieved if external wage or price pressures fall, for example through enhanced product market competition or as a result of more intensive job search as returns to work relative to welfare are improved.

LFS unemployment rates



[1] Unemployed for more than 12 months.

Labour costs

Much of the decline in unemployment during the late 1990s has been concentrated among the long-term unemployed. Long periods without employment can discourage individuals from actively searching for work and make them less attractive to potential employers due to loss of skills. As a result, the long-term unemployed may exert relatively little downward pressure on wages, perhaps explaining muted upward pressure on earnings growth as people in this group have returned to work. This fall in long-term unemployment will partly reflect a succession of labour market programmes, including a contribution from the New Deals in recent years.

This has been helped by a reduction in regional and skills mismatch compared to the first half of the 1990s. As set out in Budget 2000, divergence in unemployment rates between regions has fallen by roughly a third during the 1990s and regional dispersion in the number of unemployed per vacancy has also narrowed sharply. More efficient matching of workers and jobs may reflect improved job search on the part of the unemployed, again at least partly associated with the Welfare to Work initiative. In addition, there is some evidence of reduced skills mismatch during the late 1990s, with the CBI skilled labour shortage indicator remaining quite close to its long-run average despite strong economic growth over recent years.

Recent developments in product markets are also likely to have contributed to the fall in the NAIRU. Downward pressure on business margins boosts workers' real pay, helping contain nominal earnings growth at lower levels of unemployment. Evidence of sustained competitive pressure on margins remains widespread, with a trend towards outright deflation in a number of retail goods sectors. This partly reflects sterling's strength, but also structural changes including greater consumer price consciousness and enhanced potential for competition facilitated by new technology.

Any judgement on the NAIRU is subject to considerable uncertainty. While there are good grounds for thinking it has fallen to well below 6 per cent on the ILO measure in recent years, more pessimistic interpretations are possible. Sterling's earlier appreciation may have temporarily lowered wage pressures and hence the NAIRU, boosting the real 'consumption wage' though cheaper imports. This effect could unwind as has, decisively over the past year, the potential contribution from previously low oil prices. It will be some time before the contribution of such factors can be fully assessed.

Trend output growth and the output gap

A14. There have been significant revisions to key national accounts aggregates compared to the estimates available at the time of Budget 2000. In June, the Office for National Statistics (ONS) increased its average estimate of GDP growth in 1998 to 2.6 per cent from 2.2 per cent previously. This was more than accounted for by stronger household consumption growth and reinforced by a more modest upward revision to growth in 1999. The revisions were somewhat larger measured from the output side, leaving the level of gross value added at constant prices in the fourth quarter of 1999 some 1.2 percentage points higher than the estimate available in March.

A15. Conceivably, these upward revisions to GDP growth could be interpreted entirely as signalling greater cyclical strength in the economy, implying a correspondingly larger estimate of the output gap. Alternatively, stronger GDP growth might reflect higher trend output growth, with the cyclical position of the UK economy broadly unchanged. In practice, any assessment should be based on a range of evidence including measures of capacity utilisation, the apparent degree of domestic price pressures, and the fundamental drivers of trend output growth over recent years.

A16. Business survey indicators of capacity and labour utilisation are broadly consistent with the economy being at or close to trend around mid-1999. For manufacturing, both the CBI and British Chamber of Commerce (BCC) measures were close to their long-run averages at this point, as was the CBI indicator of skilled labour shortages. In services, the BCC capacity indicator exceeded its long-run average throughout the year, but remained close to its level during the first half of 1997 when the economy is previously estimated to have been on trend.

A17. Wage and price inflation have remained subdued over this period, though it is difficult to disentangle underlying domestic pressures from the downward impact of sterling's earlier appreciation. The upturn in underlying service sector inflation over recent years, for example, poses the risk that fairly significant pressures on capacity have emerged. However, the absence of any clear trend in domestic cost growth suggests that output has remained fairly close to productive potential throughout. Buoyant GDP growth over recent years - averaging just over $2^1/_2$ per cent a year between the first half of 1997 and mid-1999 - therefore appears to have been broadly matched by an equivalent expansion in trend output.

A18. Table A2 provides a simple[5] decomposition of estimated trend output growth in recent years, together with a comparison with the earlier 1990s and the neutral assumptions underlying the GDP forecast ranges presented in this annex. Compared to the earlier 1990s, the most striking development in recent years has been the sharp increase in the employment rate. Allowing for employment responding to output with some lag, this is estimated to have risen by 0.5 per cent a year on a trend basis between 1997 and 1999. With the labour market inactivity rate having only edged down over this period, the employment rate trend corresponds to a fall in the NAIRU of similar magnitude. Thus over the past three years the NAIRU might have fallen by around $1^1/_2$ percentage points, to around $5^1/_2$ per cent, broadly in line with the fall in the actual unemployment rate.

Table A2: Contributions to trend output growth

	Estimated trend rates of growth[1], per cent per annum				
	Trend labour productivity[2]		Trend employment rate[4]	Population of working age[5]	**Trend output**
	Underlying[3]	Actual			
	(1)	(2)	(3)	(4)	(5)
1990Q4 to 1997H1	2.0[6]	2.1	-0.2	0.3	**$2^1/_4$**
1997H1 to mid-1999	1.9[5]	1.6	0.5	0.5	**$2^1/_2$**
Forecast[7]	2.0[5]	1.9	0.1	0.5	**$2^1/_2$**

1 *Treasury analysis based on the judgement that 1990Q4, 1997H1 and mid-1999 were on-trend points of the output cycle, and allowing for employment lagging output in order to estimate trend growth rates for employment and labour productivity. Figures independently rounded.*
Columns (2) + (3) + (4) = (5)

2 *Output per workforce job.*

3 *Adjusted for effect of changes in employment rate, i.e. assuming the employment rate had remained constant. Column (1) - column (2) = (1-a). column (3), where a is the ratio of new to average worker productivity levels. The figuring is consistent with this ratio being of the order of 50 per cent, as suggested by data on relative entry wages.*

4 *Ratio of workforce jobs to working-age household population.*

5 *UK household basis.*

6 *Estimated from a regression of productivity growth on employment rate growth and the output gap over a complete output cycle from 1986Q2 to 1997H1.*

7 *Neutral case assumptions underlying the mid-points of the GDP growth ranges from 2001Q1.*

A19. This judgement is, of course, subject to considerable uncertainty. The main risk is that unemployment has fallen significantly below its sustainable rate, and hence that the economy is much further above trend than estimated. This would imply reduced scope for non-inflationary growth in the period ahead and, from a fiscal policy perspective, a weaker structural starting position for the projections of the public finances. This risk is analysed in Chapter 2, demonstrating that the Government would remain on track to meet its fiscal rules even on less favourable assumptions concerning the current cyclical position of the UK economy - the cautious case.

A20. Strong employment gains in recent years have been accompanied by subdued productivity growth, which has been below its long-run rate since 1995. This mainly reflects the temporary impact of bringing large numbers of people back into employment, as those entering work tend to have lower than average productivity levels. Adjusting for this transitory impact on productivity growth, Table A2 shows that in underlying terms the expansion in trend productivity over recent years has been close to the average for the earlier 1990s.

A21. The recent trend is still puzzling, nevertheless, given strong business investment growth and the rapid increase in Information and Communications Technology (ICT) usage. It contrasts sharply with recent US experience, where rising ICT intensity has been credited with contributing to a significant acceleration in trend productivity (see Box A2). However, such comparisons with the US also raise some important statistical issues, including the difficulty of measuring real output gains for new technology products where prices and quality are changing rapidly. The ONS is actively engaged in examining 'new economy' measurement issues[6].

A22. As in Budget 2000, the mid-point of the Pre-Budget Report GDP forecast ranges are anchored on a neutral assumption of $2^1/_2$ per cent a year trend output growth. This assumes trend productivity growth of 2 per cent in underlying terms, as estimated for the pre-1997 cycle, and only a very modest trend increase in the employment rate compared to the recent past. Revised projections from the Government Actuary's Department now show 0.5 per cent a year medium-term growth in the population of working age, 0.1 percentage points higher than previously expected. This small revision has not changed the neutral assumption for trend output growth itself. Projections for the public finances continue to be based on the cautious $2^1/_4$ per cent a year trend growth assumption, as they will be in Budget 2001.

A23. Downside risks to trend output growth are at least balanced by the possibility of continued underlying improvements in supply performance, illustrated by the upper ends of the GDP forecast ranges. Indeed, recent evidence from the US points to considerable opportunities for accelerated productivity performance based on capital deepening through ICT investment and associated diffusion of know-how across the economy. Herein lies part of the productivity challenge which, together with the Government's aim to secure further progress towards full employment, opens up the potential for sustainable growth beyond the upper ends of the GDP forecast ranges (see Box A2).

Chart A2

Output and demand

A24. GDP is expected to grow at an annualised rate of 3 per cent during the second half of 2000, reflecting some near-term firming in final demand. GfK consumer confidence remains above long-run levels, with household expectations of their own future financial position at a record level in October. Strong household spending will be reinforced by a pick up in government consumption from a relatively weak first half, partly reflecting the carry forward of underspends from the previous financial year.

A25. These developments will sustain rapid service sector growth. Manufacturing activity is likely to remain more muted for a period, though latest data show that the deterioration in business survey indicators following sterling's temporary peak in May overstated the potential impact on output. GDP is forecast to grow by 3 per cent in 2000 as a whole, unchanged from the Budget 2000 forecast. This does not include any explicit allowance for the effects of the disruption of fuel supplies in September, which appear to have been modest at the whole economy level.

A26. Based on the re-assessment of trend output growth over recent years, the economy is judged to be operating just above its supply potential at present. The output gap is estimated to have risen gradually to around $^1/_2$ per cent currently, with most survey measures of capacity utilisation moving just above their long-run averages since mid-1999. Strong output growth, nevertheless, can be accommodated for a period, with upward short-term pressures on domestic costs helping push RPIX inflation back up towards its target rate. However, as the Bank of England's Monetary Policy Committee (MPC) has made clear, it is important that growth in aggregate demand does not outpace potential output growth for long.

Box A2: Sustaining stronger growth with low inflation - supply side opportunities

The Pre-Budget Report projects a modest slowing in GDP growth in order to prevent inflation from rising above target in the medium term, so preserving long-term economic stability. However, despite a clear short-term risk that growth in domestic demand may not fall back as expected, the inflation outlook remains very finely balanced.

At the producer level, underlying growth in output prices has been relatively restrained despite much stronger upward pressures on input prices, particularly due to dearer oil. For retailers, competitive pressures remain intense and margins are still being squeezed in a number of sectors. The MPC regularly considers a range of plausible alternative assumptions for the future trend in margins, with significant implications for the inflation outlook[1]. Even in the event of stronger than expected domestic or external cost pressures, there is a clear possibility that this could be offset by continued favourable developments in prices relative to costs.

The trade-off between output growth and inflation might be more permanently improved through stronger medium-term growth in productivity. The manufacturing sector in particular will be looking to build on recent productivity improvements in order to restore profitability. Currently low levels of unemployment will encourage firms more generally to meet increases in demand through higher productivity. According to some independent forecasters, notably the National Institute for Economic and Social Research, such factors might underpin a period of 'catch-up' over the coming years, with average productivity growth rising well above the 1990s' trend[2].

Moreover, the Pre-Budget Report forecast does not assume any underlying improvements in supply performance associated with the adoption of 'new economy' technologies and related diffusion of know-how. In the US, however, the strength and longevity of the growth upswing has prompted re-assessment of the evidence. While earlier studies had concluded that most of the improvements in US productivity could be explained by more efficient production as opposed to use of ICT equipment, there is now more support for the view that economy-wide capital deepening is paying dividends (see also Box 3.1). With strong UK private investment spending in the late 1990s apparently focussed on ICT and other specialist equipment, there is a good chance that firms here may be able to emulate US performance to some degree.

Therefore businesses, individuals and the Government are faced with the challenge to secure a significantly stronger productivity performance than the 2 per cent a year trend assumption that underlies the mid-points of the Pre-Budget Report forecast ranges. Despite very favourable labour market developments in recent years, the neutral assessment of trend output growth also assumes only a 0.1 percentage points a year reduction in the sustainable rate of unemployment, mainly reflecting the long-term increase in female participation. Government policies to extend employment opportunity to all open up the possibility of much stronger improvements in underlying labour market performance. So there are considerable opportunities which, if taken, could sustain stronger GDP growth at or beyond the upper ends of the Pre-Budget Report forecast ranges.

[1] ***Bank of England Inflation Report,*** August 2000.

[2] ***National Institute Economic Review,*** No. 173, July 2000.

A27. Household consumption growth is forecast to slow further in the period ahead. Pro-active monetary policy tightening from September 1999 has already had a substantial impact, with the full effects likely to build further into 2001. Household responsiveness to interest rate changes now appears stronger than in the past, perhaps reflecting increased policy credibility as well as greater household caution following the experience of the early 1990s. In addition, support to consumer spending from past gains in household wealth is declining rapidly. Equity prices have shown no underlying growth for a year and house prices have recently been decelerating. These factors should contribute to a gradual recovery in the household saving ratio, which has recently fallen to low levels (see Box A4).

A28. Business investment growth has slowed broadly in line with the Budget 2000 forecast, though this is likely to be temporary. Manufacturing investment has begun to pick up with stronger external demand boosting output prospects, and service sector spending rebounded in the second quarter. A gradual strengthening in investment growth is therefore expected, keeping the business investment to GDP ratio close to record levels, but with already significant company deficits preventing a more rapid expansion. Net trade performance is also improving, despite the persistent weakness of the euro and rapid growth in import volumes. UK exporters' market share may be stabilising, particularly in non-EU markets, and net exports are expected to exert only a modest drag on GDP growth from now on.

A29. Government spending on key priorities, including health and education, is set to increase over the next three years, as set out in Budget 2000 and the 2000 Spending Review. The implications for aggregate demand and inflation, however, will depend on the overall fiscal position, which will remain historically tight over the next few years. Growth in private demand has remained rapid despite the significant fiscal tightening since 1996-97. This may reflect long adjustment lags and also some clear tendency for private saving rates to adjust to offset reductions in government borrowing. In either case, this suggests that the overall impact on aggregate demand of future movements in the fiscal stance is likely to be relatively modest, helping to explain still benign financial market expectations of interest rates in the period since Budget 2000.

Chart A3

A30. Domestic demand growth is forecast to slow to $2^1/_2$ to 3 per cent in 2001, with GDP rising by $2^1/_4$ to $2^3/_4$ per cent overall. However, the pace of expansion in demand and output is expected to fall just below trend rates during the year. This appears necessary to eliminate the output gap gradually and so prevent RPIX inflation moving above the Government's target in the medium term. This is reflected in some further decline in annual domestic demand growth to $2^1/_4$ to $2^3/_4$ per cent in 2002, with continued moderation in household consumption offsetting stronger business investment growth. Combined with a still modest negative contribution from net trade, GDP is forecast to grow by $2^1/_4$ to $2^3/_4$ per cent in 2002, remaining at this rate in 2003.

A31. Forecast risks are discussed in the second half of this annex. In particular, there remains a clear possibility of more rapid growth in consumption and investment. While this would tend to boost wage pressures, the short-term inflation outlook remains very finely balanced. Following some evidence of improved underlying economic performance over recent years, Box A2 examines the possibilities for stronger growth combined with low inflation. Upside risks are still balanced principally by the possibility of weaker growth in net exports. Global demand remains susceptible to revaluations in equity prices, and now also the possibility of persistent strength in oil prices (see Box A3).

Inflation

A32. RPIX inflation was 2.1 per cent in the third quarter of 2000, in line with the Budget 2000 forecast. The deflationary trend in retail goods prices has more than accounted for the modest undershoot of RPIX inflation relative to target, driven by a 16 per cent decline in import prices of goods and services between spring 1996 and late 1999. Assessing the degree of underlying domestic price pressures is not straightforward. The Bank of England's RPIX excluding import prices measure of domestically-generated inflation has fallen over recent years, to around $2^1/_2$ per cent currently. However, the full impact of sterling's earlier appreciation goes well beyond direct movements in import price inflation, and is also likely to have been more drawn out.

A33. Inflation in the service sector, which is relatively sheltered from international competition and hence movements in the exchange rate, provides another guide. Excluding rent and utilities, it has risen by more than 1 percentage point since the first half of 1997 to around $5^1/_2$ per cent currently, and is now above the 1990s' average. According to simple analysis of the past short-run trade-off between output and inflation, this would point to a larger output gap currently than is embodied in the Pre-Budget Report forecast (chart A2). This upside risk is balanced by the absence of any upward trend in domestic cost growth over the same period, suggesting that output has remained close to trend throughout.

A34. Import prices rose gradually in the first half of 2000. Growth in world non-oil commodity prices remains relatively restrained, but has been boosted for UK importers due to sterling's recent decline against the dollar. Rising cost pressures overall have been dominated by the sharp increase in crude oil prices to more than $30 per barrel recently, up from $27 per barrel at Budget time and a low of $10 per barrel in early 1999. Producer input price inflation has risen to double-digit rates, driving a significant upturn in total manufacturing cost growth to around $4^1/_2$ per cent. Service sector firms, by contrast, are likely to have seen profits improve as a result of the recent decline in average earnings growth.

A35. For many manufacturers, it has been difficult to pass on cost increases. Producer output price inflation has been running at around $2^1/_2$ per cent in recent months, and remains significantly lower on an underlying basis. Margins have also been squeezed at the retail level, with around half of goods sectors now showing year-on-year reductions in prices. Evidence from the CBI's Industrial Trends and Distributive Trades surveys suggests that competitive pressures are likely to remain intense in the shorter term. Beyond that, the forecast assumes that margins cannot continue to be squeezed at their current rate. This judgement is subject to downside risk, not least reflecting on-going technological changes such as the growth of e-commerce.

Chart A4

A36. RPIX inflation is now expected to rise gradually back to its $2^1/_2$ per cent target in mid-2001, a little later than anticipated in the Budget 2000 forecast. Direct pressures from higher oil prices have so far been offset by a deeper compression in margins. Although oil prices are assumed to fall back towards the middle of the $22-28 per barrel OPEC target band by end- 2001, the wider inflationary impact could be more drawn out (see Box A3). Import price inflation has now turned positive, boosting total cost growth. Combined with a declining negative contribution from falling business margins, this accounts for the anticipated rise in RPIX inflation. Further moderation in domestic demand should help to keep growth in average earnings within sustainable limits, though there remain some clear upside risks.

A37. GDP deflator inflation is forecast to be 2 per cent in 2000-01, down from 2.5 per cent in 1999-2000. This reflects currently low consumers' expenditure deflator (CED) inflation and the unwinding of the previously positive contribution from the terms of trade. It is expected to return to $2^1/_2$ per cent in 2001-02, as CED inflation moves back in line with RPIX.

Box A3: The economic impact of higher oil prices

Oil prices have risen sharply since their trough of $10 per barrel in early 1999, to more than $30 per barrel in September 2000 as world demand strengthened against a background of weaker than expected OPEC supply (chart A8). Prices eased temporarily following OPEC's announcement of a modest increase in supply and the US government's decision to release 30 million barrels from its strategic stockpile. However, recent tension in the Middle East drove prices to a 10-year high of $35 per barrel in mid-October.

The Pre-Budget Report audited assumption is that prices fall back towards the middle of the $22-28 per barrel OPEC target band by end-2001, as both OPEC and non-OPEC production is stepped up and oil product stocks are rebuilt. However, the near-term outlook is subject to a number of upside risks, not least from continued speculative activity. In the US - the world's biggest consumer of oil - economic activity has outstripped expectations and crude oil stocks have fallen to their lowest level since the mid-1970s.

By raising production costs and so constraining supply, higher oil prices tend to depress GDP growth, simultaneously pushing up inflation and unemployment. As an illustration, the International Monetary Fund (IMF) estimates that a $10 per barrel increase in oil prices lasting for 1 year may reduce OECD growth by around 0.4 percentage points, at the same time raising price levels by 0.4 to 0.8 percentage points[1]. In practice, the overall economic effects will depend largely on second round impacts on wages and other prices, as well as movements in business and consumer confidence.

Currently high stock market valuations and significant global current account imbalances heighten the threat posed to the world economy by a prolonged hike in oil prices. Nevertheless, there are a number of reasons for believing that it is now better placed to deal with such a shock. Global oil dependency has fallen sharply, following a doubling of oil efficiency in the US and Europe since the early 1970s. Moreover, real oil prices are well below half their peak in late 1979, and more than 40 per cent lower than their average from then through to 1985. Greater anti-inflation policy credibility should help contain second round impacts on wages and prices, as will the perceived temporary nature of the current increase in oil prices.

The UK differs from most other major industrialised economies in that it is a small net exporter of oil. Potential output losses therefore may be partly offset by increased North Sea production and gains to UK incomes due to the improvement in the terms of trade. While UK exports more generally will be affected by any reduction in global activity due to dearer oil, the overall outlook for world trade growth is buoyant. Higher oil prices impact directly on the RPI mainly through increased motoring costs, with increased petrol prices on average contributing 0.6 percentage points to inflation in 2000. Wider impacts have so far been relatively muted, with producers able to pass on only a small part of the sharp increase in input prices. However, this compression in producer margins might not be sustainable in the longer term, should oil prices stay at high levels.

[1] ***World Economic Outlook,*** IMF, October 2000.

Independent forecasts

A38. The independent consensus for GDP growth in 2000 is currently 3.0 per cent, just below its April peak. On average, growth is expected to ease to 2.7 per cent in 2001, mainly reflecting slower growth in household consumption. The average of medium-term forecasts regularly monitored by the Treasury shows growth of around $2^{1}/_{2}$ per cent during the period 2002 to 2004, consistent with the Pre-Budget Report neutral assessment of trend growth.

A39. RPIX inflation is expected to remain below target in the short-term, though the average independent projection for the fourth quarter of 2000 has edged up to 2.1 per cent. It is expected to rise gradually to 2.4 per cent by the fourth quarter of 2001. Independent forecasts for the balance of payments current account have changed little since Budget 2000, with deficits of around $1^{3}/_{4}$ per cent of GDP projected in both 2000 and 2001.

Table A3: Pre-Budget Report and independent1 forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2000			2001		
		Independent			Independent	
	Pre-Budget Report	**Average**	**Range**	**Pre-Budget Report**	**Average**	**Range**
Gross domestic product	3	3.0	2.7 to 3.3	$2^{1}/_{4}$ to $2^{3}/_{4}$	2.7	1.5 to 3.3
RPIX (Q4)	$2^{1}/_{4}$	2.1	1.5 to 2.4	$2^{1}/_{2}$	2.4	1.3 to 3.7
Current account (£ billion)	$-14^{1}/_{4}$	-15.9	-27.5 to -9.0	-15	-18.2	-28.2 to -7.2

[1] '*Forecasts for the UK Economy: A Comparison of Independent Forecasts*', *October 2000*.

UK FORECAST IN DETAIL

The household sector

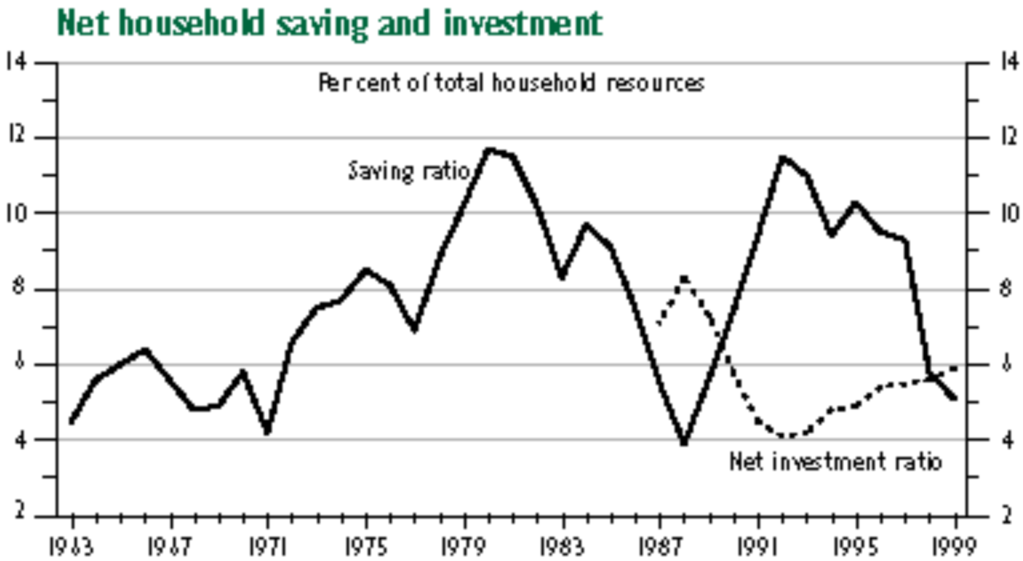
A40. Household consumption rose by 0.7 and 0.8 per cent in the first and second quarters of 2000 respectively, a considerable moderation from the very rapid rates of expansion seen through much of 1999. Services expenditure has accounted for the bulk of this slowing, reinforced by lower growth in durables spending in the second quarter as housing market activity cooled. Non-durables expenditure has remained more robust, driven by strong underlying growth in retail sales volumes throughout 2000. Lower general economy optimism has caused measures of consumer confidence to decline, though household perceptions of their own financial position remain historically high. Growth in consumer credit has eased from high levels, but the Bank of England estimates that mortgage equity withdrawal rebounded quite sharply in the second quarter.

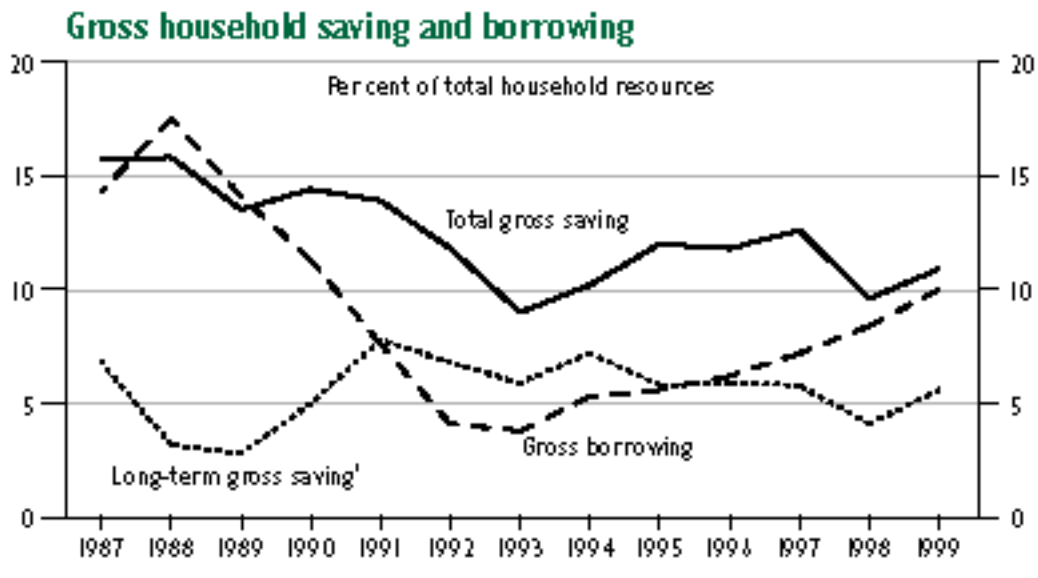
A41. House prices have decelerated sharply in 2000, with annual inflation falling from a peak of more than 15 per cent at the turn of the year to 10 per cent on the Nationwide measure and lower according to the Halifax. Housing transactions have also declined, falling below their long-run average in recent months. Recent developments reflect increases in interest rates and the abolition of MIRAS, and followed a decline in measures of housing affordability during the second half of 1999. Further moderation in house price inflation is likely during the course of 2001, though there is a clear chance of renewed housing market vigour should the economy fail to slow as expected. The recent trend may have been exaggerated by the unusual strength of housing market activity ahead of Budget 2000, and the level of mortgage loan approvals remains high.

Box A4: Household saving and borrowing

The household saving ratio fell from rates of around 10 per cent in the mid-1990s to 5 per cent in 1999. Some fall was to be expected compared to previous cycles, with sustained low inflation and greater economic stability reducing the need for precautionary saving. The further fall in the saving ratio to 3 per cent in the second quarter of 2000 has, nevertheless, prompted some commentators to make comparisons with the late 1980s. However, this masks marked divergences in the pattern of gross saving and borrowing between then and now, reflecting different structural and cyclical influences on household behaviour.

Gross borrowing rose to record rates of around 15 per cent of incomes in the late 1980s, significantly higher than today. Gross household saving increased to a lesser extent and almost exclusively in the form of liquid spendable balances. Increased long-term secured borrowing in particular helped fund the housing investment boom, but was also used to finance everyday consumption - a process known as equity withdrawal. This peaked at over 6 per cent of disposable income in 1988, facilitated by financial liberalisation and rapid house price inflation. The failure of monetary policy to react to clear signs of overheating had encouraged a sharp, though ultimately unrealistic, upward revision to household expectations of future income growth.





[1]Gross saving excluding currency and deposits.

The eventual doubling of interest rates to 15 per cent in late 1989 prompted a prolonged period of household retrenchment to restore balance sheets. With debt having risen to record levels in relation to incomes, households were faced by soaring debt service costs, sharp falls in nominal house prices, and the erosion of real financial wealth due to higher inflation in the early 1990s. Total wealth fell sharply relative to incomes, and the saving ratio rose to 12 per cent in 1992. Continued perceptions of job insecurity and widespread negative housing equity subsequently helped keep the saving ratio well above normal levels until 1996. Households showed little appetite for new debt as the economy strengthened, with gross borrowing rising only gradually from its 1993 trough.

Strong growth in asset prices has since driven household wealth to record levels relative to incomes. This has helped sustain consumer confidence at high levels contributing to the sharp reduction in net saving in the late 1990s. However, gross saving as a proportion of income has remained robust, with long-term saving in particular still close to its 1990s average last year. Household investment has increased gradually, but with the flow of funds into housing assets limited by enhanced policy credibility and lower inflation expectations. Similarly, the recent increase in equity withdrawal has been relatively restrained.

Therefore a key feature that distinguishes current household behaviour from the late 1980s is that gross household borrowing has remained much lower, despite rising to around 10 per cent of income in 1999. The proactive monetary policy tightening since the second half of 1999 is expected to restrain gross borrowing, as will the significant deceleration in asset prices over the past year. Gross saving is likely to be underpinned by the new framework for economic stability and Government measures to encourage long-term saving (see Chapter 5). Thus the household saving ratio is expected to recover gradually. Any further weakening would pose risks to the economic outlook.

A42. Household income growth is set to remain robust given labour market tightness, with consumers' real purchasing power further boosted by competitive retail pricing. Consumption growth, nevertheless, is expected to fall just below trend rates of expansion in the period ahead. It is forecast to fall to $2^1/_4$ to $2^1/_2$ per cent in 2001 and $1^3/_4$ to $2^1/_4$ per cent in 2002, consistent with a gradual recovery in the household saving ratio to around 6 per cent by 2003. The contribution of past gains in household wealth to consumption growth has eased considerably during 2000, with a further deceleration in prospect next year. The impact of previous proactive monetary policy tightening is also likely to build. Box A4 contrasts the recent trend in saving and borrowing with the late 1980s, though still high levels of consumer confidence pose some clear short-term risks.

Table A4: Household sector[1] expenditure and income

			Percentage changes on previous year		
			Forecast		
	1999	**2000**	**2001**	**2002**	**2003**
Household consumption[2]	$4^1/_4$	$3^1/_2$	$2^1/_4$ to $2^1/_2$	$1^3/_4$ to $2^1/_4$	2 to $2^1/_2$
Real household disposable income	$3^1/_2$	4	3 to $3^1/_4$	$2^3/_4$ to $3^1/_4$	$2^1/_4$ to $2^3/_4$
Saving ratio (level, per cent)	$5^1/_4$	$4^1/_2$	$4^3/_4$	$5^3/_4$	6

[1] *Including non-profit institutions serving households.*

[2] *At constant prices.*

Companies and investment

A43. As expected in Budget 2000 and earlier forecasts, business investment has decelerated significantly since early 1999, though remains at an historically high level in relation to GDP (see Chart A5). It rose by 0.5 per cent in the second quarter, contributing to growth of just 1.5 per cent over the past year. Service sector capital spending in particular has decelerated significantly, following a sharp increase in the ratio of services business investment to output during the late 1990s. Rising capital intensity in services has partly reflected new technological requirements, including millennium preparations, installation of euro compliant systems, and rapid advances in telecommunications infrastructure. Manufacturing business investment, by contrast, fell sharply in the year to mid-1999, reflecting weaker output growth and declining profitability. These falls have subsequently been partly reversed, bringing annual growth in manufacturing investment back in line with services at around 3 per cent in the second quarter.

A44. Private non-financial corporations (PNFC) gross saving fell markedly to 8.8 per cent of nominal GDP in 1999, largely reflecting a sharp increase in dividend payments with profits unchanged on the previous year. But investment only partly depends on availability of internal company finance, and PNFC fixed capital formation has remained close to its recent peak of around 11 per cent of GDP, despite the recent slowdown. The strong stock market and historically low interest rates have reduced the real cost of capital, and there has been a sharp increase in company borrowing to bridge the financing gap. PNFC net borrowing was just under 2 per cent of GDP in 1999, though it has eased in 2000 as profits and company saving firmed. Increased company indebtedness has been matched by strong growth in company assets: traditional measures of capital gearing therefore remain relatively benign, but company balance sheets have become more vulnerable to changes in market asset valuations.

Chart A5

A45. The forecast assumes that firms will wish to curtail borrowing further in the period ahead, preventing a return to rapid rates of expansion in capital spending. Survey evidence of rising capacity utilisation and increased profit expectations in 1999, nevertheless, points to a gradual strengthening in investment growth. BCC investment intentions have risen, though CBI survey evidence still paints a weaker picture. Business investment growth is expected to rise to $2^1/_4$ to $2^3/_4$ per cent by 2002, with spending as a proportion of GDP remaining very close to its recent record high across the forecast horizon. There is, however, a clear possibility of further increases in economy-wide ICT capital intensity due to technological change, for example due to increased spending associated with e-commerce strategies.

Table A5: Gross fixed capital formation

			Percentage changes on previous year		
			Forecast		
	1999	2000	2001	2002	2003
Whole economy[1]	6	2 1/2	4 1/4 to 4 1/2	3 3/4 to 4 1/4	3 1/4 to 3 3/4
of which:					
Business[2,3]	7 1/2	1 3/4	1 1/2 to 2	2 1/4 to 2 3/4	2 1/2 to 3
Private dwellings[3]	2 3/4	1	1 1/2 to 1 3/4	2 to 2 1/2	2 to 2 1/2
General government[3,4]	1 1/2	11	31 3/4	16 1/4	10 1/2

[1] *Includes costs associated with the transfer of ownership of land and existing buildings.*

[2] *Private sector and public corporations' (except National Health Service Trusts) non-residential investment. Includes investment under the Private Finance Initiative.*

[3] *Excludes purchases less sales of land and existing buildings.*

[4] *Includes National Health Service Trusts.*

A46. Growth in private residential investment has fallen to low levels recently, despite increased housebuilders' profitability due to strong gains in prices. However, private housing starts so far in 2000 are well above levels last year and so private residential investment growth is expected to strengthen gradually in the period ahead, reaching 2 to 2 1/2 per cent by 2002. Total fixed investment growth is forecast to rise more sharply, from 2 1/2 per cent in 2000 to an average of 3 3/4 to 4 1/4 per cent over the next three years, mainly due to the sharp programmed increase in general government investment. Budget 2000 set out the Government's commitment to raise public sector net investment to 1.8 per cent of GDP by 2003-04.

Trade and the balance of payments

A47. The widening of the UK balance of payments deficit since 1997 has levelled out significantly over the past year. The non-oil trade deficit was 2.5 per cent of GDP in the first half of 2000, rising only modestly compared to the previous half year and somewhat lower than forecast in Budget 2000. This turnaround has been due to the sharp acceleration in external demand, with UK export markets now expected to grow by over 9 per cent in 2000 as a whole. Total export volumes rose at a similar rate in the year to the second quarter of 2000, with latest monthly data showing continued strength into the second half of the year. Competitive import prices combined with buoyant domestic demand has, nevertheless, led to slightly stronger growth in import volumes. Net exports therefore have continued to restrain UK growth in 2000, but much more modestly than in previous years.

Chart A6

A48. Firms have responded to sterling's strength by cutting export prices significantly since late 1996, helping to contain the overall deterioration in price competitiveness and loss of export market share. The share fell markedly in the period to early 1999, but has since shown clear signs of stabilisation, particularly in non-EU markets. At the same time, strong growth in manufacturing productivity over the past year has helped to restore domestic cost competitiveness, permitting a modest upturn in export prices during 2000. Export volumes are now expected to grow by 8 per cent in 2000 overall, gradually easing to 5 1/2 to 6 per cent by 2003 as growth in UK export markets falls back to more normal rates. The trade forecast assumes no further loss of export market share, though this judgement is subject to downside risk due to the persistent weakness of the euro.

A49. Import penetration has risen significantly over recent years, reflecting the protracted fall in import prices since spring 1996. It has stepped up markedly since mid-1999, following some earlier signs of stabilisation, more than offsetting the recent moderation in domestic demand growth. Total import volumes therefore rose by nearly 11 per cent in the year to the second quarter of 2000, with growth in goods imports from non-EU countries in particular remaining very strong in the third quarter.

Import volumes are now expected to grow by $7\frac{1}{4}$ to $7\frac{1}{2}$ per cent in 2001, a significant upward revision from the Budget 2000 forecast, but lower than in 2000 and easing further in later years as domestic demand growth falls back to trend rates and import price inflation picks up further.

A50. Net export volumes overall are forecast to reduce UK GDP growth by 0.7 percentage points in 2000, down from 1.6 percentage points in 1999, and a little less than expected in March. This is reflected in a 0.3 percentage point downward revision to the trade in goods and services deficit, which is now forecast at around 2 per cent of GDP in 2000. Although growth in import volumes is broadly expected to match export volumes in later years, the deficit is forecast to rise to around $2\frac{1}{2}$ per cent of GDP due to a modest deterioration in the terms of trade.

A51. The current account deficit is now expected to be $1\frac{1}{2}$ per cent of GDP in 2000, $\frac{3}{4}$ percentage points lower that forecast in Budget 2000, partly reflecting a stronger than expected combined surplus on investment income and transfers during the first half of the year. This surplus is likely to be sustained, with the current account deficit overall peaking at $1\frac{3}{4}$ per cent of GDP in 2002 before falling back in 2003. Such deficits appear readily financeable given the strength of private sector balance sheets, though national saving may need to rise to secure further sustained improvements in the UK investment ratio.

Table A6: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices			£ billion
	Exports	Imports	Exports	Imports	Terms of trade[2]	Goods and services balance
1999	$3\frac{1}{4}$	$7\frac{3}{4}$	$-1\frac{1}{4}$	$-2\frac{1}{2}$	$1\frac{1}{4}$	$-15\frac{1}{4}$
Forecast						
2000	8	9	2	2	0	$-19\frac{1}{2}$
2001	7 to $7\frac{1}{2}$	$7\frac{1}{4}$ to $7\frac{1}{2}$	3	$3\frac{3}{4}$	$-\frac{1}{2}$	$-23\frac{1}{2}$
2002	6 to $6\frac{1}{2}$	6 to $6\frac{1}{2}$	$2\frac{3}{4}$	3	0	-26
2003	$5\frac{1}{2}$ to 6	$5\frac{1}{2}$ to 6	$2\frac{1}{2}$	$2\frac{1}{2}$	0	$-28\frac{1}{4}$

[1] *Average value indices.*

[2] *Ratio of export to import prices.*

Table A7: Summary of economic prospects[1]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast[2]				
	1999	2000	2001	2002	2003	Average errors from past forecasts[3]
Output at constant market prices						

Gross domestic product (GDP)	2¼	3	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾	1
Manufacturing output	0	1¼	2 to 2¼	1¾ to 2¼	1¾ to 2¼	2
Expenditure components of GDP at constant market prices[4]						
Domestic demand	3¾	3½	2½ to 3	2¼ to 2¾	2¼ to 2¾	1¼
Household consumption[5]	4¼	3½	2¼ to 2½	1¾ to 2¼	2 to 2½	1¼
General government consumption	3¼	2¼	4	4	3½	1½
Fixed investment	6	2½	4¼ to 4½	3¾ to 4¼	3¼ to 3¾	2¾
Change in inventories[6]	-¾	½	-¼	-¼ to 0	-¼	¼
Export of goods and services	3¼	8	7 to 7½	6 to 6½	5½ to 6	2
Imports of goods and services	7¾	9	7¼ to 7½	6 to 6½	5½ to 6	2
Balance of payments current account						
£ billion	-11	-14¼	-15	17½	-16¾	6½
per cent of GDP	-1¼	-1½	1½	-1¾	-1½	¾
Inflation						
RPIX (Q4)	2¼	2¼	2½	2½	2½	1
Producer output prices (Q4)[7]	1¼	2	2	2	2¼	1¼
GDP deflator at market prices (financial year)	2½	2	2½	2½	2½	1
Money GDP at market prices (financial year)						
£ billion	904	950	995 to 999	1042 to 1051	1091 to 1106	12
percentage change	5	5	4¾ to 5¼	4¾ to 5¼	4¾ to 5¼	1¼

[1] *The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2000, released by the Office for National Statistics on 27 September 2000, and the preliminary GDP estimate for the third quarter released on 20 October.*

[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 autumn 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.*

[4] *Further detail on the expenditure components of GDP is given in Table A8.*

[5] *Includes households and non-profit institutions serving households.*

[6] *Contribution to GDP growth, percentage points.*

[7] *Excluding excise duties.*

Table A8

THE WORLD ECONOMY

Overview

A52. The world economic outlook has strengthened considerably since the Budget. Growth in all major regions has surpassed expectations, and a more balanced pattern of economic activity is emerging in the G7. World trade has also picked up, driven by buoyant US demand. Better policymaking has helped to strengthen economic fundamentals in many developing countries, leading to improved access to capital markets. But high oil prices, if sustained, could impede the current expansion and trigger higher inflation. Significant current account imbalances, high equity valuations, and recent movements in the major exchange rates also pose risks for the world economy.

Table A9: The world economy

	Percentage change on a year earlier				
			Forecast		
	1999[1]	2000	2001	2002	2003
Major 7 countries[2]					
Real GDP	$2^3/_4$	4	3	$2^3/_4$	$2^3/_4$
Consumer price inflation[3]	$1^3/_4$	$2^1/_2$	$2^1/_4$	$2^1/_4$	$2^1/_4$
World trade in goods	$5^3/_4$	11	$7^3/_4$	$6^3/_4$	$6^1/_4$
UK export markets[4]	7	$9^1/_4$	7	6	$5^3/_4$

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 manufactures weighted according to their importance in UK exports.*

G7 activity

A53. The balance of G7 output and demand is expected to improve gradually next year as Japan's recovery becomes established, European growth continues and the US economy begins to slow. G7 growth is expected to peak at 4 per cent this year before falling back to 3 per cent in 2001 and $2^3/_4$ per cent in 2002. Japan is the only economy where activity is expected to strengthen next year, as improvements in industrial output and exports boost incomes and confidence.

A54. Euro area activity is now stronger than expected, boosted by the global recovery and currency weakness. High levels of consumer and business confidence have been accompanied by a significant decline in unemployment. The weak euro and higher oil prices have prompted the European Central Bank to raise interest rates by $1^3/_4$ percentage points during 2000, which seems likely to stabilise growth at healthy levels.

A55. The US expansion continues to exceed expectations, and there is increasing evidence that the economy can sustain stronger growth than previously without triggering inflation. Strong labour productivity growth, buoyant consumer confidence and robust investment spending should underpin still solid growth into 2001. However, sluggish equity prices, dearer oil and monetary tightening are expected to dampen the pace of expansion further ahead. The current account deficit continues to widen, increasing the risk of financial market instability if financing were to become a problem.

Rest of the world

A56. The recovery from the 1997-98 crises has taken firmer hold, aided by rapid export market growth, stronger domestic confidence and improving investor sentiment. The IMF expects all regions of the world to grow faster this year than they did in 1999, with particularly rapid growth in large economies such as Mexico and Russia. Some countries, including Brazil, are benefiting from structural reform and fiscal consolidation, which should improve their medium-term prospects. However, a number of countries, particularly in Latin America, still have large external financing requirements. Turbulence in global financial markets would pose a risk to financial flows and growth prospects.

Chart A7

World trade

A57. World trade is expected to grow by 11 per cent this year, nearly double last year's rate of $5^3/_4$ per cent. The rapid recovery in European exports and improving prospects in Latin America and Asia explain much of this improvement. World trade growth is expected to fall back to a healthy $7^3/_4$ per cent in 2001, as the global economy slows. Strong domestic demand in the US, Europe and parts of Asia is projected to boost UK export market growth to $9^1/_4$ per cent in 2000, much stronger than expected at the time of the Budget. Although prospects remain good, UK export market growth is expected to fall back in the next few years, in particular reflecting the US slowdown.

G7 inflation

A58. The sharp rise in oil prices this year has helped to push up headline inflation in the major economies. However, core inflation remains relatively subdued and there has been little upward pressure from wages so far. Inflation expectations do not appear to have risen during the year and there is still spare capacity in some major economies, notably Japan. These factors suggest that G7 inflation will fall back next year as oil prices decline. However, the unexpected extent and persistence of the rise in headline consumer prices in both the US and the Euro Area means that there could be some secondary pressures on wages and prices in 2001. This risk will increase if oil prices remain high (see Box A3).

Chart A8

Non-oil commodity prices

A59. The risk to inflation from non-oil commodity prices is low. Prices are only slightly higher than a year ago, and significantly below pre-Asian crisis levels. Metals continue to be the main source of price growth, whilst agricultural prices have yet to show clear signs of recovery. Relatively slow growth in non-oil commodity prices has been surprising, given the rapid strengthening in world demand. Prices are expected to remain stagnant in 2001, as increasing supply and high stock levels keep price pressures in check.

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[1]The forecast is consistent with national accounts and balance of payments statistics to the second quarter of 2000 released by the Office for National Statistics on 27 September, and the preliminary GDP estimate for the third quarter released on 20 October. 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.

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[3]The LFS series is based on a rolling household survey and measures the number of people in employment. The workforce jobs series is an employer-based survey providing a snapshop of the number of jobs on one particular day in the final month of each quarter.

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[4]Average earnings divided by estimated trend productivity.

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[5]In this framework, the contributions of the capital stock per worker and total factor productivity to trend output are sumsumed in estimated labour productivity (output per worker).

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[6]See *Productivity in the UK: The evidence and the Government's approach,* HM Treasury, November 2000.

B

The public finances

The updated projections of the public finances show that the underlying position remains strong. As a result of a continuing commitment to stability and prudence, the Government remains on track to meet its two fiscal rules:

- **the current budget surplus is projected to be £16$^1/_2$ billion (1$^3/_4$ per cent of GDP) in 2000-01. A similar surplus is projected for 2001-02, falling to just under $^3/_4$ per cent of GDP from 2003-04 onwards; and**
- **public sector net debt is projected to fall to about 32$^1/_4$ per cent of GDP by the end of financial year 2000-01. It is projected to continue falling as a percentage of GDP over the following year, stabilising at around 30 per cent of GDP from March 2003.**

Cyclically-adjusted public sector net borrowing is projected to be a repayment of just over $^3/_4$ per cent of GDP in 2000-01 with a repayment of just over $^1/_4$ per cent of GDP in the following year. Modest deficits are projected from 2002-03, reflecting the rapid growth of public investment, consistent with meeting the sustainable investment rule.

INTRODUCTION

B1 Chapter 2 describes the Government's fiscal framework, including the two strict fiscal rules, and shows how the updated projections of the public finances are consistent with meeting these rules. This annex 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

B2 One of the key roles of the Pre-Budget Report is to provide an update of the projections of the public finances contained in the Budget, taking account of developments in both the public finances and the economy since Budget time. It is important to note th the public finance projections in the Pre-Budget Report present an interim forecast update and do not necessarily represent the final outcome the Government is seeking. Therefore, the projections contained in the Pre-Budget Report should not be interpreted as the Government's desired outcome.

B3 Table B1 compares the PBR projections for the key fiscal aggregates, used for assessing performance against the two fiscal rules, with those made at the time of the last Budget. A current budget surplus of £16$^1/_2$ billion is now estimated for 2000-01, compared with the Budget projection of £14 billion, and surpluses in subsequent years which are at least as high as in the Budget forecast. A similar improvement is seen for public sector net borrowing. A net repayment of £10 billion is now expected in 2000-

01, compared with a projected net repayment of £6$^1/_2$ billion in the Budget. Net borrowing in later years is lower than in the Budget forecast.

Table B1: Fiscal balances comparison with Budget 2000[1]

	Outturn[2]	Projections				
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**200(0**
Fiscal balances (£ billion)						
Surplus on current budget - Budget 2000	17.1	14	16	13	8	
Surplus on current budget - PBR 2000	**19.4**	**16.6**	**16**	**14**	**8**	
Net borrowing - Budget 2000	-11.9	-6	-5	3	11	1
Net borrowing - PBR 2000	**-16.4**	**-10.1**	**-6**	**1**	**10**	**1**
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.
Surplus on current budget - PBR 2000	**1.9**	**1.5**	**1.4**	**1.1**	**0.6**	**0.**
Net borrowing - Budget 2000	-1.2	-0.5	-0.3	0.5	1.1	1.
Net borrowing - PBR 2000	**-1.6**	**-0.8**	**-0.3**	**0.3**	**1.1**	**1.**

1*Excluding windfall tax receipts and associated spending*.

2*The 1999-2000 figures were estimates in Budget 2000*.

B4 The Government remains on track to meet the fiscal rules in the years ahead. Table B2 shows latest outturns for the key fiscal aggregates, together with estimates for the current year and projections up to 2005-06. Outturns and projections of other importar measures of the public finances, including net borrowing and net worth, are also shown.

Table B2: Summary of public sector finances[1]

	Per cent of GDP							
	Outturns				**Projections**			
	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005 0**
Fairness and prudence								
Surplus on current budget	0.8	2.1	1.7	1.6	1.3	0.7	0.7	0.
Average surplus since 1999-2000		2.1	1.9	1.8	1.7	1.5	1.4	1.
Cyclically-adjusted surplus on current budget	0.5	1.9	1.5	1.4	1.1	0.6	0.7	0.
Long-term sustainability								
Public sector net debt[2]	39.6	36.8	32.3	30.9	30.1	30.2	30.3	30.
Net worth[2,3]	12.2	17.3	18.7	20.1	20.4	20.3	20.1	19.
Primary balance	3.3	4.3	3.3	2.6	1.8	0.8	0.7	0.
Economic impact								
Net investment	0.4	0.3	0.7	1.0	1.4	1.7	1.8	1.
Public sector net borrowing (PSNB)	-0.3	-1.8	-1.1	-0.6	0.1	0.9	1.0	1.
Cyclically-adjusted PSNB	0.0	-1.6	-0.8	-0.3	0.3	1.1	1.1	1.
Financing								
Central government net cash requirement[2]	-0.5	-1.0	-3.0	-0.1	0.5	1.4	1.4	1.
European commitments								

Maastricht deficit[4]	-0.7	-1.8	-1.1	-0.6	0.1	0.9	1.0	1.
Maastricht debt ratio[5]	46.8	43.6	40.1	37.7	36.1	35.6	35.5	35.
Memo: Output gap	0.4	0.2	0.5	0.4	0.3	0.2	0.1	0.

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

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

[3]*Previously net wealth.*

[4]*General government net borrowing on an ESA95 basis. The Maastricht definition includes windfall tax receipts and associated spending.*

[5]*General government gross debt.*

B5 The current budget balance improved from a surplus of $^{3}/_{4}$ per cent of GDP in 1998-99 to nearly $2^{1}/_{4}$ per cent of GDP in 199 2000. The surpluses are projected to fall gradually over the next few years, from $1^{3}/_{4}$ per cent of GDP in 2000-01 to around $^{3}/_{4}$ pe cent of GDP by 2003-04. Consistent with the need to maintain a cautious approach, this profile shows that the Government is wel 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 per cent of GDP throughout the next five years.

B6 Net borrowing is equal to net investment minus the surplus on the current budget. Public sector net investment is projected to be $^{3}/_{4}$ per cent of GDP in 2000-2001, implying a repayment of net borrowing of around 1 per cent of GDP. The ratio of net investment to GDP is projected to increase steadily over the next three years and then to steady at around $1^{3}/_{4}$ per cent of GDP from 2003-04 onwards. The rapid growth of net investment results in a declining repayment of net borrowing next year and, in conjunction with the effect of slower economic growth, modest deficits over the remainder of the period, consistent with meeting the sustainable investment rule.

B7 The primary balance is equal to net borrowing excluding net debt interest payments - thus abstracting from the implications o 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 long since improved from a deficit of $^{1}/_{2}$ per cent of GDP in 1996-97 and is projected to be in surplus by $3^{1}/$ per cent of GDP in 2000-01. It is projected to be in surplus by an average of $1^{1}/_{4}$ per cent of GDP over the next five years.

B8 The central government net cash requirement was a repayment of 1 per cent of GDP in 1999-2000. This repayment is projecte to increase to 3 per cent of GDP in 2000-01, largely reflecting the receipts from the auction of licences to access the electromagnetic spectrum (see paragraph B45). A modest repayment is projected in 2001-02. The net cash requirement moves int deficit from 2002-03 onwards, mirroring the profile of public sector net borrowing. The approximate stock counterpart to the net cash requirement is public sector net debt. The projections of net cash repayments over the next two years imply a steady fall in the debt-GDP ratio, from $36^{3}/_{4}$ per cent in March 2000 to about 30 per cent in March 2003. It is expected to remain steady at around 30 per cent of GDP for the remainder of the projected period as the public sector moves into deficit.

Chart B1

B9 The approximate stock counterpart to the current budget balance is public sector net worth. Current budget surpluses of up to per cent of GDP a year have begun to raise net worth to an estimated 19 per cent of GDP in December 2000. This follows a prolonged period in which the poor state of the public finances led to it falling to 12 per cent of GDP, from over 75 per cent of GDP in 1980. At present net worth is not used as a key indicator of the public finances, due mainly to the difficulties in measurin accurately many government assets and liabilities.

B10 Table B2 also shows the updated estimates of the cyclically-adjusted current budget and net borrowing as a per cent of GDP, which allow underlying, or structural trends in the indicators to be seen more clearly, after the estimated effects of the economic cycle are removed.

Chart B2

B11 The 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 1999-2000. It is estimated to have fallen slightly in 2000-01 to $1^1/_2$ per cent of GDP. With the economy projected to be slightly above trend during the next five years, the cyclically-adjusted current budget surpluses are a little smaller than the unadjusted projections.

B12 There has been a corresponding improvement in cyclically-adjusted net borrowing, which is used to measure the fiscal stanc From a deficit of 1 per cent of GDP in 1997-98, cyclically-adjusted net borrowing is estimated to be a repayment of $^3/_4$ per cent o GDP in 2000-01 and a further repayment of $^1/_4$ per cent in 2001-02. Modest deficits are projected from 2002-03 onwards, as the share of net investment in GDP rises.

Forecast errors and risks

B13 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 (i.e. the average error irrespective of whether the errors have been positive or negative) for one-year ahead forecasts of net borrowing has been over 1 per cent of GDP or plus or minus £9.5 billion at 2000-01 prices. The error tends to grow as the forecast horizon lengthens. Much of this error arises from forecast errors of GDP.

B14 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 over the coming year, net borrowing might be lower or higher by 0.4 per cent of GDP in the first year (equivalent to about £4 billion) and lower or higher by a further 0.3 per cent (£3 billion) in the second year.

B15 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 on prospects.

B16 It is for this reason that projections in Chapter 2, and above, illustrate the effect of uncertainty over the cyclical position of th economy by showing a cautious case in which the output gap is 1 per cent higher than the central view.

B17 The fiscal projections are based on prudent and cautious assumptions (see paragraphs B18 to B20). Chart B2 above illustrate a still more cautious case, in which 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. Eve in this more cautious case, the cyclically-adjusted current budget is estimated to have been comfortably in surplus in 1999-2000, and on this more cautious basis, the Government is on track to meet the golden rule over the economic cycle.

ASSUMPTIONS

B18 The fiscal projections assume:

- the economy follows the path described in Annex A. In the interests of caution, the fiscal projections continue to be base 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 Annex A. The main economic assumptions are summarised in Table B3;
- firm departmental expenditure limits as set out in Spending Review 2000, but adjusted for subsequent changes (see paragraph B48);
- annually managed expenditure totals as set out in the Spending Review, but adjusted from 2001-02 to 2003-04 to allow for estimated costs of spending measures announced in the Pre-Budget Report (see Table B4);
- 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. The debt to GDP ratio remains well below 40 per cent throughout the projection period; and
- there are no tax changes beyond those already announced before or in (see Table B4) this Pre-Budget Report and the indexation of rates and allowances.

Table B3: 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)	$2^{1}/_{2}$	3	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$
Prices							
RPIX	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$
GDP deflator	$2^{1}/_{2}$	2	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$
RPI (September[1])	1	$3^{1}/_{4}$	$2^{1}/_{2}$	$2^{3}/_{4}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$
Rossi[2] (September[1])	$1^{1}/_{2}$	$1^{1}/_{2}$	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$
Money GDP (£ billion)	907	950	995	1042	1091	1142	1196

1 *Used for projecting social security expenditure over the following financial year.*

2 *RPI excluding housing costs, used for uprating certain social security benefits.*

B19 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 the PBR, the NAO have reviewed the assumptions for equity prices, the consistency of price indices and deflators, and the ratio of VAT receipts to consumption. In each case the review concluded that tl assumptions adopted three years ago were reasonable and were generally cautious. The NAO also commented that it was reasonable to continue using these assumptions. The NAO also carried out the postponed review of the assumptions on the November 1996 Spend to Save programmes which were last audited in July 1997. Insufficient information was available to NAO on some of the smaller programmes, but they concluded that the figures on direct savings assumed by most departments were on the whole reasonable and cautious.

B20 As a result of these reviews the key assumptions and conventions used for the Budget public finance projections are unchanged. In accordance with these assumptions and conventions, trend GDP growth is assumed to be $2^{1}/_{4}$ per cent a year. Details are given in Box B1.

PRE-BUDGET REPORT MEASURES

B21 The effect of the measures announced in the PBR on the fiscal projections are set out in Table B4. The Pre-Budget Report also includes a number of transport measures which have not been included in the forecast since they are subject to consultation. These would cost in total around £$1^{3}/_{4}$ billion a year if they were all to be implemented. Decisions on these measures will be take in the Budget when the Government will also review its AME forecast and the AME margin. In the light of a reduced forecast fo AME expenditure in the current year, the £50 increase in this year's winter fuel payment and the rebate of lorry vehicle excise duty, costing £700 million in total, have been absorbed within the AME margin in 2000-01. In line with the usual convention adopted in previous Pre-Budget Reports, changes to the forecast for AME programmes have been offset in the AME margin. The interim forecast shows that the interim AME margin has increased over the level set in the 2000 Spending Review by £1.7 billio in 2001-02, £1.6 billion in 2002-03 and £1.6 billion in 2003-04.

Table B4: Estimated costs for measures announced in the Pre-Budget Report

	(+ve is an Exchequer yield) £ millio			
	2000-01[1]	**2001-02**	**2002-03**	**2003 0**
Total	**-720**	**-2,615**	**-3,945**	**-3,93**
Pensioners' package	**-435**	**-1,830**	**-2,540**	**-2,59**
of which				
Increase Winter Fuel Payment for Winter 2000	-435	0	0	

Increase in basic state pension and Minimum Income Guarantee for 2001-02 and 2002-03	0	-1,830	-2,540	-2,59
Disability and carers package	**0**	**-180**	**-205**	**-22**
One year nominal freeze for all fuel duties	**0**	**-560**	**-575**	**-59**
Rebate of lorry VED	**-265**	**0**	**0**	
Urban regeneration package	**0**	**-165**	**-245**	**-23**
of which				
Stamp duty: exemption for property within disadvantaged communities	0	-50	-100	-10
Tax relief for residential conversions	0	-80	-90	-9
Tax relief for cleaning contaminated sites	0	-35	-55	-4
Unapproved share options	**-20**	**+200**	**-230**	**-8**
Green transport measures	**0**	**-45**	**-50**	**-5**
of which				
Reform of authorised mileage rates	0	-40	-40	-4
Green travel package	0	-5	-10	-1
Extending £7,000 ISA limit for 5 years to April 2006	**0**	**-20**	**-80**	**-14**
Abolition of capital limits for Sure Start Maternity Grant and Funeral Payments	**0**	**-10**	**-15**	**-1**
Extend CGT business asset definition	**0**	**-5**	**-5**	**-1**

1 *These measures have no effect on overall expenditure in 2000-01 because the costs will be met from the AME margin.*

Box B1: Key assumptions audited by the NAO

• **Privatisation proceeds**[1,6]	**Credit is taken only for proceeds from sales that have been announced.**
• **Trend GDP growth**[1,6]	**$2^1/_4$ per cent a year.**
• **UK claimant unemployment**[1,4,7]	**Constant at recent levels, 1.05 million.**
• **Interest rates**[1,6,7]	**3 month market rates change in line with market expectations (as of October 27).**
• **Equity prices**[2,7]	**FT-All share index rises from 3046 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]	**Shares of labour income and profits in national income are broadly constant in the medium term.**
• **Funding**[3]	**Funding assumptions used to project debt interest are consistent with the public finances forecast and with financing policy.**
• **Oil prices**[5]	**$25.40 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 2000 Report (HC959).*

FISCAL AGGREGATES

B22 Tables B5 and B6 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 associated spending are given in Table 4.1.

Table B5: Current and capital budgets

	£ billion						
	Outturn		Projections				
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-0[illegible]**
Current budget							
Current receipts	357.1	380.3	399	416	432	452	47[illegible]
Current expenditure	323.9	349.6	369	388	408	427	44[illegible]
Depreciation	14.4	15.0	15	16	17	17	1[illegible]
Surplus on current budget (including WTAS[1])	18.8	15.7	15	13	8	8	[illegible]
Surplus on current budget[2]	**19.4**	**16.6**	**16**	**14**	**8**	**8**	[illegible]
Capital budget							
Gross investment	22.4	25.8	30	34	38	41	4[illegible]
less asset sales	-4.8	-3.8	-4	-4	-4	-4	-[illegible]
less depreciation	-14.4	-15.0	-15	-16	-17	-17	-1[illegible]
Net investment	3.2	7.0	11	15	18	20	2[illegible]
Net borrowing (including WTAS[1])	-15.6	-8.7	-5	2	10	12	1[illegible]
Net borrowing[2]	**-16.4**	**-10.1**	**-6**	**1**	**10**	**12**	**1[illegible]**
Public sector net debt - end year	340.1	314.5	314	321	337	354	37[illegible]
Memos:							
General government net borrowing[3]	-16.7	-10.1	-6	1	9	11	1[illegible]
General government gross debt[3]	395.3	381.0	375	376	388	405	42[illegible]

1 *Windfall tax receipts and associated spending.*

2 *Excluding windfall tax receipts and associated spending.*

3 *Maastricht measures of the government deficit and debt.*

B23 The current budget surplus in 2000-01 is estimated to be £16.6 billion. Net investment is estimated to be £7 billion this year, giving a repayment of net borrowing of £10.1 billion.

B24 The current budget surplus is projected to fall slightly next year, to £16 billion. Net investment rises to £11 billion, reducing the repayment of net borrowing to £6 billion in 2001-02.

B25 The current budget surplus is projected to decline to £14 billion in 2002-03, and then to fall to £8 billion from 2003-04 onwards. The profile of a modest decline in the current budget surplus from 2001-02 reflects the planned real increase in current

DEL expenditure and PBR spending measures, together with receipts projections that are based on a cautious projection of real GDP growth of $2^{1}/_{4}$ per cent a year. Together with a rising ratio of net investment to GDP, this results in a projection of net borrowing rising to around 1 per cent of GDP in 2003-04.

B26 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 about 30 per cent of GDP in 2002-03. (The debt-GDP ratio has been reduced by over $2^{1}/_{4}$ per cent in 2000-01 by the cash receipts from the auction of licences to access the electromagnetic spectrum The debt-GDP ratio stabilises at around this level in the remainder of the projection period.

B27 Table B6 shows the Maastricht measures of the deficit and debt used in the Excessive Deficits Procedure of the Maastricht Treaty, as a per cent of GDP. The Maastricht measures are now reported under ESA95 accounting conventions, and are thus now fully consistent with the UK national accounts, which moved to being on an ESA95 basis in September 1998. The reference leve 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 B6: Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate	Projections				
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-04**	2004-05	**2005 0**
Current budget							
Current receipts	39.4	40.0	40.2	40.0	39.6	39.6	39.
Current expenditure	35.7	36.8	37.1	37.2	37.4	37.4	37.
Depreciation	1.6	1.6	1.6	1.5	1.5	1.5	1.
Surplus on current budget (including WTAS[1])	2.1	1.7	1.5	1.2	0.7	0.7	0.
Surplus on current budget[2]	**2.1**	**1.7**	**1.6**	**1.3**	**0.7**	**0.7**	**0.**
Capital budget							
Gross investment	2.5	2.7	3.0	3.3	3.5	3.6	3.
less asset sales	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3	-0.
less depreciation	-1.6	-1.6	-1.6	-1.5	-1.5	-1.5	-1.
Net investment	0.4	0.7	1.1	1.4	1.7	1.8	1.
Net borrowing (including WTAS[1])	-1.7	-0.9	-0.5	0.2	0.9	1.0	1.
Net borrowing[2]	**-1.8**	**-1.1**	**-0.6**	**0.1**	**0.9**	**1.0**	**1.**
Public sector net debt - end year	**36.8**	**32.3**	**30.9**	**30.1**	**30.2**	**30.3**	**30.**
Memos:							
General government net borrowing[3]	-1.8	-1.1	-0.6	0.1	0.9	1.0	1.
General government gross debt[3]	43.6	40.1	37.7	36.1	35.6	35.5	35.

1 *Windfall tax receipts and associated spending*.

2 *Excluding windfall tax receipts and associated spending*.

3*Maastricht measures of the government deficit and debt*.

B28 Table B7 sets out the effects of forecasting changes since the Budget on the main fiscal aggregates and of Spending Review 2000 discretionary changes and PBR policy measures. The only effect of Spending Review 2000 on overall spending was the decision to carry forward
£$^{3}/_{4}$ billion of the additional £2 billion underspend in 1999-2000 since Budget 2000 into 2000-01 and £$^{3}/_{4}$ billion into 2001-02. C the amount carried forward £$^{1}/_{2}$ billion is capital expenditure and has no effect on the current budget surplus. Details of the

forecasting changes are given in subsequent sections.

Table B7: Fiscal balances comparison with Budget 2000[1]

	Outturn[2]			Projections		
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004 0**
Fiscal balances (£ billion)						
Surplus on current budget[1]						
Budget 2000	17.1	14	16	13	8	
Effects of revision/forecasting changes	2.3	2.7	4	5	4	
Effect of PBR policy measures on receipts		0.0	-1	-1	-1	-
Effect of SR2000 policy measures on spending		-0.3	-1	0	0	
Effect of PBR policy measures on spending		0.0	-2	-3	-3	-
PBR 2000	**19.4**	**16.6**	**16**	**14**	**8**	
Net borrowing[1]						
Budget 2000	-11.9	-6	-5	3	11	1
Effects of revision/forecasting changes	-4.5	-4.4	-4	-6	-5	-
Effect of PBR policy measures on receipts		0.0	1	1	1	
Effect of SR2000 policy measures on spending		0.8	1	0	0	
Effect of PBR policy measures on spending		0.0	2	3	3	
PBR 2000	**-16.4**	**-10.1**	**-6**	**1**	**10**	**1**
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.
Surplus on current budget - PBR 2000	**1.9**	**1.5**	**1.4**	**1.1**	**0.6**	**0.**
Net borrowing - Budget 2000	-1.2	-0.5	-0.3	0.5	1.1	1.
Net borrowing - PBR 2000	**-1.6**	**-0.8**	**-0.3**	**0.3**	**1.1**	**1.**

1 *Excluding windfall tax receipts and associated spending*.

2 *The 1999-2000 figures were estimates in Budget 2000*.

B29 The table shows that the projected current budget surplus and repayment of net borrowing in 2000-01 increased by over £2 billion and £3 $^1/_2$ billion respectively since Budget 2000. Much of this improvement reflects higher projections of receipts.

B30 The effects of higher receipts forecasts on the current surplus from 2001-02 to 2003-04 are partially offset by slightly higher current expenditure than forecast in the Budget. However, the forecast changes still outweigh the effects of policy measures and the current surplus is still at least as high as in the Budget. In line with the usual convention adopted in previous Pre-Budget Reports, changes to the forecast for AME programmes have been offset in the AME margin. With net investment marginally low than the Budget projections, the improvement in net borrowing since the Budget, at £1-2 billion a year, is slightly greater than fo the current budget.

RECEIPTS

B31 Table B8 gives projections of receipts as a percentage of GDP. Changes in the receipts projections since Budget 2000 are shown in Table B9. Table B10 sets out the Budget and PBR projections of the tax-GDP ratio. A detailed breakdown of receipts, i £ billion, for 1999-2000, 2000-01 and 2001-02 is given in Table B11.

Table B8: Current receipts

	Per cent of GDP						
	Outturn	Projections					
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-0**
Income tax (gross of tax credits)	10.6	10.9	11.0	11.2	11.3	11.4	11.
Non-North Sea corporation tax (gross of tax credits)	3.6	3.1	3.4	3.4	3.2	3.2	3.
Tax credits[1]	-0.3	-0.5	-0.7	-0.8	-0.7	-0.7	-0.
of which:							
Working Families' Tax Credit[2]	-0.1	-0.5	-0.5	-0.5	-0.5	-0.5	-0.
North Sea revenues[3]	0.3	0.6	0.7	0.7	0.6	0.5	0.
Value added tax	6.2	6.2	6.2	6.1	6.1	6.0	6.
Excise duties[4]	3.8	3.9	3.8	3.8	3.7	3.6	3.
Social security contributions	6.2	6.3	6.3	6.1	6.1	6.2	6.
Other taxes and royalties[5]	6.5	6.8	6.8	6.8	6.7	6.7	6.
Net taxes and social security contributions[6]	36.9	37.3	37.5	37.3	36.9	36.9	36.
Accruals adjustments on taxes	0.5	0.3	0.1	0.1	0.1	0.1	0.
less EU transfers	-0.6	-0.7	-0.5	-0.4	-0.4	-0.3	-0.
Tax credits[7]	0.3	0.5	0.6	0.5	0.5	0.5	0.
Other receipts	2.3	2.6	2.5	2.5	2.4	2.4	2.
Current receipts[8]	39.4	40.0	40.2	40.0	39.6	39.6	39.
Memo:							
Current receipts (£bn)	357.1	380.3	399	416	432	452	47

1 *Mainly MIRAS and tax reliefs under the Working Families' Tax Credit and Children's Tax Credit schemes. Includes corporation tax credits (R&D tax credit and tax credit for cleaning contaminated sites).*

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 tax credits. Cash basis.*

7 *Excludes Children's Tax Credit, which scores as a tax repayment in the national accounts.*

8 *Accruals basis.*

B32 Total receipts are projected to rise by $6^1/_2$ per cent this year, and by 5 per cent in 2001-02. This compares with projected money GDP growth of $4^3/_4$ per cent in both years. Most of the additional buoyancy this year is attributable to income tax and North Sea revenues, as a result of a number of factors, including higher employment and earnings growth and higher oil prices. Non-North Sea corporation tax is expected to fall significantly this year but partially recover in 2001-02.

Table B9: Changes in current receipts since Budget 2000

	£ billion		
	1999-00	2000-01	2001-0
Income tax (gross of tax credits)	0.7	2.8	2.
Non-North Sea corporation tax (gross of tax credits)	0.0	-1.7	-0.
Tax credits	-0.1	0.1	0.
North Sea revenues	0.0	1.0	1.
Capital taxes[1]	-0.2	-0.3	-1.
Stamp duty	0.3	1.1	0.
Value added tax	-0.3	-0.4	-0.
Excise duties[2]	0.3	-0.2	-0.
Social security contributions	0.1	1.0	1.
Other taxes and royalties[3]	0.2	1.9	1.
Net taxes and social security contributions	1.0	5.3	4.
Other receipts and accounting adjustments	-0.1	-0.6	0.
Current receipts	**0.9**	**4.7**	**4.**

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.*

Total taxes

B33 Chart B3 and Table B10 show the tax-GDP ratio, measured as net taxes and social security contributions, as a percentage of GDP. The changes in the tax-GDP ratio over the next few years are mainly attributable to North Sea revenues and non-North Sea corporation tax. Much of the increase in the tax ratio in 2000-01 reflects higher oil prices, which increase North Sea revenues. These increase further in 2001-02, but then fall steadily as a per cent of GDP, as North Sea oil production is expected to decline. The temporary rise in the tax-GDP ratio also reflects changes in the corporation tax payment regime. Corporation tax receipts fall as a percentage of GDP when the transitional period for the new system of instalment payments comes to an end. The direct tax burden on a typical family with two children will fall in 2001-02 to its lowest level since 1972.

Chart B3

Table B10: Net taxes and social security contributions[1]

	Per cent of GDP						
	Outturn[2]		Projections				
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-0
Budget 2000	37.0	36.9	37.3	37.1	36.7	36.6	
PBR 2000[3]	**36.9**	**37.3**	**37.5**	**37.3**	**36.9**	**36.9**	**36.**

1 *Net of tax credits; cash basis.*
2 *The 1999-2000 figures were estimates in Budget 2000.*

3 *Tax changes subject to consultation are not included in the PBR 2000 projections of the tax burden. If implemented, they would have the following impact:*

2001-02	*2002-03*	*2003-04*	*2004-05*	*2005-0*
-0.2	*-0.2*	*-0.2*	*-0.2*	*-0.*

Income tax

B34 Income tax receipts (net of tax credits) in 2000-01 are expected to be about £99 billion, some £3 billion higher than forecast the time of the Budget. Most of this increase stems from higher PAYE receipts and lower income tax repayments to date. This is partly offset by a lower forecast of tax deducted at source from interest paid by banks and building societies, reflecting lower thar expected interest paid in the first half of 2000. There are slightly smaller increases over the Budget forecast in 2001-02 and subsequent years, partly because of PBR measures. As shown in Table B12, data for the first half of 2000-01 shows substantial growth on the same period in 1999-2000, despite the reduction in the basic rate of tax that took effect in April 2000, and the effec of the Working Families' Tax Credit, which only started in October 1999. The increase in receipts in the first half of 2000-01, which is mainly attributable to PAYE, is expected to be maintained in the second half. Some of the increase in PAYE so far in 2000-01 reflects earlier Budget measures. These include the ending of tax relief on profit related pay, which, as announced in the November 1996 Budget, was phased out over a number of years, and the extension of PAYE to cover tax due when certain share options are exercised. This tax would previously have been paid after the end of the year in which the options were exercised. Income tax receipts in 2001-02 increase to £102$^{1}/_{2}$ billion, but fall slightly as a share of GDP, mainly as a result of measures in earlier Budgets.

Non-North Sea corporation tax

B35 Non-North Sea corporation tax in 2000-01 is expected to be about £1$^{3}/_{4}$ billion below the Budget forecast. The forecast is based on the latest information available to Inland Revenue, including preliminary data for October 2000. The main contributions to the lower forecast are:

- the final instalment payments and the first tranche of balance payments for tax on profits in 1999 were below forecast, implying lower levels of tax accruals than had been expected. Full explanations of these shortfalls will not be available until further payments are made and assessments are filed.
- in addition, repayments of mainstream corporation tax and advanced corporation tax (ACT) were higher than forecast.
- these reductions were partly offset by higher than forecast receipts of arrears of tax for earlier periods and receipts from small companies (which are not included in the instalment regime).

B36 There are similar effects on forecasts for 2001-02 and later years, but the decreases from the Budget forecast are lower, at around (or slightly less than) £1 billion a year, reflecting higher profits forecasts. Receipts are expected to rise by £4$^{1}/_{2}$ billion in 2001-02 as a result of increasing liabilities and the effect of the third year of the transition to quarterly instalments.

B37 Corporation tax is projected to rise by about £1 billion in 2002-03, but then to fall in 2003-04 back to its 2001-02 level, as th extra tax paid during the four year transition to quarterly instalments ends. The yield is expected to increase steadily with increasing profits thereafter.

B38 As shown in Table B12, receipts of total corporation tax in the first half of 2000-01 are
£0.9 billion higher than in the same period a year earlier. However, such comparisons are affected by the abolition of ACT in 199 and the transition to quarterly instalments starting at the same time. These reforms will bring payments steadily forward over the four year transition. Whereas in previous years the bulk of corporation tax payments were made in October and January, there wi now be a much more even quarterly profile of payments. Receipts in the second half of the year are expected to be about £3 billic lower than in the second half of 1999-2000.

North Sea revenues

B39 North Sea revenues are higher than in the Budget forecast because of higher oil prices, slightly offset by lower oil productioi Details of the NAO audited oil price assumption are in Box B1 and the effects of changes to prices are explained in Box B2. Overall revenues are up by £1 billion this year, by £1$^{3}/_{4}$ billion next year and by slightly smaller amounts thereafter, as productio declines. Most of the increase in 2000-01 is petroleum revenue tax and royalties. North Sea corporation tax is only slightly highe in 2000-01, partly because the price effects take longer to affect receipts and partly because, as with non-North Sea corporation tax, balancing payments on profits made in 1999 were below forecast.

Capital taxes

B40 Capital gains tax in 1999-2000 was about £$^{1}/_{4}$ billion lower than forecast at the time of the Budget. After taking account of this lower than expected outturn and the most recent information on the pattern of asset disposals, the projected outturn for 2000-01 has been revised down by about £$^{1}/_{2}$ billion. Capital gains tax is forecast to drop back by about £$^{1}/_{4}$ billion in 2001-02, reflecting the Budget 2000 measure on taper reform. For 2001-02 onwards capital gains tax receipts are expected to be about £1 billion a year lower than in the Budget forecast. Inheritance tax receipts are broadly unchanged from the Budget.

Stamp duty

B41 Stamp duty receipts for 1999-2000 were some £$^{1}/_{4}$ billion above the Budget forecast due to particularly strong activity in share transactions at the end of the financial year. This higher than expected level continued into the first part of the current year and consequently the receipts forecast is just over £1 billion higher than at the time of the Budget. The higher activity in the second half of 1999-2000 and first half of this year affects comparisons shown in Table B12. Receipts are well up on last year in the first half of the year, which also saw a particularly high level of receipts from mergers and acquisitions, but are expected to be unchanged in the second half.

VAT receipts

B42 VAT receipts in 2000-01 are expected to be broadly in line with the Budget forecast. The forecast of VAT revenues in later years continues to be governed by 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. Compared with a flat VAT ratio, this cautious assumption reduces receipts by nearly £2 billion by 2005-06.

Excise duties

B43 Excise duties in 2000-01 are expected to be broadly in line with the Budget forecast. Although tobacco duty has risen strong in the first half of 2000-01, see Table B12, this reflects a change in the timing of forestalling between 1999-2000 and 2000-01; thi change will depress the annual comparison in the second half. Total excise duties in 2001-02 are projected to be £$^{3}/_{4}$ billion lowe than the Budget forecast, mostly reflecting the nominal freeze in fuel duty in that year. This reduces projected receipts throughout the forecast period. (The Budget forecast assumed that fuel duties increase in line with inflation in all years.) The forecast of tobacco duty remains unchanged from the Budget projections; the forecast of alcohol duty is little changed.

Social security contributions

B44 Social security (national insurance) contributions are projected to be £59.8 billion this year, an increase of 6 per cent. This compares with projected wages and salaries growth of under 5 per cent. The strong growth of receipts - apparent in the outturns for the first half of 2000-01 (see Table B12) - is probably related to the rapid growth of PAYE receipts over the same period. The ratio of social security contributions to GDP is projected to fall slightly over the next five years, reflecting assumed higher rates o contracting out of the state pension scheme, as individuals increasingly make use of stakeholder pensions.

Box B2: The impact of higher oil prices on government revenue

In 1999-2000 total oil-related receipts amounted to about £27$^{1}/_{2}$ billion. This included fuel duties (£22$^{1}/_{2}$ billion), VAT on petrol and diesel (approximately £2$^{1}/_{2}$ billion), and £2$^{1}/_{2}$ billion from North Sea revenues (royalties, petroleum revenue tax (PRT) and corporation tax). Oil companies also pay corporation tax on their profits from refining and distribution. Box A3 discusses the economic impact of higher oil prices on the economy in general and such effects could in turn impac on other government receipts.

Only North Sea revenues are significantly affected by higher oil prices. Fuel duties are levied as a fixed amount on each litre purchased, and hence are not directly affected by oil prices (but to the extent higher petrol prices reduce consumption, the impact is negative). Although higher petrol pump prices increase VAT from fuel, this will largely displace VAT receipts from other household spending, with little overall effect on VAT revenues. VAT on petrol and diesel purchased for business use is generally reclaimed.

The three components of North Sea revenues have very different assessment and collection regimes. All are scored on a cash receipts basis in the national accounts and hence the impact of higher oil prices on government revenues depends on the time lags involved in the payment of the various taxes.

Details of the different regimes can be found in *Inland Revenue Statistics* available at

http://www.inlandrevenue.gov.uk/stats/corporate.htm.

Oil royalties for the second half of the calendar year are not paid until February and although the PRT payment system i more complex there are similar time lags - the impact of oil price changes in the second half of the year will not be felt until March. For both royalties and PRT, payments received in a financial year approximately reflect oil prices in the corresponding calendar year.

The position is less straightforward for corporation tax. As large companies now pay this tax in quarterly instalments (based on the companies' own estimates of liability) and a later balancing payment, the effect of price changes on tax receipts will depend on exactly when the price changes happen and how the oil companies incorporate this in their estimates of taxable profits for the year as a whole. Some of the impact on receipts will be delayed until the second financial year, but the extent of this is changing during the full transition to quarterly instalments. Price changes in the last three months of a financial year will have no effect on receipts until the following financial year.

The average oil price for calendar 2000 is now estimated to be about \$6 higher than the \$22.40 assumed at the time of the Budget, with much higher prices in second half of the year. North Sea revenues are expected to be £1 billion higher in 2000-01 than in the Budget forecast. This is a slightly lower first year impact than implied by applying the published ready reckoner[1], which assumes a constant price change throughout the year. The PBR forecasts also allow for other factors such as exchange rate changes and declining production levels.

As set out in Box B1 the PBR projections of North Sea revenue are based on the audited assumption of an oil price of \$25.40 for calendar year 2001. This is the average of independent forecasts for the year ahead, which is used in the public finance projections unless it shows a rising oil price. A temporary change of \$1 in this price across the whole calendar year would lead to a change of about £225 million in North Sea revenues in financial year 2001-02 and a change of about £60 million in 2002-03. A sustained price change of \$1 from 2001 onwards would change revenues by £225 million in 2001-02 and about £300 million in subsequent years, assuming no changes in production from 2001 levels or in the other factors affecting tax liabilities. This assumes that companies will be able to estimate their annual corporation tax liabilities accurately at the time each instalment is due.

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[1]***Audit of the Future Oil Price Convention for the November 1999 Pre-Budget Report, HC873 1998-99.***

Spectrum licence receipts

B45 The auction earlier this year of licences to access the electromagnetic spectrum by mobile phone companies raised £22.5 billion. In line with Office for National Statistics latest views on the national accounts treatment of these receipts, they are treated as rent in these forecasts and spread evenly over the whole of the licence period. The actual proceeds were much higher than the amount allowed for in the Budget forecast and this leads to a higher level of accruals of about £0.9 billion a year.

Table B11: Public sector current receipts

		£ billion	
	Outturn	Projections	
	1999-00	**2000-01**	**2001-0**
Inland Revenue			
Income tax (gross of tax credits)	95.9	103.8	109.
Corporation tax (gross of tax credits)1	34.2	32.2	38.
Tax credits	-3.0	-4.9	-7.
Petroleum revenue tax	0.9	2.0	2.
Capital gains tax	2.1	3.0	2.
Inheritance tax	2.0	2.3	2.
Stamp duties	6.9	8.3	8.
Total Inland Revenue taxes (net of tax credits)	**139.0**	**146.7**	**156.**

Customs and Excise			
Value added tax	56.4	59.2	61.
Fuel duties	22.5	23.2	23.
Tobacco duties	5.7	7.4	7.
Spirits duties	1.8	1.8	1.
Wine duties	1.7	1.7	1.
Beer and cider duties	3.0	3.0	3.
Betting and gaming duties	1.5	1.5	1.
Air passenger duty	0.9	1.0	1.
Insurance premium tax	1.4	1.7	1.
Landfill tax	0.4	0.5	0.
Climate change levy			0.
Customs duties and levies	2.0	2.1	2.
Total Customs and Excise	**97.3**	**103.0**	**107.**
Vehicle excise duties	4.8	4.9	5.
Oil royalties	0.4	0.6	0.
Business rates2	15.3	17.0	17.
Social security contributions	56.4	59.8	62.
Council Tax	13.0	13.9	14.
Other taxes and royalties3	8.3	8.8	9.
Net taxes and social security contributions4	**334.6**	**354.7**	**373.**
Accrual adjustments on taxes	4.3	2.9	0.
less VAT and own resources contribution to EU budget	-5.7	-6.6	-5.
less PC corporation tax payments	-0.4	-0.4	-0.
Tax credits5	3.0	4.9	5.
Interest and dividends	3.4	5.2	5.
Other receipts	17.9	19.6	20.
Current receipts	**357.1**	**380.3**	**399.**
Memo:			
North Sea revenues[6]	2.6	5.3	7.

1*Includes advance corporation tax (net of repayments): 1.8 -0.2 0.0*

Also includes North Sea corporation tax after ACT set off, and corporation tax on gains. Gross of corporation tax credits (R&D tax credit and tax credit for cleaning contaminated sites.)

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 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 B12: Net taxes and social security contributions 2000-01

			£ billion			
	Outturn[1]			Change on 1999-2000		
	Apr-Sep	Oct-Mar	2000-01	Apr-Sep	Oct-Mar	2000(0
Inland Revenue						
Income tax and capital gains tax[2]	47.5	54.4	101.9	3.2	3.7	6.
Corporation tax	12.3	19.9	32.2	0.9	-2.9	-2.
Petroleum revenue tax	0.8	1.2	2.0	0.5	0.6	1.
Inheritance tax	1.1	1.2	2.3	0.1	0.1	0.
Stamp duties	4.4	3.9	8.3	1.3	0.0	1.
Total Inland Revenue taxes (net of tax credits)	**66.1**	**80.6**	**146.7**	**6.1**	**1.6**	**7.**
Customs and Excise						
Value added tax	28.6	30.6	59.2	1.3	1.5	2.
Fuel duties	11.3	11.9	23.2	0.4	0.2	0.
Tobacco duties	4.5	2.9	7.4	2.6	-1.0	1.
Alcohol duties	3.3	3.3	6.6	0.1	0.0	0.
Other Customs duties and levies	3.4	3.2	6.7	0.3	0.1	0.
Total Customs and Excise	**51.1**	**51.9**	**103.0**	**4.9**	**0.8**	**5.**
Vehicle excise duties	2.4	2.6	4.9	-0.2	0.2	0.
Oil royalties	0.3	0.4	0.6	0.1	0.1	0.
Business rates[3]	10.2	6.8	17.0	1.3	0.4	1.
Social security contributions	29.6	30.1	59.8	1.9	1.4	3.
Council Tax	7.7	6.2	13.9	0.4	0.6	0.
Other taxes and royalties[4]	4.3	4.4	8.8	0.4	0.2	0.
Net taxes and social security contributions[5]	**171.7**	**182.9**	**354.7**	**14.8**	**5.4**	**20.**

[1] *Provisional.*

[2] *Net of tax credits.*

[3] *Includes district council rates in Northern Ireland.*

[4] *Includes money paid into the National Lottery Distribution fund.*

[5] *Includes VAT and 'traditional own resources' contributions to EU budget. Net of tax credits. Cash basis.*

PUBLIC EXPENDITURE

B46 Table B13 shows projections for public expenditure for the current year and the three years covered by the 2000 Spending Review. 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. The table tracks changes to these three aggregat from Budget 2000 through the 2000 Spending Review to the projections set out in this Pre-Budget Report.

B47 The 2000 Spending Review 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 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. Table B13 shows that the move to resource budgeting does not affect TME but does lead to changes within DEL and AME. Budget 2000 cash figures are therefore set out on comparable resource basis to allow subsequent changes in DEL and AME allocations within and after the Spending Review to be shown.

B48 The Pre-Budget Report sets out an interim report on the public finances. For this purpose, TME remains unchanged for the current year but has been increased thereafter to accommodate the package for pensioners and other AME measures, rising by £2 billion by 2003-04. Table B4 shows the estimated costs of these measures. Departmental Expenditure Limits for the next three years were set at the Spending Review and remain unchanged with the exception of a classification change which leads to a switc from DEL to AME of around £1.5 billion, due to the impact of the Major Repairs Allowance. The introduction of the latter into Housing Revenue Account Subsidies from April 2001 reduces the Department for the Environment, Transport and Regions' DEL but increases AME.

Table B13: Public expenditure aggregates[1]

	£ billion				
	Outturn[2]	Estimate[3]	Projections		
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003 0**
Departmental Expenditure Limits (DEL)[2]					
Budget 2000 - cash allocations[3]	178.9	193.7	202.6		
Budget 2000 - resource based allocation[4]	178.8	194.5	203.2		
plus Budget 2000 unallocated addition[5]	178.8	194.5	209.1		
changes in Spending Review 2000	-2.0	0.8	3.0		
Spending Review 2000	176.8	195.2	212.1	229.3	245.
classification changes[6]	*0.0*	*0.0*	*-1.6*	*-1.5*	*-1.*
PBR 2000	**176.8**	**195.2**	**210.5**	**227.7**	**244.**
Annually Managed Expenditure (AME)[2]					
Budget 2000 - cash estimates	166.3	177.2	183.6		
Budget 2000 - resource based estimates[4]	166.4	176.4	183.0		
changes in Spending Review 2000	-2.5	0.0	-2.2		
Spending Review 2000	163.9	176.4	180.8	186.2	193.
changes since Spending Review 2000	0.8	0.0	3.7	4.3	4.
of which:					
classification changes[6]			*1.6*	*1.5*	*1.*
revisions/forecasting changes	0.8	-1.8	-1.7	-1.6	-1.
mid-year changes to AME margin		1.1	1.7	1.6	1.
PBR policy measures		0.7	2.1	2.8	2.
PBR 2000	**164.7**	**176.4**	**184.4**	**190.5**	**198.**
Total Managed Expenditure (TME)					
Budget 2000[5]	345.2	370.9	392.1		
changes in Spending Review 2000	-4.5	0.8	0.8		
Spending Review 2000	340.7	371.6	392.9	415.4	439.
changes since Spending Review 2000	0.8	0.0	2.1	2.8	2.
PBR 2000	**341.5**	**371.6**	**394.9**	**418.3**	**442.**
of which:					
Public sector current expenditure	323.9	349.6	368.8	387.8	407.
Public sector net investment	3.2	7.0	10.7	14.5	18.

Public sector depreciation	14.4	15.0	15.4	16.0	16.
Memo: PBR 2000 TME as a percentage of money GDP	37.7	39.1	39.7	40.1	40.

1 *Figures may not sum due to rounding.*

2 *Figures for DEL and AME beyond 2001-02 were not published in Budget 2000.*

3 *Includes £3.1 billion allocated to UK health in 2001-02.*

4 *On a resource basis and including DEL/AME transfers, to allow comparison with Spending Review figures which are on a resource basis.*

5 *Includes unallocated Budget addition of £5.9 billion in 2001-02 (see Table C11 of the March 2000 Financial Statement and Budget Report).*

6 *Classification changes are switches from DEL to AME resulting from the introduction of the Major Repairs Allowance in April 2001.*

B49 Forecasts of individual AME programmes have been reviewed for this Pre-Budget Report. Excluding the additional spendin on measures from 2001-02 onwards and the DEL/AME switch mentioned above, total AME remains unchanged from the Spending Review and, in line with the convention adopted in previous PBRs, savings in AME programmes have been offset in th margin. Total AME for 2000-01 is unchanged as the costs of the measures are met from the AME margin. The main economic assumptions underpinning the AME projections are set out in Table B3. In addition, the projections assume that UK claimant unemployment remains flat at the recent level of 1.05 million. Forecast of AME programmes will be reviewed at the Budget.

B50 Chart B4 shows the ratio of TME to GDP. The ratio rises over the next few years, reflecting the higher levels of public investment.

Chart B4

B51 Table B14 shows the Departmental Expenditure Limits in terms of the resource and capital budgets. It has been updated sinc Spending Review 2000 to reflect transfers between departments and programmes.

B52 Tables B15 and B16 analyse the DELs allocated in the 2000 Spending Review. The 1998 Comprehensive Spending Review (CSR) set DELs from 1999-00 to 2001-02. The 2000 Spending Review made additions to 2001-02 allocations and set new plans for 2002-03 and 2003-04. Table B15 sets out the new funding committed in the 2000 Spending Review from the original allocations in 2001-02 as set out in Budget 2000. To ensure the comparison is on a consistent basis, the original 2001-02 allocations are adjusted for transfers between departmental lines and the move to resource budgeting. Table B16 shows average annual real growth rates between 2000-01 and 2003-04.

Table B14: Departmental Expenditure Limits - current and capital budgets

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	£ billion				
	Outturn	**Estimate**	**Plans**		
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003 0**
Resource budget					
Education and Employment	14.2	16.8	18.8	20.4	21.
Health	40.0	43.6	46.9	51.2	55.
of which: NHS	*39.4*	*42.9*	*45.7*	*49.1*	*53.*
Environment, Transport and Regions	4.2	4.4	5.1	5.6	5.
Local Government	33.9	35.3	36.8	39.0	41.

Home Office	7.0	7.6	8.8	9.3	9.
Legal Departments	2.7	2.9	3.0	3.1	3.
Defence[1]	16.9	17.8	18.1	18.5	18.
Foreign and Commonwealth Office	1.0	1.0	1.0	1.0	1.
International Development	2.2	2.5	2.7	2.9	3.
Trade and Industry[2]	2.8	3.3	3.9	3.6	3.
Agriculture, Fisheries and Food[3]	1.0	0.9	1.1	1.1	1.
Culture, Media and Sport	0.9	0.9	1.0	1.1	1.
Social Security (administration)	3.2	3.2	3.8	4.1	4.
Scotland[4]	12.0	12.7	13.6	14.4	15.
Wales[4]	6.3	6.9	7.3	7.9	8.
Northern Ireland Executive[4]	4.3	4.5	4.9	5.0	5.
Northern Ireland Office[4]	1.0	1.0	1.0	1.1	1.
Chancellor's Departments	3.4	3.8	3.9	4.1	4.
Cabinet Office	1.2	1.2	1.3	1.3	1.
Employment Opportunities Fund[5]	0.5	0.9	0.9	0.9	1.
Invest to Save Budget		0.0	0.1	0.1	0.
Capital Modernisation Fund					
Policy Innovation Fund		0.0	0.0	0.0	0.
Reserve[6]		1.8	1.2	1.6	2.
Total resource budget DEL	**158.9**	**172.8**	**185.1**	**197.3**	**209.**
Capital budget					
Education and Employment	1.0	1.9	2.5	3.0	3.
Health	0.9	1.8	2.7	3.2	3.
of which: NHS	*0.9*	*1.7*	*2.6*	*3.2*	*3.*
Environment, Transport and Regions	5.5	6.2	6.4	8.4	10.
Local Government	0.3	0.0	0.1	0.3	0.
Home Office	0.5	0.6	0.9	1.0	0.
Legal Departments	0.1	0.1	0.1	0.2	0.
Defence[1]	5.0	5.2	5.5	5.7	6.
Foreign and Commonwealth Office	0.1	0.1	0.1	0.2	0.
International Development	0.3	0.3	0.4	0.4	0.
Trade and Industry[2]	0.2	0.5	0.7	0.8	1.
Agriculture, Fisheries and Food[3]	0.1	0.2	0.2	0.3	0.
Culture, Media and Sport	0.1	0.1	0.1	0.1	0.
Social Security (administration)	0.0	0.0	0.1	0.1	0.
Scotland[4]	1.7	2.3	2.6	3.0	3.
Wales[4]	0.8	0.9	1.0	1.2	1.
Northern Ireland Executive[4]	0.6	0.8	0.8	1.0	1.
Northern Ireland Office[4]	0.0	0.0	0.1	0.1	0.
Chancellor's Departments	0.2	-0.1	0.2	0.2	0.
Cabinet Office	0.2	0.2	0.2	0.2	0.

Employment Opportunities Fund[5]	0.4	0.6	0.0	0.0	0.
Invest to Save Budget			0.0	0.0	0.
Capital Modernisation Fund		0.1	0.4	0.9	1.
Policy Innovation Fund		0.0	0.0	0.0	0.
Reserve[6]		0.5	0.3	0.4	0.
Total capital budget DEL	**18.0**	**22.4**	**25.4**	**30.4**	**35.**
Total Departmental Expenditure Limits	**176.8**	**195.2**	**210.5**	**227.7**	**244.**
Total education spending	40.6	46.0	49.5	53.4	57.

[1]*Provisional for 1999-2000 and 2000-01.*

[2]*Includes the capital expenditure of the Export Credits Guarantee Department.*

[3]*Includes spending on BSE related programmes.*

[4]*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.*

[5]*Formerly Welfare to Work, until 2000-01 includes all spending financed by the windfall tax. Thereafter includes Employment Opportunities Fund spending only.*

[6]*Reserve has been arbitrarily apportioned between current and capital, with 10% allocated to capital.*

Table B15: 2000 Spending Review: Departmental Expenditure Limits new allocations by Department

	£ billion			
	Budget cash basis	**Spending** Review base[1]		**Chang**
	2001-02	**2001-02**	**2003-04**	
Education and Employment	19.3	19.6	25.7	6.
Health	48.8[2]	48.9[2]	59.0	10.
of which: NHS	*48.0*	48.1	*56.7*	8.
Environment, Transport and Regions	11.9	10.3	16.4	6.
Local Government	36.6	36.6	41.9	5.
Home Office	8.1	8.1	10.6	2.
Legal Departments	2.8	2.9	3.3	0.
Defence	23.0	23.0	25.0	1.
Foreign and Commonwealth Office	1.1	1.1	1.2	0.
International Development	3.1	3.1	3.5	0.
Trade and Industry	3.6	3.6	4.3	0.
Agriculture, Fisheries and Food	1.2	1.0	1.3	0.
Culture, Media and Sport	1.1	1.1	1.2	0.
Social Security (administration)	3.3	3.3	4.2	0.
Scotland	15.5[2]	15.7[2]	18.4	2.
Wales	8.1[2]	8.1[2]	9.8	1.

Northern Ireland	6.3[2]	6.3[2]	7.4	1.
Chancellor's Departments	3.7	3.7	4.3	0.
Cabinet Office	1.3	1.3	1.5	0.
Employment Opportunities Fund	1.3	1.0	1.4	0.
Invest to Save Budget	0.1	0.1	0.1	0.
Capital Modernisation Fund	0.4	0.4	1.2	0.
Policy Innovation Fund	0.0	0.0	0.1	0.
Reserve	2.3	2.4	2.5	0.
Total Departmental Expenditure Limits	**202.6**	**201.6**	**244.3**	**42.**

1 *Budget 2000 cash numbers adjusted for move to Resource Accounting and Budgeting and including transfers between departments and programmes (see Table A8 in Spending Review 2000 New Public Spending Plans 2001-2004).*

2 *Includes the allocation of the £3.1billion Budget addition for the NHS in 2001-02.*

Table B16: 2000 Spending Review: average annual growth rates in Departmental Expenditure Limits between 2000-01 an 2003-04

		£ billion		
	2000-01	**2003-04**	Change	**3 yea real averag growt (per cen**
Education and Employment	18.6	25.7[1]	7.1	8.
Health	45.3	59.0	13.7	6.
of which: NHS	*44.5*	*56.7*	12.1	5.
Environment, Transport and Regions	10.7	16.4	5.8	12.
Local Government	35.4	41.9	6.5	3.
Home Office	8.2	10.6	2.5	6.
Legal Departments	3.0	3.3	0.3	0.
Defence	22.9	25.0	2.0	0.
Foreign and Commonwealth Office	1.1	1.2	0.1	0.
International Development	2.8	3.5	0.8	6.
Trade and Industry	3.8	4.3	0.5	1.
Agriculture, Fisheries and Food	1.0	1.3	0.3	6.
Culture, Media and Sport	1.0	1.2	0.2	4.
Social Security (administration)	3.2	4.2	1.0	6.
Scotland	15.0	18.4[1]	3.4	4.
Wales	7.7	9.8[1]	2.1	5.
Northern Ireland	6.3	7.4[1]	1.1	2.
Chancellor's Departments	3.7	4.3	0.6	2.
Cabinet Office	1.4	1.5	0.1	0.
Employment Opportunities Fund	1.4	1.4	-0.1	-3.
Invest to Save Budget	0.0	0.1	0.1	
Capital Modernisation Fund	0.1	1.2	1.1	

Policy Innovation Fund	0.0	0.1	0.1	
Reserve	2.5	2.5	0.0	
Total Departmental Expenditure Limits	**195.2**	**244.3**	**49.0**	**5.**
Memo items				
Education (UK)	46.0	57.7	11.7	5.
NHS UK	54.2	68.7	14.5	5.
Transport (DETR - England)	4.9	9.1	4.2	20.
Criminal Justice System (England and Wales)	12.5	15.3	2.7	4.

[1] *Includes New Deal for Schools money formerly in the Employment Opportunities Fund*

B53 Tables B17 and B18 set out the forecast for individual AME programmes and show comparisons between the latest forecast and projections published in the Budget. Table B19 shows changes to the AME components since the forecasts published in the 2000 Spending Review.

B54 The most significant change since the Budget is the downward revision to the forecast for social security expenditure. Before taking account of the pensioner package announced in the PBR, this is forecast to be lowe by around £1 billion in the current year. There is an even larger reduction of £1.7 billion in 2001-02. Even after allowing for the extra costs of the pensioner package, the total is only slightly higher than in the Budget. The lower forecast is due primarily to lower actual unemployment and, reflecting this, a lower unemployment assumption for the future (see Box B1) and the availabili of new data showing lower benefit caseloads than forecast at the Budget.

B55 At the time of the 2000 Spending Review the only changes made to the social security forecast were those stemming from changes to the audited assumptions for unemployment and from new spend to and save and other service modernisation measure Table B19 sets out the further changes made since then. These mainly represent further updating of the unemployment assumptio the new benefit caseload forecasts and the PBR pensioner package. Before taking account of the package, spending on social security would be, for 2001-02 onwards, £1$^{1}/_{2}$ to £2 billion a year lower than in the Spending Review.

B56 Projections for central government gross debt interest are also substantially lower than forecast at the Budget. This is due to combination of lower levels of government debt following the higher than expected proceeds from the auction of licences to access the electromagnetic spectrum, a revised DMO remit, and lower market interest rate expectations. The forecast for debt interest was revised in the 2000 Spending Review to take account of the spectrum licence proceeds and the revised remit. Further reductions since then are due to further lower estimates of government borrowing and updated market interest rate expectations.

B57 The other main changes to AME programmes since the Budget are lower forecast expenditure for net public service pension reflecting lower expenditure to date, and increased lending by the Export Credits Guarantee Department in the current year.

Table B17: Annually Managed Expenditure

Annually Managed Expenditure

Departmental AME:

			£ billion		
	Outturn		Projections		
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-0**
Social Security Benefits	97.2	99.0	105.0	108.7	112.
Housing Revenue Account subsidies	3.2	3.2	4.6	4.3	4.
Common Agricultural Policy	2.7	2.7	2.8	2.7	2.
Export Credits Guarantee Department	0.9	1.1	0.3	0.2	0.
Self-financing public corporations capital spending	1.0	1.4	1.5	1.2	1.

Net public service pensions	5.2	5.5	5.5	5.7	6.
National Lottery	1.9	2.2	2.2	2.1	2.
Other programme expenditure	-0.1	0.0	0.0	0.0	0.
Non-cash items:					
Depreciation	7.3	6.9	7.3	8.4	9.
Cost of capital charges	13.0	12.8	12.8	12.0	12.
Provisions and other charges	0.6	0.1	0.0	0.1	0.
Total departmental AME (inc. non-cash items)	**133.0**	**134.9**	**141.9**	**145.4**	**150.**
Other AME:					
Net payments to EC institutions[1]	2.9	2.8	2.6	2.5	2.
Locally financed expenditure	17.2	18.4	19.3	20.2	21.
CG debt interest	25.5	26.9	24.6	24.8	24.
Accounting and other adjustments[2,3]	-13.8	-9.2	-6.7	-6.0	-5.
Total other AME	**31.7**	**38.9**	**39.8**	**41.5**	**43.**
AME Margin	0.0	2.6	2.7	3.6	4.
Annually Managed Expenditure	**164.7**	**176.4**	**184.4**	**190.5**	**198.**

[1] *Net payments to EC institutions exclude the UK's contribution to the cost of EC aid to non-Member States (which is attributed t 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*	*2003-0*
3.3	*3.4*	*3.3*	*3.4*	*3.*

Figures from 2001-02 are trend estimates.

[2] *Includes adjustments to deduct non-cash items in DEL and departmental AME which do not score in TME.*

[3] *Includes a reconciliation adjustment to national accounts estimate of TME.*

Table B18: Changes in Annually Managed Expenditure since Budget 2000[1]

	£ billion		
	1999-00	**2000-01**	**2001-0**
Annually Managed Expenditure			
Social Security benefits	0.0	-0.5	0.
Housing Revenue Account subsidies	-0.1	-0.2	1.
Common Agricultural Policy	-0.1	0.0	-0.
Export Credits Guarantee Department	0.0	0.8	0.
Net public service pensions	-0.4	-0.2	-0.
National Lottery	-0.1	-0.1	0.
Net Payments to EC institutions	0.3	0.1	0.
Locally financed expenditure	0.0	0.3	0.
CG debt interest	0.0	-0.8	-2.
AME margin	0.0	1.6	0.
Other AME	-1.3	-0.9	1.

Annually Managed Expenditure	**-1.7**	**0.0**	**1.**

[1] *Figures show comparisons between PBR projections and Budget forecasts on a consistent basis, adjusted for the move to resource budgeting and classification changes*.

Table B19: Changes in Annually Managed Expenditure since 2000 Spending Review

Annually Managed Expenditure

Departmental AME:

	£ billion				
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-0**
Social security benefits	0.1	-0.4	0.6	1.4	0.
Housing Revenue Account subsidies	0.0	-0.2	1.3	1.1	1.
Common Agricultural Policy	0.0	0.0	-0.1	-0.1	0.
Export Credits Guarantee Department	0.0	0.3	0.0	0.0	0.
Self-financing public corporations capital spending	0.1	-0.2	0.3	-0.1	-0.
Net public service pensions	0.1	-0.2	0.0	0.0	0.
National Lottery	0.0	-0.1	0.2	0.0	0.
Other programme expenditure	0.0	0.0	0.0	0.0	0.
Non-cash items:					
Depreciation	0.1	-0.4	-0.5	0.1	0.
Cost of capital charges	0.3	-0.1	-0.5	-1.5	-1.
Provisions and other charges	0.3	0.5	0.2	0.1	0.
Total departmental AME (incl. non-cash items)	**1.0**	**-0.9**	**1.5**	**1.1**	**0.**
Other AME:					
Net Payments to EC institutions	0.0	0.1	0.1	-0.1	-0.
Locally financed expenditure	0.0	0.4	0.4	0.4	0.
CG debt interest	-0.1	-0.1	-1.5	-0.5	-0.
Accounting and other adjustments	-0.1	-0.7	1.4	1.8	2.
Total Other AME	**-0.2**	**-0.2**	**0.5**	**1.6**	**2.**
AME Margin	*0.0*	*1.1*	*1.7*	*1.6*	*1.*
Annually Managed Expenditure	**0.8**	**0.0**	**3.7**	**4.3**	**4.**

B58 The main accounting adjustments, those items within TME but outside DEL and AME main programmes, are shown in Tabl B20. Since the Budget and the Spending Review there have been a number of changes to the adjustments of which the most significant are the higher forecasts for non-trading capital consumption and VAT refunded on general government expenditure. These are due to higher outturn data. The adjustments increase over the next two years mainly because of the introduction of the Working Families Tax Credit.

Table B20: Accounting and other adjustments

	£ billion				
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-0**
1 Non-trading capital consumption	7.9	8.2	8.4	8.7	9.
2 VAT refunded on general government expenditure	5.9	6.2	6.5	6.8	7.

3	EC Contributions	-5.7	-6.6	-5.4	-4.8	-4.
4	Tax credits	3.0	4.9	5.5	5.7	5.
	of which Working Families' Tax Credit and Disabled Person's Tax Credit[1]*:*	*1.0*	*4.5*	*5.1*	*5.3*	*5.*
5	Adjustments for public corporations	3.9	3.8	3.8	3.7	4.
6	Intra general government debt interest	-3.4	-2.8	-2.9	-3.2	-2.
7	Financial transactions in departmental budgets	-1.9	-2.4	-1.8	-1.8	-1.
8	Adjustments for expenditure financed by receipts	0.0	0.0	0.1	0.1	0.
9	Other accounting adjustments	-0.4	-0.3	-0.5	-0.5	-0.
10	Reconciliation to national accounts	-1.9				
	less					
	non-cash items in DEL	0.3	0.3	0.3	0.3	0.
	non-cash items in AME	20.9	19.8	20.1	20.5	21.
Total accounting and other adjustments		**-13.8**	**-9.2**	**-6.7**	**-6.0**	**-5.**

[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*

B59 Table B21 gives a breakdown of public sector capital expenditure.

Table B21: Public sector capital expenditure

			£ billion		
	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-0**
CG spending and LA support in DEL	9.9	13.7	16.8	20.9	25.0
Locally-financed spending	0.9	0.8	2.2	2.2	2.1
National Lottery	1.4	1.3	1.3	1.3	1.3
Public corporations[1]	4.5	4.5	4.5	4.7	4.8
Other capital spending in AME	0.9	1.0	1.0	1.1	1.1
Allocation of reserve and AME margin	0.0	0.7	0.3	0.4	0.5
Public sector gross investment[2]	**17.6**	**22.0**	**26.2**	**30.5**	**34.7**
Less depreciation	-14.4	-15.0	-15.4	-16.0	-16.5
Public sector net investment[2]	**3.2**	**7.0**	**10.7**	**14.5**	**18.2**
Proceeds from the sale of fixed assets[3]	4.8	3.8	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*.

B60 Table B22 shows estimated receipts from asset and loan sales from 1998-99 to 2002-03. The table shows that following two years of total sales of fixed assets of over £4 billion the Government continue to forecast further sales of some £4 billion over this year and the next two years.

Table B22: Loans and sales of assets

	£ billion				
	Outturn		Projections		
	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**
Sales of fixed assets[1]					
Central Government	1.3	1.1	1.0	1.0	1.0
Local Authorities	2.8	3.7	2.8	2.8	2.8
Total sales of fixed assets	**4.1**	**4.8**	**3.8**	**3.8**	**3.8**
Loans and sales of financial assets					
Sale of student loans portfolio	1.0				
Other loans and sales of financial assets	-1.5	-1.7	-3.0	-3.0	-2.9
Total loans and sales of financial assets	**-0.5**	**-1.7**	**-3.0**	**-3.0**	**-2.9**
Total loans and sales of assets	**3.6**	**3.1**	**0.7**	**0.8**	**0.9**

[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.*

B61 The figures for sales of financial assets include proceeds from the sale of British Energy debt and from the public private partnerships for National Air Traffic Services and the Defence Evaluation and Research Agency.

LIST OF ABBREVIATIONS

AEI	Average Earnings Index
AESOP	All-Employee Share Ownership Plan
AME	Annually Managed Expenditure
APPs	Appropriate personal pensions
BCC	British Chamber of Commerce
BCS	British Crime Survey
CAT	Charges Access Terms
CBI	Confederation of British Industry
CED	Consumers' expenditure deflator
CFCs	Controlled Foreign Companies
CGT	Capital gains tax
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
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
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
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
IPPC	Integrated Pollution and Prevention Control
IPRs	Intellectual Property Rights
IRB	Income Related Benefits
IRU	Indefeasible Right of Use
ISMI	Income Support for Mortgage Interest
ISA	Individual Savings Account
IT	Information Technology
ITCE	Information Technology and Communication Engineers

JSA	Jobseekers' Allowance
LEL	Lower earnings limit
LFS	Labour Force Survey
LLP	Limited Liability Partnership
LPG	Liquefied Petroleum Gas
LSP	Local Strategic Partnership
LRP	Lead Replacement Petrol
MA	Maternity Allowance
MCA	Married Couple's Allowance
MCT	Mainstream corporation tax
MDR	Marginal Deduction Rate
MFR	Minimum Funding Requirement
MIG	Minimum Income Guarantee
MIT	Massachusetts Institute of Technology
MIRAS	Mortgage Interest Relief at Source
MPC	Monetary Policy Committee
MtC	Million tonnes of carbon
NAIRU	Non-accelerating inflation rate of unemployment
NAO	National Audit Office
NAR	National Asset Register
NDLP	New Deal for Lone Parents
NESI	New Enterprise Support Initiative
NFC	Non-financial company
NHS	National Health Service
NICs	National Insurance Contributions
NIESR	National Institute of Economic and Social Research
NOx	Nitrogen Oxides
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 Task-force
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
SIT	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
UEL	Upper earnings limit
UfI	University for Industry
UK	United Kingdom
ULSD	Ultra Low Sulphur Diesel
ULSP	Ultra Low Sulphur Petrol
URC	Urban Regeneration Companies
US	United States of America
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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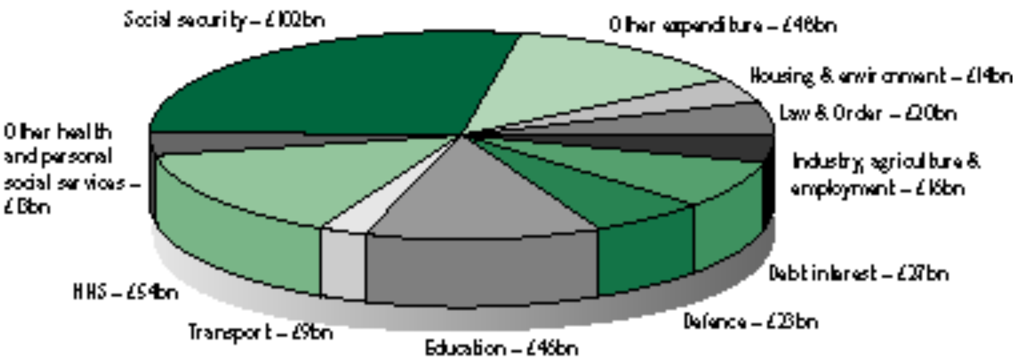
Chart 1.1: Government spending by function

Total managed expenditure: £372 billion



Source: HM Treasury, 2000–01 estimate.

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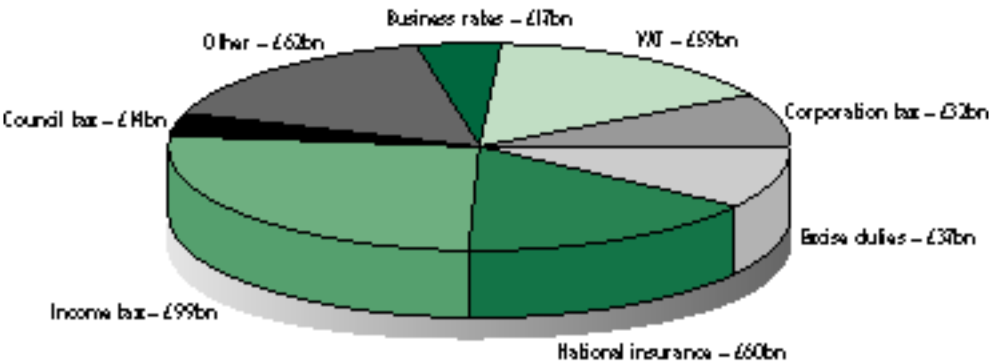
Chart 1.2: Government receipts

Total receipts: £380 billion



Source: HM Treasury 2000–01 estimates.

Chart 2.1: Inflation performance against target

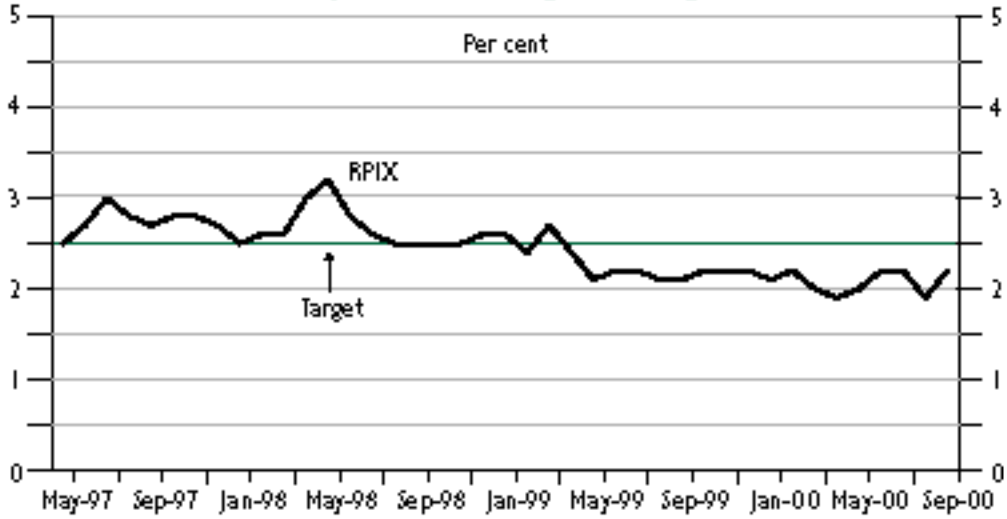


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Chart 2.2: Meeting the fiscal rules – cyclically adjusted surplus on current budget and public sector net debt

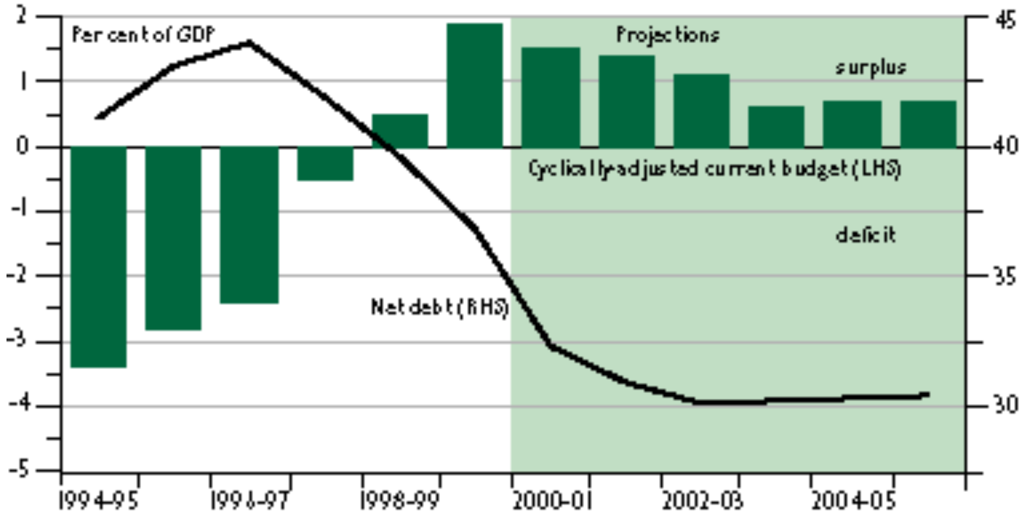

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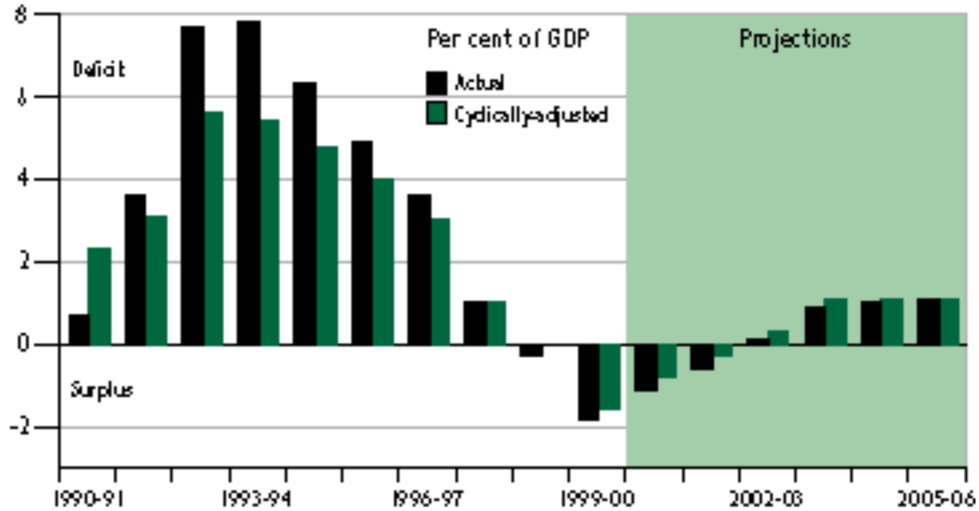
Chart 2.3: Public sector net borrowing – actual and cyclically-adjusted[1]



[1] Excluding windfall tax receipts and associated spending.

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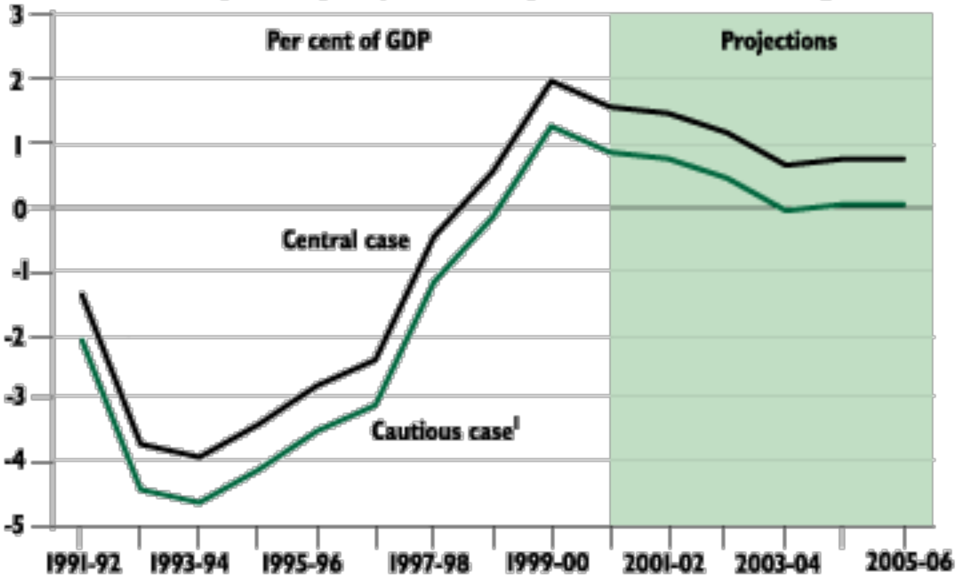
Chart 2.4: Cyclically-adjusted surplus on current budget



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

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Chart 3.2: UK productivity growth, 1995–2000

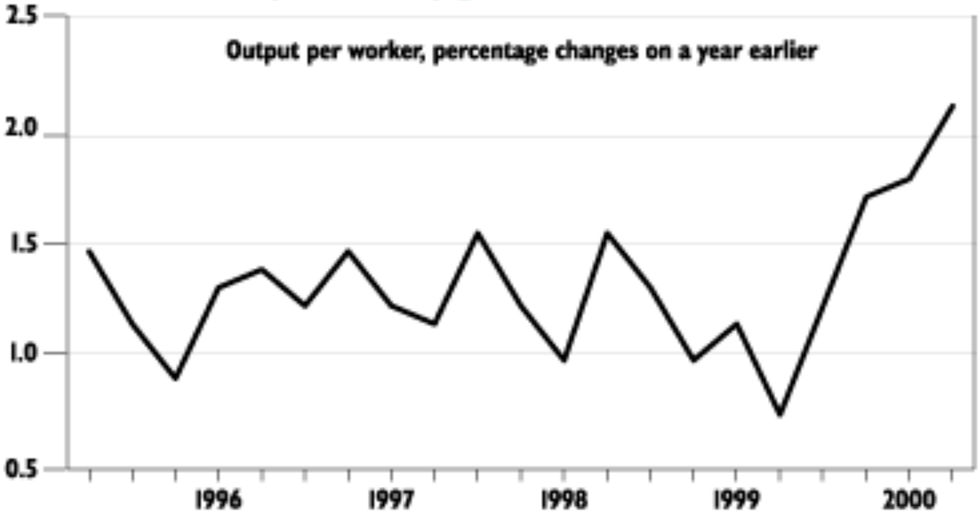

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Chart 3.2: UK productivity growth, 1995–2000

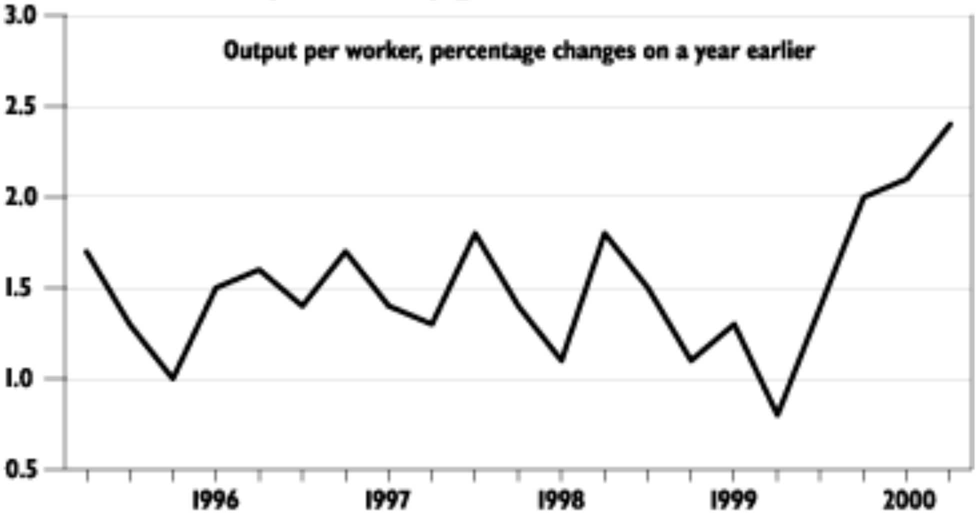

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Chart 3.3: Public sector net investment

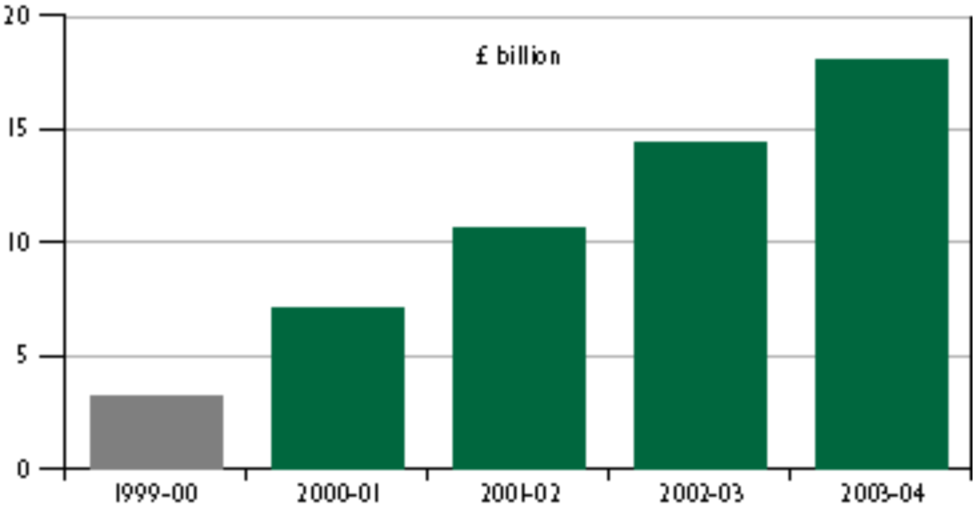

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Chart 4.1: UK employment rate

Chart 4.2: Gains to work before and after reforms

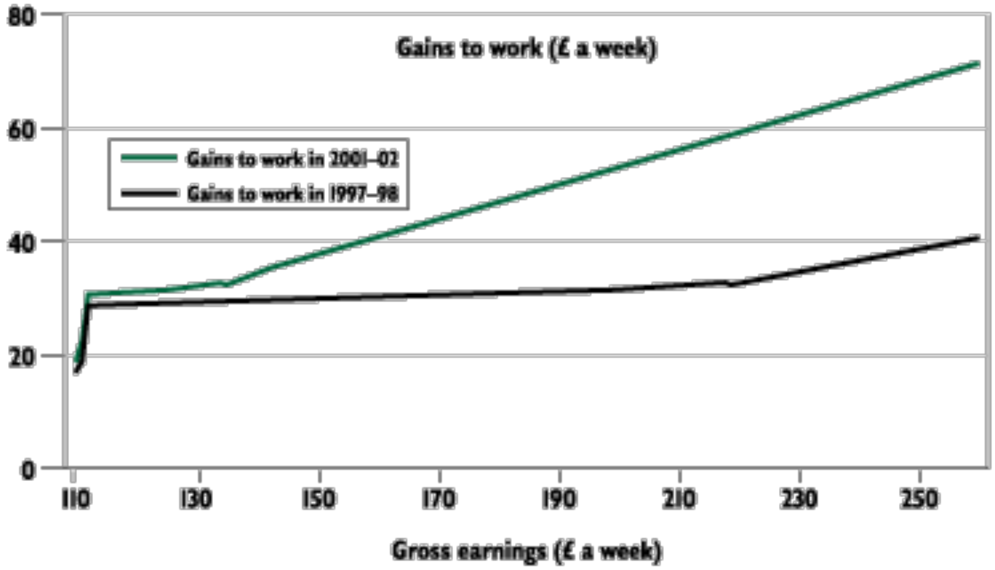

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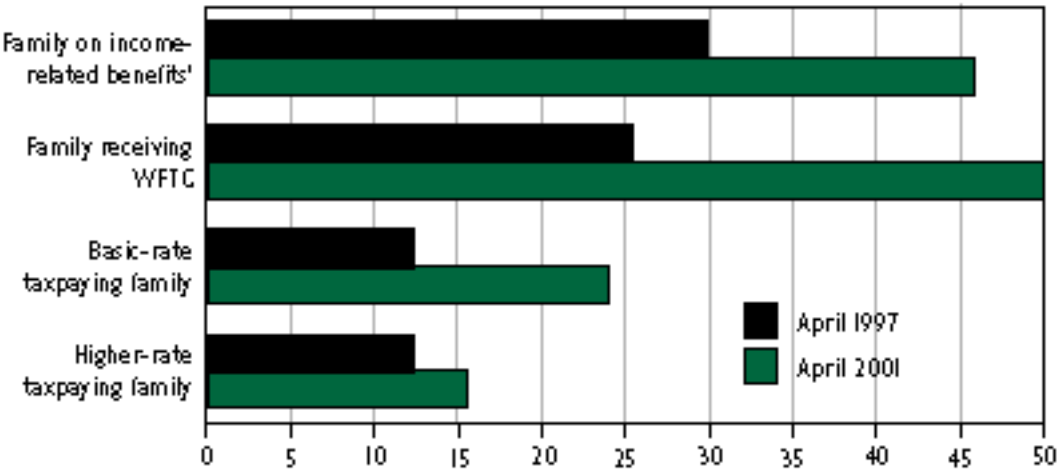
Chart 5.1: Financial support for the first child, in 2001–02 prices



[1] Income Support recipients receive a lower cash payment compared to Working Families' Tax Credit (WFTC). This reflects the fact that families on Income Support get help with free school meals, to which families receiving Working Families' Tax Credit are not entitled.

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

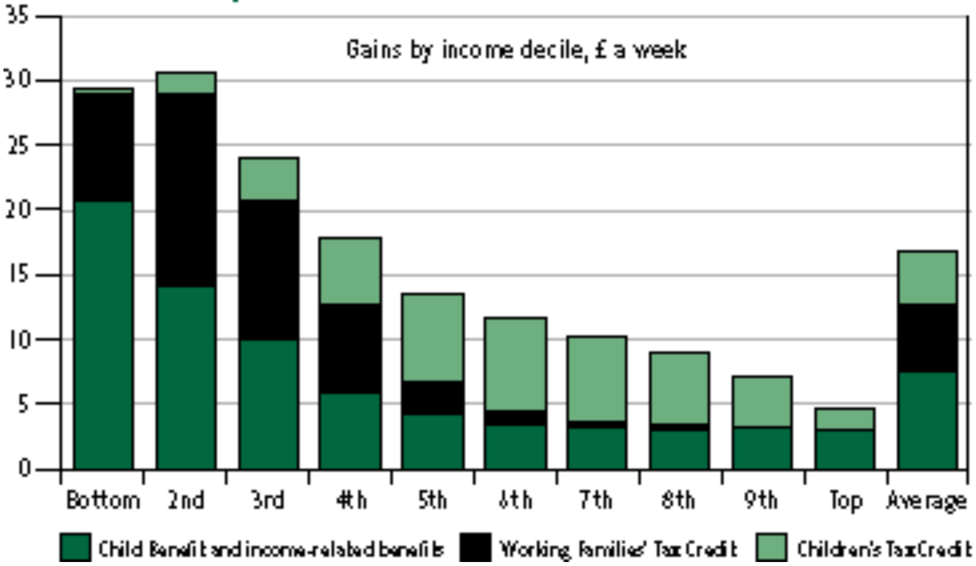


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Chart 5.3: Overall gains for pensioner families from pensioner policies including Budget 2001 changes

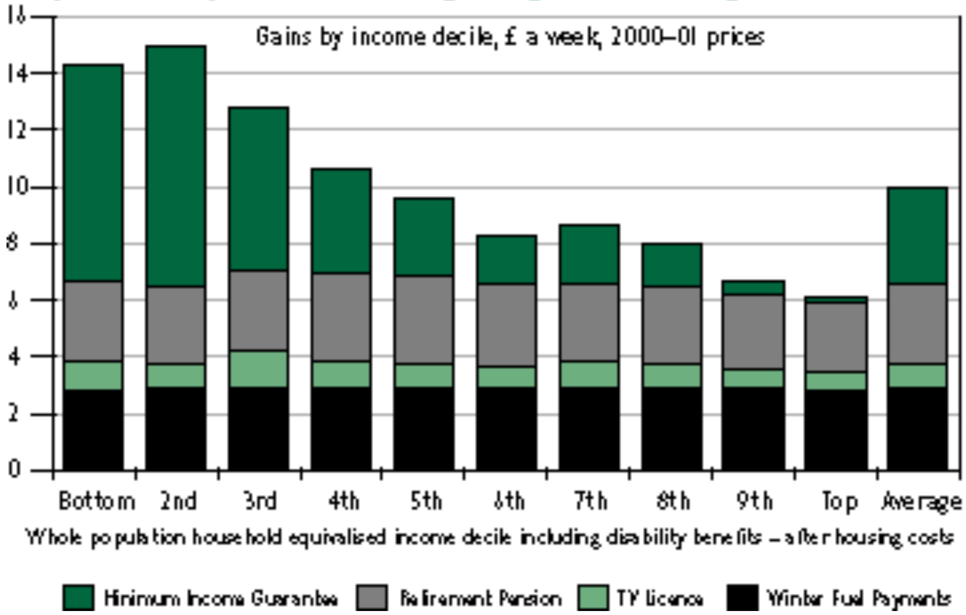

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Chart 5.4: Rise in departmental and locally-financed expenditure from 2000–01 to 2003–04

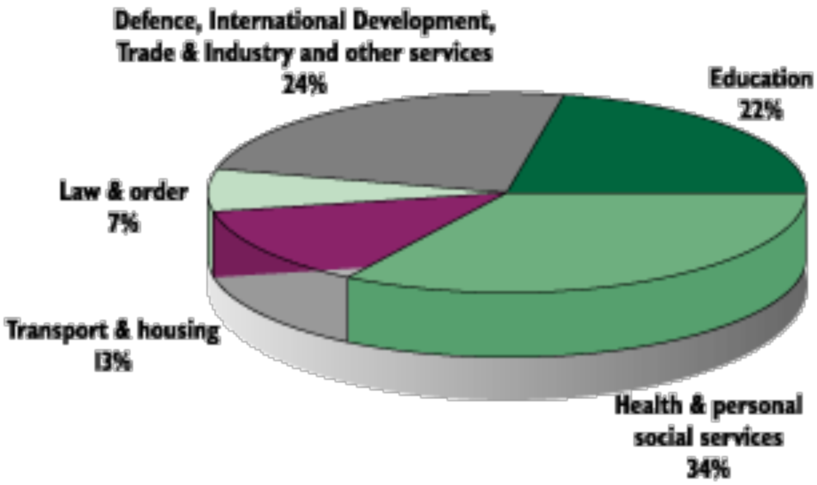
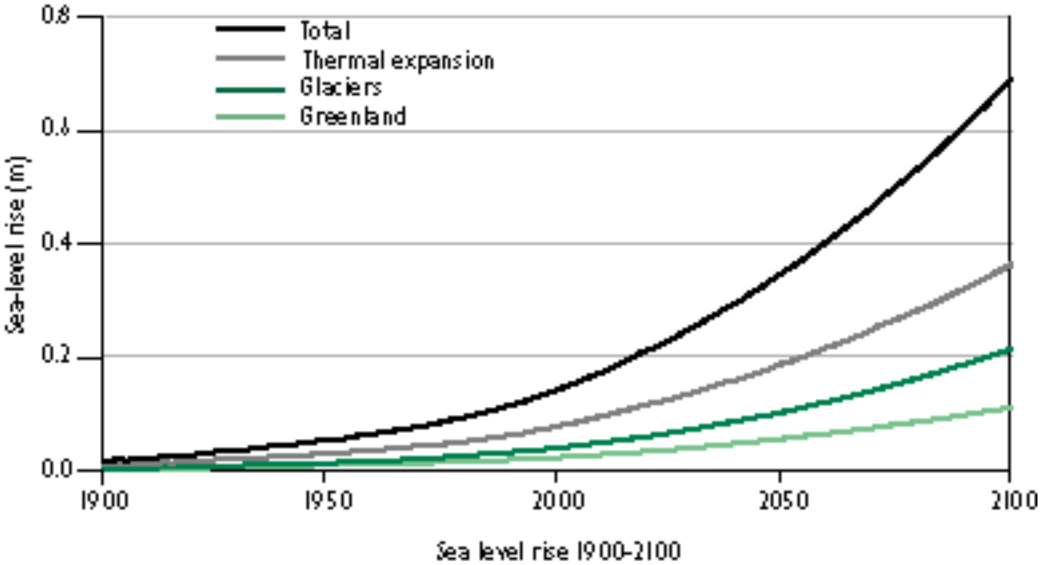


Chart 6.1: Projected sea-level rise and its components



Source: *The Met Office's Hadley Centre for Climate Prediction and Research.*

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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 • Emission trading • Reforms to company car tax • VED reforms • Green travel plans • Authorised mileage rates • Reduced rate of VAT on the installation of energy saving materials • Fuel duty differentials	• Draft climate change programme[2] • Emissions Trading Consultation Document[3] • Ten Year Plan for transport[4] • Air Quality Strategy[5]	• CO_2 emissions • Days of air pollution • Electricity from renewable sources • 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 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 • Possible pesticides voluntary package/tax	• 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 1999.

[2]*Draft Climate Change Programme,* DETR March 2000. The Final programme will be published shortly.

[3]*Emissions Trading Consultation Document,* DETR, October 2000.

[4]*Ten Year Plan for transport,* DETR July 2000.

[5]*Consultation document Report on the Air Quality Strategy,* DETR, October 2000.

[6]*Urban White Paper,* DETR to be published shortly.

[7]*Waste Strategy*, DETR May 2000.

[8]*A Better Quality of Life*, DETR May 2000.

[9]*Rural White Paper*, DETR (to be published shortly).

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]	Savings of at least 2.0 MtC
	Negotiated agreements[4]	Savings of at least 2.5 MtC
	Energy efficiency measures	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 allowances	Reductions in CO_2 and air particulates	
• Reform to car and lorry VED	Reduction in emissions of CO_2, NO_X and particulates	
• Road fuel duty differentials[7]	The ULSP differential is estimated to reduce NO_X by 1 per cent, reduce CO by 4 per centy and reduce VOCs by 1 per cent in 2004. The ULSD differential is estimated to result in a reduction of 8 per cent of particulates and up to 1 per cent of NO_X. The road fuel gas differential will result in a reduction in emissions of particulates and NO_X.	
• 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 by 2010 and small reductions in emissions of local air pollutants	
• Reduced rate of VAT on the installation of energy saving materials	Reduction in 0.1 MtC	
• Reduced rate of VAT on domestic fuel and power	Estimated to increase carbon emissions by 0.2 million tonnes by 2010.	
• Capital allowances for flats over shops • Tax relief for cleaning contaminated land • Stamp duty relief for disadvantaged areas • Reforms to the VAT treatment on conversion activity	Reduce pressure on the countryside due to increase in the number of empty and derelict properties Increases in clean up of contaminated land 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] 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.

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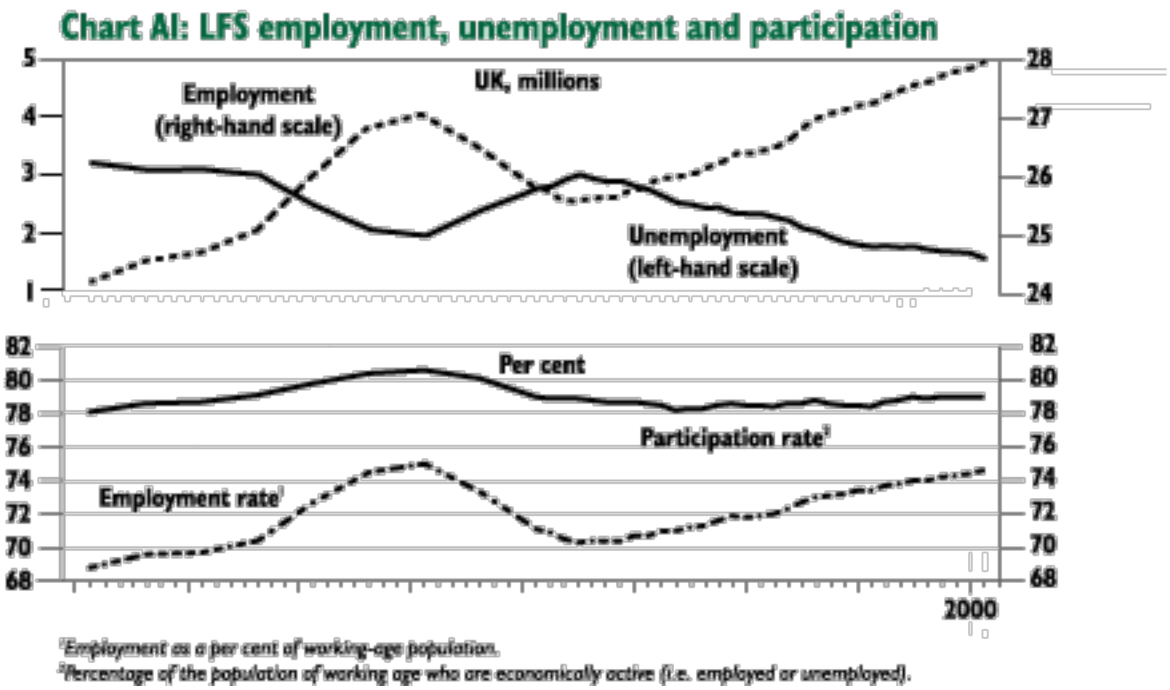
Chart A1: LFS employment, unemployment and participation
UK, millions
Employment
(right-hand scale)
Unemployment
(left-hand scale)
5
4
3
2
1
28
27
26
25
24
Per cent
Participation rate[2]
Employment rate[1]
82
80
78
76
74
72
70
68
2000
[1]Employment as a per cent of working-age population.
[2]Percentage of the population of working age who are economically active (i.e. employed or unemployed).

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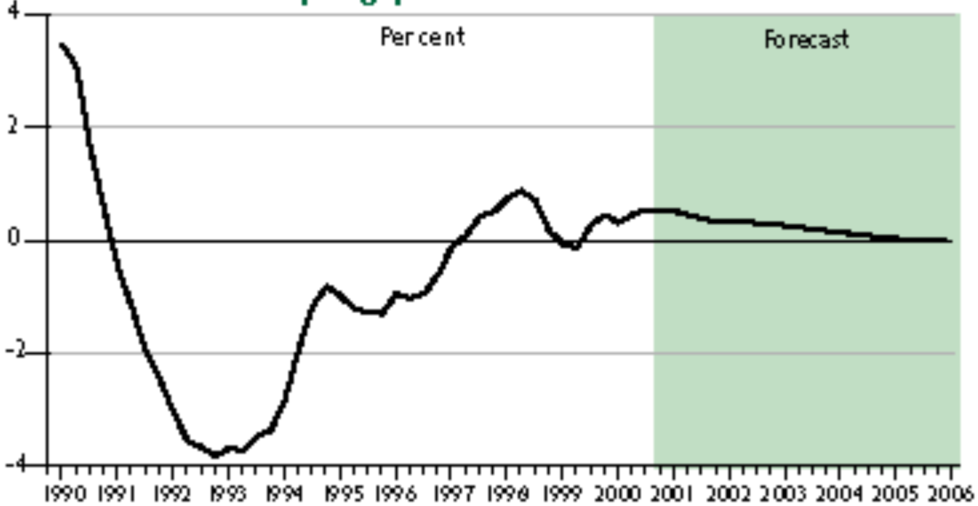
Chart A2: The output gap[1]



[1]Actual output less trend output as a percent of trend output (non-oil basis).

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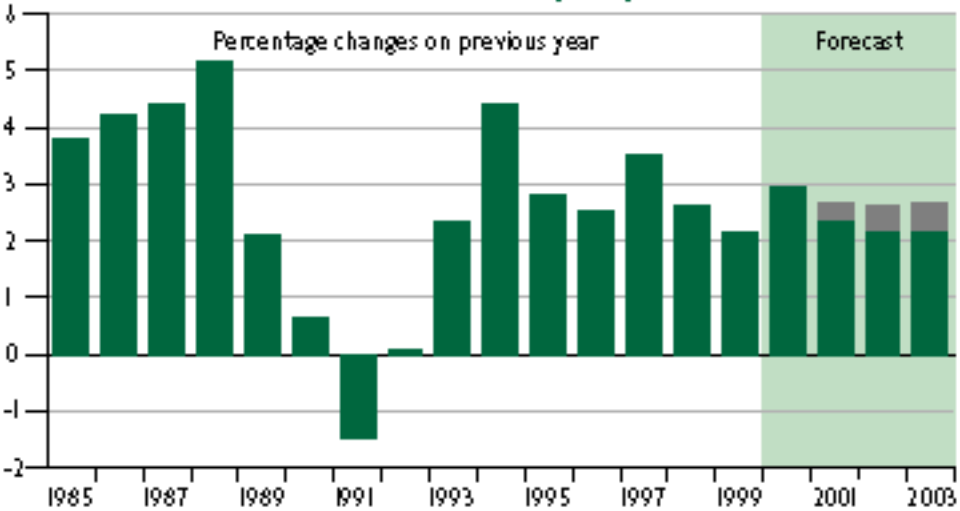
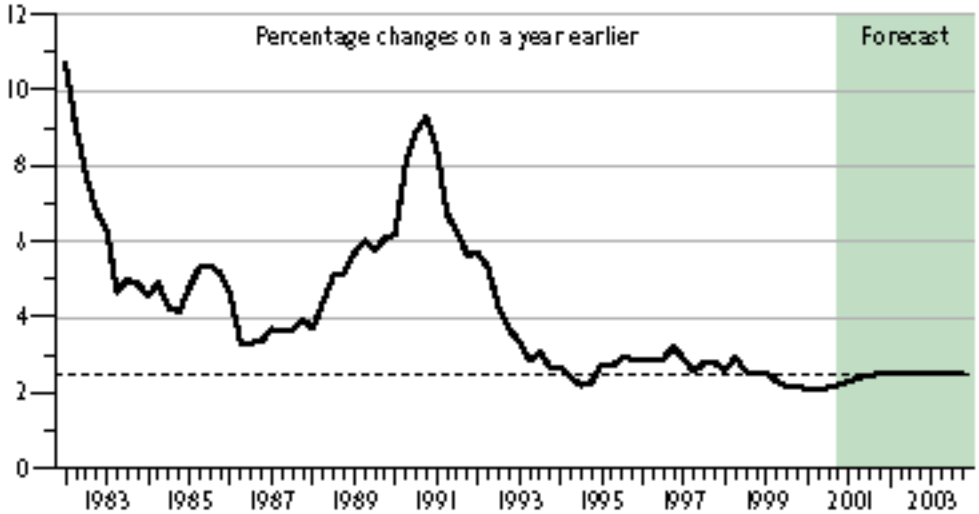
Chart A3: Gross Domestic Product (GDP)[1]



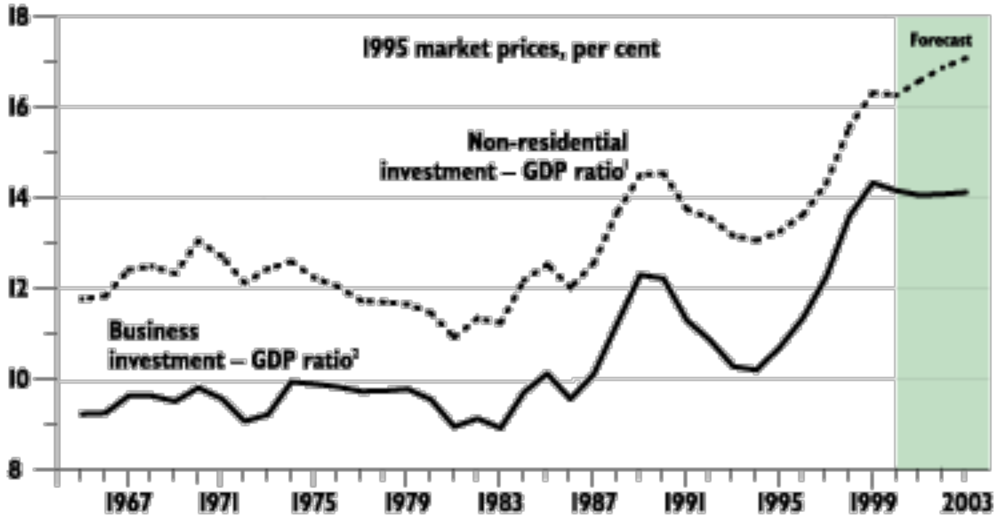
[1]Shaded areas on bars represent forecast ranges.

Chart A4: RPIX[1]



[1]Outturns until 2000Q3; forecasts for every second quarter from 2000Q4 to 2003Q4.

Chart A5: Business and non-residential investment ratios



[1]*Whole economy less dwellings.*
[2]*Business investment includes investment by public corporations (except National Health Service Trusts) and investment under the Private Finance Initiative.*

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Chart A6: Balance of payments current account

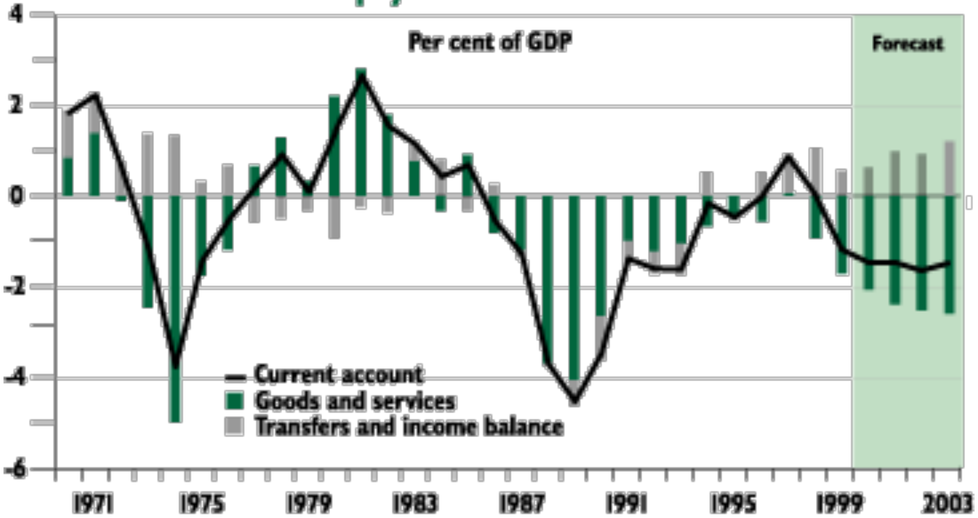

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Table A8: Gross domestic product and its components

£ billion at 1995 prices, seasonally adjusted

	Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
1999	531.4	147.8	153.3	-1.4	831.5	250.4	1081.9	286.6	-0.6	794.7
2000	550.2	151.0	157.0	2.4	860.6	270.3	1130.9	312.2	-0.4	818.3
2001	562.1 to 563.8	157.0	163.6 to 164.1	0.4 to 0.9	883.2 to 885.9	289.4 to 290.3	1172.6 to 1176.2	334.7 to 335.7	-0.4	837.5 to 840.1
2002	571.5 to 576.1	163.3	169.7 to 171.0	-0.6 to 0.7	903.9 to 911.1	306.5 to 309.0	1210.4 to 1220.1	354.7 to 357.5	-0.4	855.4 to 862.2
2003	582.9 to 590.5	169.1	175.4 to 177.6	-2.6 to -0.4	924.8 to 936.8	323.5 to 327.6	1248.3 to 1264.4	374.1 to 379.0	-0.4	873.8 to 885.1
1999 1st half	263.1	73.9	76.0	-1.2	411.9	121.4	533.3	139.1	-0.3	393.9
2nd half	268.3	74.0	77.3	-0.2	419.6	129.0	548.6	147.5	-0.3	400.8
2000 1st half	273.2	74.3	77.5	1.4	426.3	132.4	558.8	152.4	-0.2	406.1
2nd half	277.1	76.7	79.5	1.0	434.3	137.8	572.1	159.8	-0.2	412.1
2001 1st half	279.9 to 280.4	77.9	81.2 to 81.4	0.1 to 0.2	439.1 to 439.9	142.5 to 142.8	581.7 to 582.7	164.8 to 165.1	-0.2	416.7 to 417.4
2nd half	282.1 to 283.3	79.2	82.4 to 82.8	0.3 to 0.7	444.0 to 445.9	146.9 to 147.5	590.9 to 593.4	169.9 to 170.6	-0.2	420.8 to 422.6
2002 1st half	284.5 to 286.4	80.8	84.0 to 84.6	-0.1 to 0.5	449.3 to 452.3	151.1 to 152.1	600.4 to 604.5	174.9 to 176.0	-0.2	425.3 to 428.2
2nd half	287.0 to 289.7	82.5	85.6 to 86.4	-0.5 to 0.2	454.6 to 458.8	155.4 to 156.8	610.0 to 615.6	179.8 to 181.5	-0.2	430.0 to 434.0

2003 1st half	289.9 to 293.3	84.1	87.1 to 88.1	-1.3 to -0.4	459.8 to 465.2	159.6 to 161.4	619.4 to 626.6	184.6 to 186.8	-0.2	434. to 439.
2nd half	293.0 to 297.1	85.0	88.2 to 89.5	-1.2 to -0.1	465.0 to 471.6	163.9 to 166.2	628.9 to 637.8	189.5 to 192.2	-0.2	439. to 445.
					Percentage changes on previous year[4, 5]					
1999	$4^1/_4$	$3^1/_4$	6	$-^3/_4$	$3^3/_4$	$3^1/_4$	$3^1/_2$	$7^3/_4$	0	$2^1/$
2000	$3^1/_2$	$2^1/_4$	$2\ ^1/_2$	$^1/_2$	$3^1/_2$	8	$4^1/_2$	9	0	
2001	$2^1/_4$ to $2^1/_2$	4	$4^1/_4$ to $4^1/_2$	$-^1/_4$	$2^1/_2$ to 3	7 to $7^1/_2$	$3^3/_4$ to 4	$7^1/_4$ to $7^1/_2$	0	$2^1/_4$ to $2^3/$
2002	$1^3/_4$ to $2^1/_4$	4	$3^3/_4$ to $4^1/_4$	$-^1/_4$ to 0	$2^1/_4$ to $2^3/_4$	6 to $6^1/_2$	$3^1/_4$ to $3^3/_4$	6 to $6^1/_2$	0	$2^1/_4$ to $2^3/$
2003	2 to $2^1/_2$	$3^1/_2$	$3^1/_4$ to $3^3/_4$	$-^1/_4$	$2^1/_4$ to $2^3/_4$	$5^1/_2$ to 6	$3^1/_4$ to $3^3/_4$	$5^1/_2$ to 6	0	$2^1/_4$ to $2^3/$

[1] *Includes households and non-profit institutions serving households*.

[2] *Also includes acquisitions less disposals of valuables*.

[3] *Expenditure adjustment*.

[4] *For change in inventories and the statistical discrepancy, changes are expressed as a per cent of GDP.*

[5] *Growth ranges for GDP components do not necessarily sum to the $^1/_2$ percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges*.

Chart A7: G7 GDP and world trade

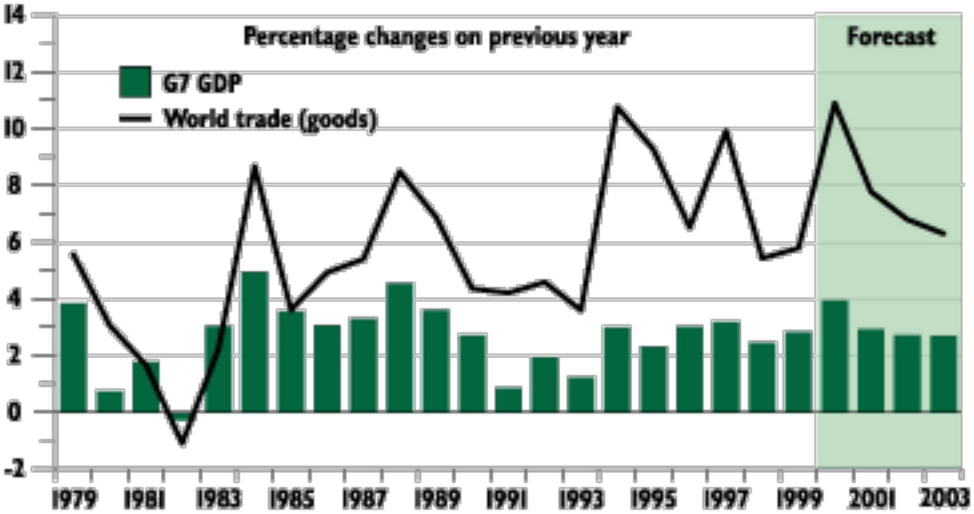

Chart A8: G7 consumer price inflation (CPI) and oil prices

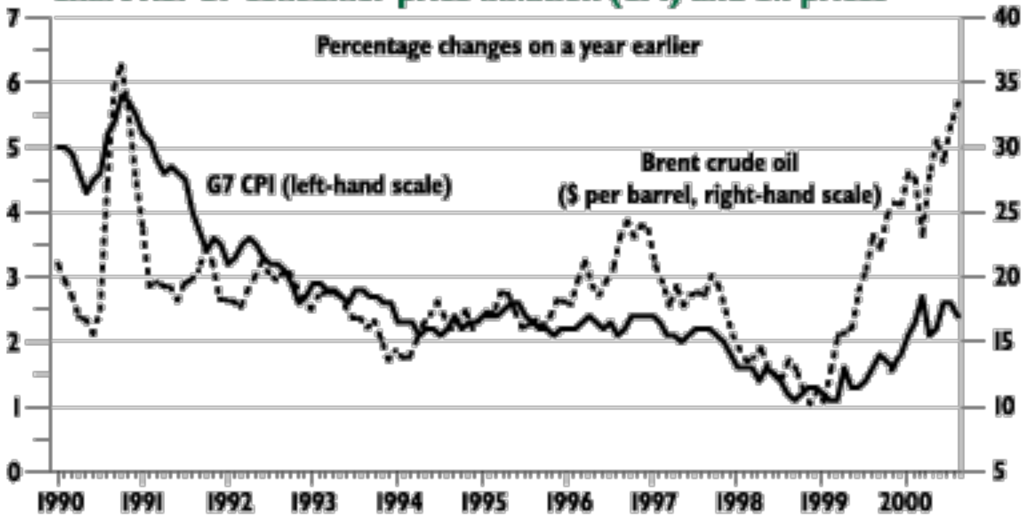

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Chart B1: Public sector net debt and net worth

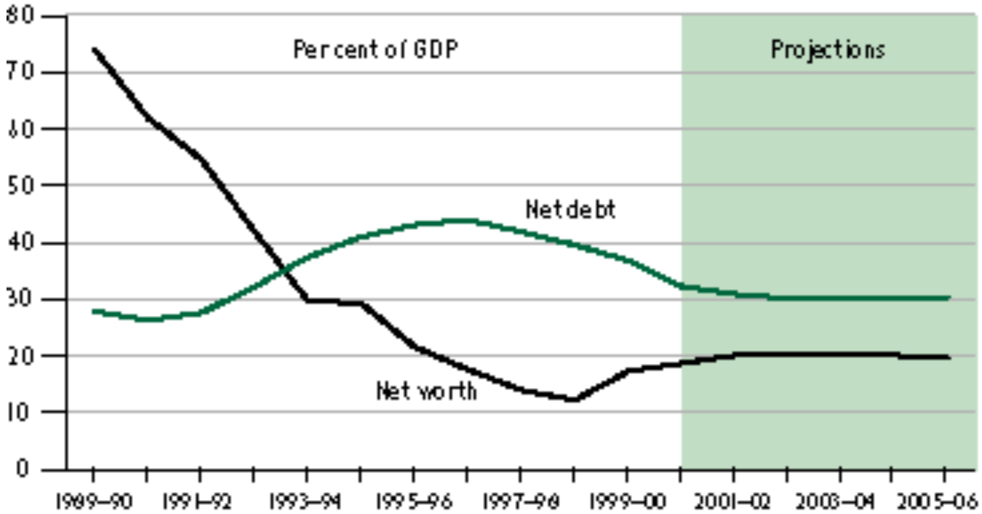

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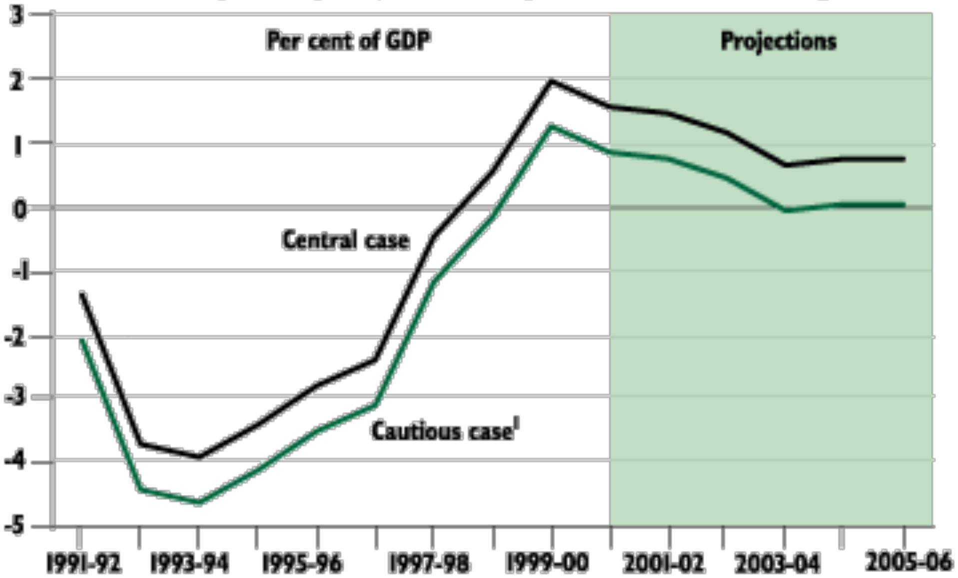
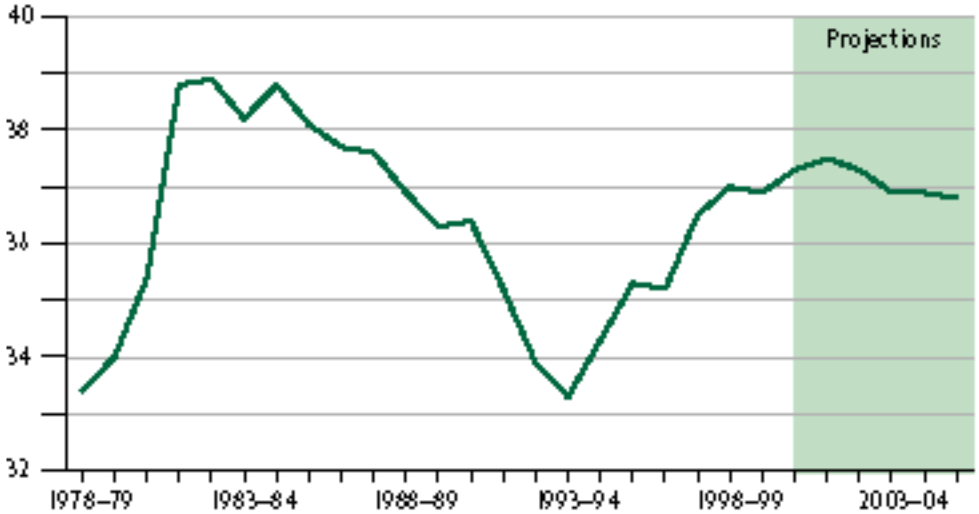
Chart B2: Cyclically-adjusted surplus on current budget



[1]Cautious case assumes trend output 1 per cent lower in relation to actual output than in the central case.

Chart B3: Tax-GDP ratio[1]



[1]Net taxes and social security contributions as defined in Table B10.

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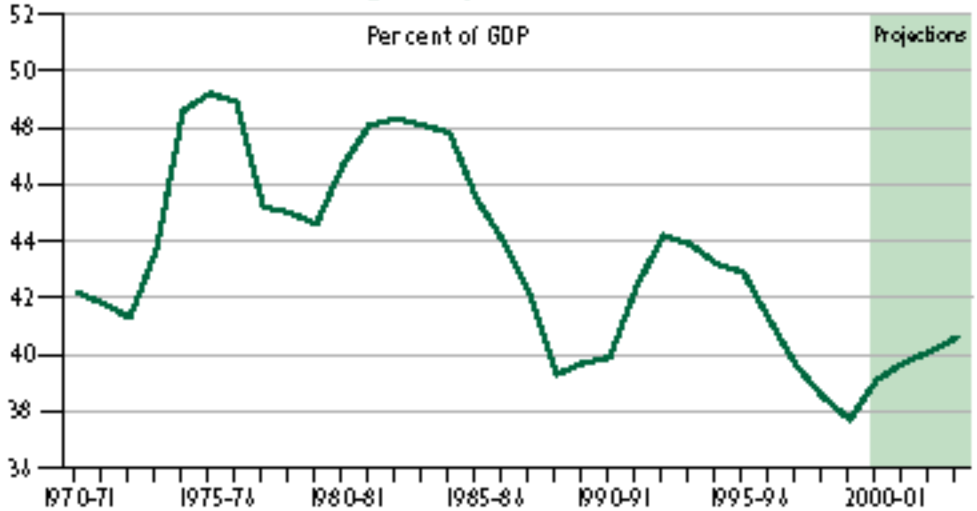
Chart B4: Total Managed Expenditure



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Financing Requirement

B62 Table B23 presents projections of the net cash requirement by sector, giving details of the various financial transactions that do not affect net borrowing (the change in the sector's net financial indebtedness) but do affect its financing requirement.

Table B23: Public sector net cash requirement[1]

B63 Table B24 updates the financing arithmetic for 2000-01 to allow for the latest forecast of the central government net cash requirement.

Table B24: Financing requirement forecast

B64 As a consequence of the strong state of the public finances and the receipts from the spectrum licence auction, the Government has decided to increase the planned total of debt buy-backs to £5 billion (cash). However, given the commitment to maintain gilt issuance at £10 billion (cash), net short-term debt will be reduced in total by £12.4 billion compared to the positions announced in the revision to the DMO's remit on 12 June. This is being achieved by a further reduction of £1.6 billion in the Ways and Means advance planned for end March 2001 (to £13.4 billion) and a further reduction of £4.5 billion in the planned Treasury bill stock at end March 2001 (to £3.5 billion). The residual reduction in net central government debt, which will be invested in short-term assets, is £6.3 billion. Any under or overshooting of the CGNCR forecast for 2000-01 will be accommodated by changes in short-term asset holdings or the Treasury bill stock.

B65 At the time of the June revision to the DMO's remit, it was expected that the reduction in net short-term debt would be unwound over the next two financial years. However, in the light of the continued improvement in the public finances, it is now expected that the increase in assets will be unwound over the next three financial years.

B66 The DMO will be responsible for the management of the assets as an extension to their cash management responsibilities. The DMO will publish the range of instruments in which they may invest.

Table B25: Public sector transactions by sub-sector and economic category

B67 Tables B26 and B27 set out historical data for the main fiscal aggregates.

Table B26: Historical series of public sector balances, receipts and debt

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Table B27: Historical series of government expenditure

Table B23: Public sector net cash requirement[1]

	£ billion							
	1999-2000				**2000-01**			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Net borrowing	**-15.9**	**-0.7**	**1.1**	**-15.6**	**-10.1**	**0.0**	**1.5**	**-8.7**
Financial transactions								
Net lending to private sector and abroad	2.2	0.0	0.0	2.1	3.2	-0.1	0.0	3.1
Cash expenditure on company securities (including privatisation proceeds)	-0.3	-0.2	0.0	-0.4	-0.1	0.0	0.0	-0.1
Accruals adjustments on receipts	5.5	0.9	0.2	6.6	-18.9	0.0	0.0	-18.9
Other accruals adjustments	-1.3	0.0	0.0	-1.3	-2.7	0.0	0.0	-2.7
Miscellaneous financial transactions	-0.7	0.9	-0.3	-0.1	-1.0	0.7	-0.5	-0.9
Own account net cash requirement	-10.6	0.9	1.0	-8.7	-29.6	0.6	0.9	-28.1
Net lending within the public sector	1.4	-1.4	0.0	0.0	1.4	-1.0	-0.4	0.0
Net cash requirement[2]	-9.1	-0.6	1.0	-8.7	-28.2	-0.4	0.5	-28.1

[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 -£9.4 billion (-1.0 per cent of GDP) in 1999-2000 and is projected to be -£29.6 billion (-3.1 per cent of GDP) in 2000-01. It is projected at £-4 billion (-0.4 per cent of GDP) in 2001-02 and £4 billion (0.4 per cent of GDP) in 2002-03.*

[2] *Market and overseas borrowing for local government and public corporation sectors.*

Table B24: Financing requirement forecast

	2000-01		
	Original remit	Revised remit[1]	Pre-Budget
£ billion	March 2000	12 June 2000	Report
Central government net cash requirement	**-4.9**	**-4.9**	**-28.2**
Unanticipated spectrum receipts		**-19.5**	
Expected net financing of official reserves[2]	3.5	9.5	9.3
Expected gilt redemptions	18.6	18.6	18.6
Gilts sales residual 1999-2000	-9.5	-12.8	-12.8
Debt buy-backs	3.5	3.5	5.0
Financing requirement	**11.2**	**-5.6**	**-8.1**
Less Assumed net National Savings contribution	-0.8	-0.8	-1.5
Less DMO's balance at the BoE	-0.2	-0.2	-0.2
Net financing requirement	**12.2**	**-4.6**	**-6.4**
Contingencies			
Less repayment of Ways and Means facility	na	-2.0	-3.6
Less reduction in planned Treasury Bill stock	na	-2.0	-6.5
Less further reduction in net short term debt[3]	na	-10.7	-6.3
Planned gross gilt sales[4]	12.2	10.0	10.0
Gilt sales to date (April-October 2000)			4.9
of which			
Short conventionals (3-7 years)			0.0
Medium conventionals (7-15 years)			0.0
Long conventionals (>15 years)2.4			
Index-linked			2.5
Further planned gilt sales			
Long conventionals			4.1
Index-linked			1.0

Note: Figures may not sum due to rounding.

1 *Remit revised following UMTS licence auction.*

2 *This includes original remit financing and implementation of contingencies (worth £5.9 billion), the difference is due to exchange rate fluctuations.*

3 *PBR figure is implied DMO cash position at end March 2001.*

4 *Gross gilt sales were fixed for £10 billion for the remainder of the year on 12 June 2000.*

Table B25: Public sector transactions by sub-sector and economic category

	Line	General government: Central government	Local authorities	Total	Public corporations	Public sector
		£ billion				
		1999-00				
Current receipts						
Taxes on income and wealth	*1*	133.8	0.0	133.8	-0.4	133.4
Taxes on production and imports	*2*	126.5	0.1	126.7	0.0	126.7
Other current taxes	*3*	3.5	13.2	16.8	0.0	16.8
Taxes on capital	*4*	2.0	0.0	2.0	0.0	2.0
Social contributions	*5*	56.6	0.0	56.6	0.0	56.6
Gross operating surplus	*6*	4.8	8.3	13.1	3.7	16.8
Rent and other current transfers	*7*	0.8	0.0	0.8	0.6	1.4
Interest and dividends from private sector and abroad	*8*	2.6	0.6	3.2	0.2	3.4
Interest and dividends from public sector	*9*	6.3	-4.0	2.3	-2.3	0.0
Total current receipts	*10*	**336.9**	**18.3**	**355.3**	**1.8**	**357.1**
Current expenditure						
Current expenditure on goods and services	*11*	99.7	65.3	165.0	0.0	165.0
Subsidies	*12*	5.0	0.8	5.8	0.0	5.8
Net social benefits	*13*	97.9	12.5	110.4	0.0	110.4
Net current grants abroad	*14*	-0.5	0.0	-0.5	0.0	-0.5
Current grants (net) within public sector	*15*	64.3	-64.3	0.0	0.0	0.0
Other current grants	*16*	17.7	0.0	17.7	0.0	17.7
Interest and dividends paid	*17*	25.5	0.4	25.8	-0.3	25.5
Apportionment of DEL reserve and AME margin	*18*	0.0	0.0	0.0	0.0	0.0
Total current expenditure	*19*	**309.5**	**14.7**	**324.3**	**-0.3**	**323.9**
Depreciation	*20*	4.4	6.4	10.8	3.6	14.4
Surplus on current budget	*21*	**23.0**	**-2.7**	**20.3**	**-1.4**	**18.8**
Capital expenditure						
Gross domestic fixed capital formation	*22*	3.9	5.4	9.3	4.5	13.8
Less depreciation	*23*	-4.4	-6.4	-10.8	-3.6	-14.4
Increase in inventories	*24*	-0.2	0.0	-0.2	-0.2	-0.4
Capital grants (net) within public sector	*25*	3.9	-2.8	1.1	-1.1	0.0
Capital grants to private sector	*26*	3.9	0.8	4.6	0.0	4.6
Capital grants from private sector	*27*	0.0	-0.5	-0.5	0.0	-0.5
Apportionment of DEL reserve	*28*	0.0	0.0	0.0	0.0	0.0
Net capital expenditure	*29*	**7.1**	**-3.5**	**3.6**	**-0.4**	**3.2**

Net borrowing	30	-15.9	-0.7	-16.7	1.1	-15.6

Table B25: Public sector transactions by sub-sector and economic category

£ billion

2000-01

Line	General government					
	Central government	Local authorities	Total	Public corporations	Public sector	
						Current receipts
1	142.0	0.0	142.0	-0.4	141.6	Taxes on income and wealth
2	132.6	0.1	132.8	0.0	132.8	Taxes on production and imports
3	3.6	13.9	17.5	0.0	17.5	Other current taxes
4	2.3	0.0	2.3	0.0	2.3	Taxes on capital
5	60.6	0.0	60.6	0.0	60.6	Social contributions
6	5.1	8.7	13.7	4.0	17.7	Gross operating surplus
7	1.9	0.0	1.9	0.6	2.5	Rent and other current transfers
8	4.3	0.7	5.0	0.2	5.2	Interest and dividends from private sector and abroad
9	5.6	-3.4	2.2	-2.2	0.0	Interest and dividends from public sector
10	**358.0**	**20.0**	**378.0**	**2.3**	**380.3**	**Total current receipts**
						Current expenditure
11	105.4	68.6	173.9	0.0	173.9	Current expenditure on goods and services
12	5.7	0.8	6.5	0.0	6.5	Subsidies
13	104.3	13.5	117.8	0.0	117.8	Net social benefits
14	-0.9	0.0	-0.9	0.0	-0.9	Net current grants abroad
15	66.7	-66.7	0.0	0.0	0.0	Current grants (net) within public sector
16	21.0	0.0	21.0	0.0	21.0	Other current grants
17	26.9	0.3	27.2	-0.3	26.9	Interest and dividends paid
18	4.4	0.0	4.4	0.0	4.4	Apportionment of DEL reserve and AME margin
19	**333.4**	**16.5**	**349.9**	**-0.3**	**349.6**	**Total current expenditure**
20	4.7	6.6	11.3	3.7	15.0	Depreciation
21	**19.9**	**-3.1**	**16.8**	**-1.1**	**15.7**	**Surplus on current budget**
						Capital expenditure
22	6.7	6.5	13.2	4.5	17.6	Gross domestic fixed capital formation
23	-4.7	-6.6	-11.3	-3.7	-15.0	*Less* depreciation
24	-0.1	0.0	-0.1	0.0	-0.1	Increase in inventories
25	3.7	-3.3	0.4	-0.4	0.0	Capital grants (net) within public sector
26	3.7	1.0	4.7	0.0	4.7	Capital grants to private sector
27	0.0	-0.8	-0.8	0.0	-0.8	Capital grants from private sector
28	0.5	0.0	0.5	0.0	0.5	Apportionment of DEL reserve
29	**9.8**	**-3.1**	**6.7**	**0.4**	**7.0**	**Net capital expenditure**
30	**-10.1**	**0.0**	**-10.1**	**1.5**	**-8.7**	**Net borrowing**

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Table B26: 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	52.2	60.4	77.5
1975-76	-1.6	7.0	9.2	4.8		42.5	54.0	58.7	65.6
1976-77	-1.3	5.6	6.4	4.3		43.6	52.4	59.1	64.6
1977-78	-1.4	4.2	3.7	3.6		41.3	49.2	57.1	58.1
1978-79	-2.4	4.8	5.2	4.0	33.4	40.5	47.3	56.2	65.1
1979-80	-1.7	3.9	4.7	2.8	34.0	41.0	44.1	51.8	72.1
1980-81	-2.9	4.6	5.1	3.6	35.4	42.4	46.2	52.9	75.6
1981-82	-1.3	2.1	3.4	3.1	38.8	46.2	46.4	51.7	75.1
1982-83	-1.6	3.0	3.2	3.1	38.9	45.6	44.9	50.4	67.1
1983-84	-2.1	3.7	3.2	3.8	38.2	44.6	45.2	50.4	65.5
1984-85	-2.7	4.1	3.1	3.8	38.8	43.9	45.4	50.3	61.2
1985-86	-1.2	2.3	1.6	2.5	38.1	43.4	43.6	49.5	60.9
1986-87	-1.5	2.1	0.9	2.4	37.7	42.0	41.2	48.9	66.6
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	26.3	33.3	62.0
1991-92	-1.9	3.6	2.3	3.5	35.2	38.8	27.6	34.4	54.7
1992-93	-5.8	7.7	5.9	7.6	33.9	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	35.5	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	-1.8	36.9	39.4	36.8	43.6	17.3

1 *Excluding windfall tax and associated spending*.

2 *UK national accounts definition*. *Including windfall tax and associated spending*.
3 *At end-March, GDP centred on end-March*.
4 *At end-December, GDP centred on end-December.*

Table B27: Historical series of government expenditure

	£ billion (1999-2000 prices)				Per cent of GDP			
	Public sector current expenditure	Public sector net capital expenditure	General government expenditure	Total Managed Expenditure	Public sector current expenditure	Public sector net capital expenditure	General government expenditure	Total Managed Expenditure
1970-71	153.0	30.5	193.0	198.6	32.5	6.5	41.0	42.2
1971-72	160.3	26.7	199.2	203.0	33.0	5.5	41.0	41.8
1972-73	168.3	25.8	207.6	210.9	33.0	5.1	40.7	41.3
1973-74	185.2	29.0	223.2	232.9	34.8	5.4	41.9	43.7
1974-75	204.3	30.4	251.2	255.5	38.8	5.8	47.7	48.6
1975-76	209.3	30.1	251.7	260.3	39.5	5.7	47.5	49.2
1976-77	214.9	24.7	245.0	261.5	40.2	4.6	45.4	48.9
1977-78	211.5	17.3	233.7	250.8	38.2	3.1	42.2	45.2
1978-79	217.9	15.1	244.9	255.6	38.4	2.7	43.1	45.0
1979-80	224.3	14.3	251.4	261.5	38.3	2.4	42.9	44.6
1980-81	231.5	11.2	259.3	266.5	40.6	2.0	45.5	46.7
1981-82	241.5	6.2	263.3	271.4	42.8	1.1	46.7	48.1
1982-83	247.3	9.7	269.2	279.9	42.7	1.7	46.5	48.3
1983-84	254.7	11.6	272.6	289.2	42.4	1.9	45.4	48.1
1984-85	261.3	10.2	278.1	293.5	42.6	1.7	45.3	47.8
1985-86	262.0	8.5	277.0	290.2	41.1	1.3	43.4	45.5
1986-87	266.4	4.9	276.5	291.9	40.1	0.7	41.7	44.0
1987-88	269.6	3.7	277.7	294.2	38.6	0.5	39.7	42.1
1988-89	263.6	1.9	270.8	286.6	36.1	0.3	37.2	39.3
1989-	264.8	8.1	283.6	294.6	35.7	1.1	38.2	39.7

90								
1990-91	266.2	9.5	284.5	295.0	36.0	1.3	38.5	39.9
1991-92	281.9	12.5	297.8	310.8	38.4	1.7	40.6	42.4
1992-93	296.8	14.2	314.8	326.2	40.2	1.9	42.7	44.2
1993-94	305.9	11.5	324.6	332.3	40.4	1.5	42.9	43.9
1994-95	316.7	10.7	333.4	342.7	40.0	1.4	42.1	43.2
1995-96	321.3	10.0	340.8	347.0	39.7	1.2	42.1	42.9
1996-97	323.5	5.1	335.2	343.6	38.8	0.6	40.2	41.2
1997-98	322.5	4.0	336.2	341.2	37.5	0.5	39.0	39.6
1998-99	320.6	4.1	336.4	339.4	36.4	0.5	38.2	38.5
1999-00	323.9	3.2	340.3	341.5	35.7	0.4	37.5	37.7

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