Building a Stronger, fairer Britain in an uncertain world

Pre-Budget Report
November 2001

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Contents

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 ther economy and projections for the public finances. The status of the latter are subject to the poionts made in paragraph 1.13. After approval for the purposes of Section 5 of te 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.

1 OVERVIEW

This **Pre-Budget Report**, *Building a Stronger, Fairer Britain in an Uncertain World*, is an integral part of the Government's annual Budget process. It reports on how the Government's policies are contributing towards the achievement of its long-term economic goals for Britain. In particular, the Pre-Budget Report:

- provides a progress report on what the Government has achieved so far;
- sets out updated forecasts for the economy and public finances; and
- details the next stage of reforms that the Government is considering in the run up to Budget 2002 and on which it will be consulting in the months ahead.

INTRODUCTION

1.1 Global economic conditions pose significant challenges for policy-makers around the world. The world economy has slowed more sharply this year than at any time over the past two decades. For the first time since the mid-1970s growth has slowed significantly in almost every region of the world. The events of 11 September in the US have further weakened demand, delayed the global recovery and intensified the risks to global growth.

1.2 Over the past four and a half years, the Government has laid the foundations for long-term economic stability. Extensive reforms to the frameworks for monetary and fiscal policy have established a platform of stability with low inflation, low interest rates, low unemployment and sound and sustainable public finances. This platform of stability has allowed the Government to devote more resources to the nation's priorities - promoting enterprise, innovation and investment across Britain; extending employment opportunity to all; tackling poverty for families, children and pensioners; and building high quality public services.

1.3 In an integrated global economy, no country can fully insulate itself from international economic events. But as a result of the steps the Government has taken, and the platform of stability it has created, the UK economy is now better placed than on previous occasions to continue to steer a course of economic stability.

1.4 In an uncertain global environment, countries need to build greater economic strength. Building on the steps taken over the last Parliament, the Government has set a series of ambitious ten-year goals to build a stronger and fairer Britain. In these testing economic times, the Government remains determined to advance its long-term goals to:

- deliver long-term economic stability, ensuring that the fiscal rules are met, inflation remains low, and the UK has faster productivity growth than its main competitors;
- sustain a higher proportion of people in employment than ever before, seeking to ensure full employment in every UK region;
- eradicate child poverty and tackle pensioner poverty, extending opportunity for all children and providing security for all pensioners;
- establish world-class public services, delivering investment to raise standards in education, improve national healthcare for all, modernise Britain's transport and tackle crime; and
- tackle global poverty and climate change, delivering the UK's commitments under the Kyoto Protocol and helping to achieve the Millenium Development Goals by 2015.

1.5 The Pre-Budget Report describes the next steps in the Government's strategy for meeting its long-term goals - combining a stronger, more enterprising, economy with a fairer, more just, society. The principal elements of the Government's strategy, as set out in this Pre-Budget Report, are:

- maintaining macroeconomic stability;
- meeting the productivity challenge;
- increasing employment opportunity for all;

- ensuring fairness for families and communities;
- delivering high quality public services; and
- protecting the environment.

1.6 Each element of the strategy is covered separately in subsequent chapters of this report. The Government's updated forecasts for the economy and the public finances are set out in Annexes A and B respectively.

MAINTAINING MACROECONOMIC STABILITY

1.7 The Government's economic goal is to deliver long-term economic stability, ensuring that the fiscal rules are met and inflation remains low. Chapter 2 describes how the Government is working to achieve this goal, maintaining stability in testing economic times.

The policy framework

1.8 In the last Parliament, the Government acted swiftly to introduce new frameworks for monetary and fiscal policy based on the principles of transparency, responsibility and accountability, and designed to deliver long-term economic stability. The Bank of England was given operational independence to set interest rates to deliver the Government's inflation target, while a new fiscal policy framework was introduced to improve fiscal management and deliver sound public finances. These policies work together in a coordinated way to deliver economic stability.

1.9 While no country can fully insulate itself from the slowdown in the world economy, the macroeconomic framework the Government has put in place has allowed monetary policy to respond pro-actively to the downturn while enabling fiscal policy to support monetary policy, this year and next, in limiting the impact on the UK economy. As a result, the UK is now well positioned to respond appropriately to the global slowdown and to preserve stability in the face of uncertain external events.

The economy

1.10 Even before the terrorist attacks on America, world economic conditions were deteriorating more sharply than forecast in Budget 2001. Growth has slowed in almost all regions of the world, accompanied by sharp declines in world trade growth, investment, industrial production and stock markets. In the Pre-Budget Report forecast:

- **G7 GDP** is now expected to increase by 1 per cent in 2001, compared with 2 per cent forecast in Budget 2001;
- growth in **world trade** is expected to slow to $1^1/_4$ per cent in 2001, compared with $6^3/_4$ per cent forecast in Budget 2001 and $11^1/_2$ per cent recorded for 2000; and
- growth in **UK export markets** is expected to slow significantly to 1 per cent in 2001, compared with 6 per cent forecast in Budget 2001 and $11^1/_4$ per cent in 2000.

1.11 Despite a weaker external environment, strong economic fundamentals and pre- emptive macroeconomic policy action have helped cushion the impact on the UK economy in 2001. The key features of the Pre-Budget Report forecast are that:

- **GDP** is expected to increase by $2^1/_4$ per cent in 2001, in line with the lower end of the Budget 2001 forecast range;
- as the global recovery gathers pace from the middle of 2002, **UK GDP** is expected to become stronger and more balanced, growing by between 2 and $2^1/_2$ per cent in 2002 and by between $2^3/_4$ and $3^1/_4$ per cent in 2003; and
- the economy is continuing to experience its longest period of sustained low inflation since the 1960s. **RPIX inflation** is expected to remain close to the Government's $2^1/_2$ per cent target over the forecast period.

1.12 Prospects for the world economy have become more uncertain in the aftermath of 11 September and are a continued source of risk. The impact of the terrorist attacks on confidence has reinforced the downward momentum in activity and is expected to delay the economic recovery across the G7. A deeper or more protracted global slowdown, prompted by a further deterioration in consumer and business confidence, is a downside risk to the Pre-Budget Report forecast. However, the deterioration in economic conditions could also prove relatively short-lived. If the impact of the terrorist attacks on confidence proves less severe than anticipated, then recent decisive policy action in the world's major economies could stimulate a recovery which is stronger, or begins earlier, than expected. With sound public finances and low inflation in the UK, macroeconomic policy is currently well placed to respond to either eventuality.

The public finances

1.13 The public finance projections published in the Pre-Budget Report, and summarised in Tables 2.5 and 2.6, provide an interim forecast update. They do not necessarily represent the fiscal outcome the Government is seeking and have a different status from those published at the time of the Budget which include all the effects of Budget policy measures. 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.

1.14 The fiscal projections continue to be based on the prudent and cautious assumption of $2^1/_4$ per cent trend growth. This is one of a number of assumptions set out in Box B1 that underpin the public finance projections and are audited by the National Audit Office (NAO) under the three-year rolling review to ensure they remain reasonable and cautious.

1.15 Tough decisions on taxation and spending taken by the Government over the course of the last Parliament have put the public finances on a sustainable footing. Public sector net debt has been brought down from 44 per cent of GDP in 1997 to close to 30 per cent at present. UK debt ratios are now the lowest in the G7. The fiscal position is therefore sound and better able than in the past to deal with instability in the global economy. Fiscal policy is able to support monetary policy this year and next in maintaining economic stability as the economy moves temporarily below trend.

1.16 The current budget surplus in 2001-02 was £$2^3/_4$ billion higher than forecast in the Budget, while repayments on net borrowing exceeded the Budget projection by £$3^3/_4$. The slowdown in the world economy since Budget 2001 means that receipts are now expected to be lower than forecast in the short-term. Much of the reduction in receipts is attributed to the economic cycle and the impact of the cautious, audited assumptions, including lower equity prices. Financial companies' profits have been hit by the downturn in international capital markets, leading to a significant temporary reduction in tax revenues from this source.

1.17 A current budget surplus of £$10^1/_4$ billion is now expected in 2001-02, compared with £16 billion at the time of the Budget. The surplus is expected to fall further to £3 billion in 2002-03 before returning towards the Budget profile from 2003-04 as global economic conditions improve and financial companies' profits move back towards a cautious view of their long-term trend. The forecast demonstrates that fiscal policy is supporting monetary policy this year and next in maintaining stability.

1.18 The updated forecast takes into account firm policy decisions taken in the Pre-Budget Report, including a comprehensive package of further support for pensioners, worth £$2^3/_4$ billion a year by 2004-05. In line with the *Code for Fiscal Stability,* the forecast does not take into account measures proposed in the Pre-Budget Report for consultation or where final decisions have yet to be taken. Decisions on these measures will be taken in the Budget. Changes to the forecast for AME programmes in the Pre-Budget Report have been offset in the AME margin in the usual way.

The fiscal rules

1.19 Taking into account non-discretionary changes to receipts and spending as a result of the slowdown in the world economy and the prudent use of cautious assumptions, and after releasing new resources for measures announced in the Pre-Budget Report, the Government remains on track to meet its fiscal rules over the cycle, including in the cautious case.

1.20 As shown in Table 1.1, the current budget is projected to remain in surplus throughout the forecast period, including when adjusted for the effects of the economic cycle. Public sector net debt is expected to remain close to 31 per cent of GDP in each year of the forecast - comfortably below the 40 per cent guideline set by the sustainable investment rule.

Table 1.1: Meeting the fiscal rules

	Per cent of GDP							
	Outturn		Projections					
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Golden rule								
Surplus on current budget	2.3	2.6	1.0	0.3	0.4	0.6	0.7	0.7
Average surplus since 1999-2000	2.3	2.5	2.0	1.6	1.3	1.2	1.1	1.1
Cyclically-adjusted surplus on current budget	2.0	2.3	1.0	0.3	0.3	0.5	0.7	0.7
Sustainable investment rule								
Public sector net debt	36.4	31.2	30.7	30.6	31.0	31.1	31.1	31.1

MEETING THE PRODUCTIVITY CHALLENGE

1.21 Productivity growth, alongside higher levels of employment, is a key route to delivering greater economic prosperity. The productivity performance of the UK economy has historically been weak, creating a substantial productivity gap between the UK and other advanced industrial economies. In difficult economic times, it is more important than ever that reforms are introduced to close the productivity gap. The Government is therefore continuing to take action to achieve its long-term economic goal of raising Britain's productivity performance to deliver rising living standards for all.

Measures so far

1.22 The Government's strategy for raising productivity is described in detail in Chapter 3 and focuses on five priority areas for action - the five drivers of productivity performance. Significant reforms have been introduced in each of these areas, including:

- **competition:** through the Competition Act 1998 which strengthened the powers of the Office of Fair Trading and modernised the overall UK competition regime; as well as detailed investigations into competition in particular markets, including banking and the professions;
- **enterprise and innovation:** with major reforms to capital gains tax; a new All-Employee Share Ownership Plan (the Share Incentive Plan) and Enterprise Management Incentives to help smaller companies recruit and retain highly skilled people; a research and development (R&D) tax credit for SMEs; and wide-ranging consultations on two new tax credits to encourage private investment in disadvantaged areas and to stimulate R&D by larger companies;
- **investment:** through reduced corporation tax rates, including a new 10 pence starting rate for smaller companies; a comprehensive review of institutional investment in the UK; and spending plans that will double net public sector investment by 2003-04;
- **skills:** by providing extra resources for education to raise standards in primary and secondary schools and additional funding for places in higher education; and
- **public sector productivity:** with a stronger focus on outcomes for public service delivery through Public Service Agreements (PSAs), Departmental Investment Strategies (DISs) to improve public sector investment, and a new Office of Government Commerce to deliver more efficient procurement within government.

Next steps

1.23 The Government is committed to working with all stakeholders to support business and the manufacturing sector during the current global slowdown. In this context, it welcomes the success of the CBI-TUC productivity campaign in identifying and addressing key areas for action. To support further the drivers of productivity growth in every community and region, the Government is now:

- planning to introduce a **volume-based research and development (R&D) tax credit for large companies** in Budget 2002;
- taking further steps to build a **modern and pro-enterprise business tax system,** by improving the capital gains tax

business assets taper, and publishing draft legislation for an exemption for capital gains and losses on substantial shareholdings and a new regime for providing relief for the costs of intellectual property, goodwill and other intangible assets;

- **piloting new measures to improve access to training** and enable employees to attain basic and level 2 skills, recognising that employers, individuals and the Government have shared responsibilities to deliver a highly-skilled, high productivity economy;
- **publishing a Green Paper on planning reform** next month, setting out proposals to improve the flexibility, speed and responsiveness of the land use planning system;
- introducing **a package of measures to support small business,** improving access to finance, reducing the administrative burden of VAT and publishing a review of payroll administration;
- taking further steps to support enterprise and investment in Britain's disadvantaged communities by **introducing a stamp duty exemption for all property transfers up to £150,000 in disadvantaged areas** and announcing further decisions on the new Community Investment Tax Credit;
- confirming a radical programme of **further enhancements to the UK's competition regime;**
- **enhancing Enterprise Management Incentives,** by doubling the gross asset limit for companies which can qualify to £30 million; and
- **publishing a new analysis of Britain's regional productivity challenge.**

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.24 To build a stronger economy and a fairer society, employment opportunity must be extended to all groups and areas in the country. Worklessness, particularly on a long-term basis, is a waste of human resources and a source of misery and degradation for those affected. It is also an important cause of child poverty and a determinant of future pensioner poverty. The Government is determined to advance its long-term economic goal of having a higher proportion of people in work than ever before by the end of the decade. This means continuing to help people move off welfare and into work, easing the transition to work, and making work pay. In times of economic uncertainty it also requires flexible working practices and responsive employment policies to ensure that people remain attached to the labour market.

Measures so far

1.25 The Government's strategy for achieving its long-term goal is described in Chapter 4. To extend employment opportunity and deliver higher levels of employment, the Government has introduced a range of reforms, including:

- **welfare to work:** reducing structural unemployment with the help of the New Deal programmes for young people and the long-term unemployed, and addressing concentrations of inactivity through the New Deal programmes for lone parents and people with disabilities. Starting in 49 pathfinder areas, the Government is delivering an active, "employment first", service to all working age benefit recipients through Jobcentre Plus, with rights and responsibilities balanced at every stage. Action Teams are tackling the problems of worklessness in many disadvantaged areas and the Job Transition Service provides security and assistance to those in areas affected by large-scale redundancies;
- **making work pay:** with reforms to the tax and benefit system underpinned by the National Minimum Wage, including reform of national insurance contributions (NICs), extension of the new 10 pence starting rate of income tax, and a reduction in the basic rate of income tax to 22 pence; and by introducing the Working Families' Tax Credit (WFTC) and the Disabled Persons' Tax Credit (DPTC); and
- **easing the return to work:** through the new Job Grant, simplified extended payments in Housing Benefit, and by providing more childcare places through the National Childcare Strategy.

Next steps

1.26 The Government is taking further steps to promote work, targeting those groups that have in the past been allowed to fall behind the rest of society. In addition to measures already announced, the Government is now taking steps to:

- **introduce a new Working Tax Credit** to extend in-work support to those on low incomes without children. The rates and thresholds for the new tax credit will be set in Budget 2002;
- provide additional help with re-skilling and jobsearch for people affected by large-scale redundancies, especially in deprived areas, by **strengthening the Job Transition Service;** and
- provide further help to communities with concentrations of long-term unemployment, **by piloting transitional employment opportunities for hard to help groups in deprived areas.**

FAIRNESS FOR FAMILIES AND COMMUNITIES

1.27 A strong and productive economy must be underpinned by fairness and inclusion so that every individual can contribute to, and share in, rising national prosperity. The Government is determined to meet its long-term goal of eradicating child poverty and tackling pensioner poverty, extending opportunity for all children and providing security for all pensioners. In seeking to build social inclusion, the Government is rewarding saving, working to create stronger communities and establishing a fair and efficient tax system. It is also playing a leading role in international efforts to tackle global poverty and help to achieve the Millenium Development Goals by 2015.

Measures so far

1.28 As described in Chapter 5, the Government has already taken action on a range of fronts to address these priorities:

- **support for families and children:** lifting children out of poverty through the introduction of the WFTC and the Children's Tax Credit; targeted help for low-income parents under the Sure Start Maternity Grant; a new Children's Fund to provide improved support for children, young people and their families; and increases in the level of Child Benefit, the children's allowances in Income Support and the JobSeekers' Allowance, and the flat rate of Statutory Maternity Pay;
- **fairness for pensioners:** through the introduction of the Minimum Income Guarantee (MIG) uprated by earnings for the poorest pensioners; increases in the basic state pension; an annual winter fuel payment for every household containing someone aged 60 or over; concessionary TV licences for those aged 75 or over; and the Budget 2001 commitment to raise the age-related income tax personal allowances at at least in line with earnings in 2003-04 and for the remainder of the Parliament; and
- **supporting saving:** by introducing Individual Savings Accounts (ISAs) and retaining the £7,000 annual contribution limit (and the associated £3,000 cash limit) until April 2006; through the introduction of Stakeholder Pensions to help people provide for financial security in old age; and by increasing the 10 pence income tax band by more than indexation from April 2001.

Next steps

1.29 Building on this comprehensive programme of reform, the Government is now taking additional steps to create a fairer and more inclusive society by:

- **introducing a further package of support to raise living standards for pensioners,** including:
    - **a guaranteed increase in the annual basic state pension** of £100 for single pensioners and £160 for pensioner couples in 2003-04. Subsequently, the basic state pension will rise each year by $2^1/_2$ per cent or the increase in the September Retail Price Index - whichever is higher;
    - maintaining **the winter fuel payment at £200 a year for the remainder of this Parliament;** and
    - **introducing a new Pension Credit from 2003** to tackle the unfairness and complexities of the existing system and ensure that pensioners on low and modest incomes are rewarded, rather than penalised, for their savings.
- **announcing the next steps in introducing a new Child Tax Credit for families with children.** The rates and thresholds for the new tax credit will be set in Budget 2002;
- taking further steps to extend the benefits of saving and asset-ownership by **commencing Saving Gateway pilot schemes and launching further consultation on the Saving Gateway and Child Trust Fund;** and
- announcing further steps to promote a modern and fair tax system by **continuing to crack down on smuggling and fraud,** and replacing the current pools betting duty with a **new tax on pools companies' gross profits**.

DELIVERING HIGH QUALITY PUBLIC SERVICES

1.30 The Government's long-term goal is to establish world-class public services through significant and sustained increases in investment and reforms to ensure that taxpayers receive real value for money. Strong and dependable services are vital to extend opportunity, tackle social exclusion and improve people's quality of life. They are also fundamental in laying the foundations for a high productivity economy. High and stable levels of growth and employment provide the platform from which the Government is working to deliver lasting improvements in Britain's public services.

Measures so far

1.31 As described in Chapter 6, the Government has already taken important steps to improve Britain's public services, including:

- **introducing a new framework for controlling public spending** that provides greater certainty for long-term planning, removes past discrimination against investment, and delivers a sharper focus on the quality and outcome of public service provision;
- **allocating substantial increases in resources over three years in the 2000 Spending Review,** including average annual real growth of 5.6 per cent for education and 5.7 per cent for health and a doubling of public sector net investment. Departmental spending on services will be £50 billion higher in 2003-04 than it was in 2000-01; and
- **extending the principle of outcome-focused public service delivery to local government** by establishing stretching new targets with local authorities in return for greater freedoms, flexibilities and financial rewards if they succeed.

Next steps

1.32 By maintaining economic stability in difficult economic times, and ensuring that the fiscal rules are met, the Government is now laying the foundations for further, sustained increases in investment in Britain's public services to ensure that they deliver high standards throughout the country. The Government is now:

- publishing **Derek Wanless' interim report on the trends affecting the UK health service over the next two decades.** A consultation process will now seek views from patients and those who work in the service. The review will report to the Chancellor next year on the resources required for the health service over the next 20 years;
- **providing an additional £1 billion to the National Health Service in the UK in 2002-03** by reallocating resources from lower debt interest payments;
- **conducting a Spending Review, to be completed next year,** to determine how departments' programmes can most effectively deliver investment and modernisation in priority services and to establish new departmental annual spending plans up to and including 2005-06. The Pre-Budget Report describes the Government's priorities for the Review; and
- **publishing shortly a White Paper on modernising local government,** setting out steps to strengthen the delivery of high-quality, cost-effective local public services throughout the country.

PROTECTING THE ENVIRONMENT

1.33 Sustainable development is vital to ensure a better quality of life for everyone, today and for generations to come. Economic growth is key to rising national prosperity. But growth must not come at the expense of the environment or social progress. The Government is pursuing a far-reaching strategy to deliver its long-term goal of tackling climate change, and fulfilling its commitments under the Kyoto Protocol. To meet the challenge of sustainable development, it is also taking wider action to improve air quality, regenerate Britain's towns and cities and protect Britain's countryside.

Measures so far

1.34 Chapter 7 describes the Government's strategy for protecting and, where possible, enhancing the environment. In addition to environmental appraisal and evaluation of Budget policy measures, the Government has introduced significant policy measures to deliver its environmental objectives, including:

- **tackling climate change and air quality:** through the introduction of the climate change levy in April 2001 which is encouraging business to become more energy-efficient; significant reforms to car vehicle excise duty (VED) and to company car tax; a range of tax incentives to promote the use of greener fuels; launching the world's first economy-wide greenhouse gas emissions trading scheme in April 2002; and the launch of a Green Technology Challenge to encourage investment in certain environmentally-friendly technologies and products;
- **regenerating Britain's towns and cities:** with a major package of fiscal measures to support sustainable regeneration of urban areas, including targeted VAT reliefs and tax incentives for cleaning up contaminated land; and
- **protecting the countryside:** with continued 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 the use of pesticides.

Next steps

1.35 The Pre-Budget Report sets out the next steps in the Government's strategy to protect and improve the environment.

These include:

- responding to business through the Green Technology Challenge by announcing the next steps in **extending Enhanced Capital Allowances (ECAs) to encourage investment targeted at wider environmental objectives,** including energy-saving, cleaner vehicles and fuels, and water;
- **consulting on options for modernising road haulage taxation,** to ensure that hauliers contribute fairly to reducing the environmental impact of freight transport, irrespective of nationality, while ensuring that the UK haulage industry does not pay more as a result;
- continuing to pursue environmental reforms of vehicle taxation by **consulting on further measures, including changes to motorcycle VED and reforms to encourage cleaner vans;**
- launching shortly a proposed strategy for **promoting future road vehicles and fuels** by encouraging innovative and ground-breaking new low-carbon technologies; and
- following the Green Fuel Challenge, announcing support through **fuel duty concessions for three research projects into environmentally-friendly alternative road transport fuels.**

GOVERNMENT SPENDING AND REVENUES

Chart 1.1: Government spending by function

1.36 Chart 1.1 presents public spending by main function. Total public spending (Total Managed Expenditure - TME) is expected to be around £394 billion in the current financial year, 2001-02. TME is divided into Departmental Expenditure Limits (DEL), shown in Table B15, and Annually Managed Expenditure (AME), shown in Table B13. A number of DELs, especially those of the devolved administrations, contribute to spending on more than one function. Chart 1.1 also includes spending by local authorities, rather than the grants they receive from central government, which are included in Tables B13 and B15 in Annex B.

Chart 1.2: Government receipts

1.37 Chart 1.2 shows the different sources of government revenue. Public sector current receipts are expected to be around £391 billion in 2001-02. Table B11 provides a more detailed breakdown of receipts consistent with this chart.

2 Maintaining macroeconomic stability

Current world economic conditions pose significant challenges for policymakers. The Government's reforms to the macroeconomic framework leave the UK better placed than on previous occasions to cope with instability in the global economy and to continue to steer a course of stability:

- the **monetary policy framework** is delivering low and stable inflation and is enabling the Bank of England's Monetary Policy Committee (MPC) to respond quickly to risks to the symmetrical inflation target;
- the **fiscal rules are set over the cycle** and the automatic stabilisers are allowed to operate fully, which lets fiscal policy smooth the path of the economy in the face of slower growth.

Low inflation prospects have enabled the MPC to react pre-emptively to the global economic slowdown, cutting interest rates to their lowest level since 1964. Tough decisions on taxation and spending taken by the Government over the past four years to repay debt mean that fiscal policy is able to support monetary policy in maintaining economic stability as the economy temporarily moves below trend.

UK GDP is forecast to grow by $2^1/_4$ per cent this year, the bottom end of the Budget 2001 forecast range, and by between 2 and $2^1/_2$ per cent next year. The Pre-Budget Report interim projections of the public finances show that the Government remains on track to meet both its fiscal rules over the cycle, including in the cautious case:

- the current budget remains in surplus throughout the projection period, even using cautious assumptions, ensuring the Government remains on track to meet the golden rule;
- public sector net debt is expected to remain low and stable through the next five years; comfortably meeting the sustainable investment rule and, at 31 per cent of GDP, the lowest in the G7.

The public finance projections show that, despite the world economic slowdown, the fiscal position remains sound, existing public spending plans are fully affordable, and the UK is better able than in the past to deal with the ups and downs of the global economy. In the short term, temporarily lower receipts compared to the Budget profile mean that fiscal policy is supporting monetary policy in maintaining economic stability. The forecast for the economy shows that the monetary policy response, supported by fiscal policy this year and next, will contribute to stronger and more balanced growth resuming next year.

THE MACROECONOMIC FRAMEWORK

2.1 In an increasingly integrated global economy, no country can be insulated from the impact of current world developments. The world economy is slowing more now than at any time over the past two decades, while the events of September 11 have intensified uncertainty, delaying the world recovery and adding to the risks to global growth. For the first time since 1974, the US, Europe and Japan are simultaneously facing a significant slowdown in growth. As one of the most open of the major economies, and a leading international financial centre, this external environment poses challenges for the UK economy.

2.2 The Government's role is to ensure that macroeconomic policy is able to react to adverse developments so that the UK can maintain high and stable levels of growth and employment. Large and unpredictable fluctuations in output, employment and inflation create uncertainty and difficulties across the economy - for people, companies and the public sector. By contrast, economic stability helps businesses, people and the Government to plan effectively for the long term.

2.3 Over the past four years, the Government has implemented important reforms to the macroeconomic framework. Based on principles of transparency, responsibility and credibility, the framework establishes a platform of economic stability for the long term.[1] The increasing interdependence of the world economy means that the Government must address the causes of domestic and international instability, minimising the risk and impact of disruption from external events. Because of the Government's reforms, the UK is now better placed than on previous occasions to respond to developments in the world economy and to continue to steer a course of economic stability.

2.4 The monetary policy framework aims to deliver low and stable inflation, while avoiding damaging fluctuations in output and growth. The fiscal policy framework is designed to achieve sound public finances over the medium term, and to support monetary policy over the cycle. Sound public finances are a prerequisite for sustained investment in public services. The public spending framework provides for better long-term planning and places a greater focus on the quality of public service provision and the outcomes achieved. All three components of policy work together in a coherent and integrated way.

The monetary policy framework

2.5 The introduction of a stable and credible monetary policy framework in 1997 has delivered positive results. In particular, the Bank of England's Monetary Policy Committee (MPC) has been able to respond pre-emptively to the current global slowdown, cushioning the impact of world events on the UK economy. The framework supports the Government's objective of maintaining economic stability and is based on:

- clear and precise objectives. The goal of monetary policy, price stability, is defined in terms of a symmetric inflation target. This means that outcomes below target are treated as seriously as those above target, eliminating incentives for the MPC to drive inflation below target at the cost of lost output and employment;
- full operational independence for the MPC in setting interest rates to meet its target of $2^1/_2$ per cent for the 12 month increase in the Retail Prices Index excluding mortgage interest payments (RPIX), which applies at all times;
- openness, transparency and accountability which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings and publication of the Bank of England's quarterly Inflation Report; and
- flexibility and credibility. Because monetary policy is based on a credible framework the MPC can use discretion in deciding how quickly to react to external events or temporary difficulties beyond its control. This discretion is constrained by the inflation target and an 'Open Letter' system, under which, if inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the length of time before inflation will return to target and how this meets the MPC's remit.

The fiscal policy framework

2.6 The Government's fiscal policy framework is designed to ensure that the highest standards of transparency, responsibility and accountability apply to fiscal policy decisions. The *Code for Fiscal Stability* sets out five key principles of fiscal management that are at the heart of the framework: transparency, stability, responsibility, fairness and efficiency. The Code sets out how these principles relate to the formulation and implementation of fiscal policy in practice and requires the Government to state its objectives for fiscal policy based on these principles. The Government's objectives are:

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

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

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

2.8 These fiscal rules promote economic stability by ensuring sound public finances, while allowing flexibility in two key respects:

- the rules are set over the cycle, allowing fiscal balances to vary between years in line with the cyclical position of the economy. Box 2.1 sets out how this enables the automatic stabilisers to operate freely over the cycle; and

- the rules promote and protect capital investment while ensuring sustainable public finances in the longer term. The golden rule requires the current budget to be in balance or surplus on average over the cycle, allowing the Government to borrow only for capital spending. The sustainable investment rule limits government borrowing to a stable and prudent level.

2.9 The fiscal framework also recognises that projections of the current budget and net debt inevitably involve a considerable element of uncertainty. Projections of the public finances are therefore based deliberately on prudent assumptions for key economic variables,

Box 2.1 The automatic stabilisers

Several features of the tax and spending regime help to stabilise the economy over the economic cycle. As the economy strengthens, incomes tend to rise, resulting in higher income and corporation tax receipts. At the same time, lower unemployment rates reduce social security spending. As the economy weakens, the opposite effects occur. This means that government borrowing tends to fall when growth is relatively high, and rises when growth is relatively low. These 'automatic' effects help to reduce volatility in output over the cycle, by boosting aggregate demand when the economy is below trend, and reducing aggregate demand when the economy is above trend.

The Government's objectives for fiscal policy are to ensure sound public finances, while allowing the automatic stabilisers to operate over the cycle. This permits fiscal policy to support monetary policy in smoothing the path of the economy in the face of variations in demand, and explains why the fiscal rules are set over the economic cycle. For the golden rule, it means the surpluses in the current budget in periods of stronger growth can offset deficits in periods of weaker growth, helping to stabilise the economy. This is illustrated in Chart 2.5. Public debt will tend to rise as a proportion of GDP during periods of weaker growth, and fall as a proportion of GDP during periods of stronger growth.

The strength of the automatic stabilisers depends on the characteristics of the tax and spending regime, such as the progressivity of taxes, as well as the composition of changes in demand in the economy. Their impact can be seen by examining the difference between actual public sector net borrowing (PSNB) and the cyclically-adjusted PSNB position. Attempting to balance the current budget at all times would significantly increase swings in output over the economic cycle, damaging economic stability.

including the trend rate of growth of the economy. These assumptions, which include the levels of oil prices and equity prices, are audited by the National Audit Office (NAO) under a three-year rolling review to ensure they remain both reasonable and cautious. This minimises the need for unexpected changes in taxation or spending.

The public spending framework

2.10 Sound public finances that are sustainable over the cycle are not only essential to ensure economic stability. They are also necessary for sustainable investment in public services. A detailed description of the Government's public spending framework, how it is helping to deliver resources for key public services, and the Government's priorities for the 2002 Spending Review are provided in Chapter 6. The main elements of the framework are:

- three-year Departmental Expenditure Limits (DEL) to help departments plan and manage resources more effectively over the medium term;
- Annually Managed Expenditure (AME) which covers those elements of spending which cannot reasonably be subject to firm multi-year limits. DEL and AME sum to Total Managed Expenditure (TME);
- separate resource and capital budgets for each department, consistent with the distinction in the fiscal rules. Departments are required to manage their resource and capital budgets separately, removing the bias against investment which was present in the previous planning regime; and

Box 2.2: The fight against terrorism

The attacks of 11 September were an assault against all those who strive for global peace and stability. They have also further destabilised the world economy, damaging confidence and delaying the recovery in major economies. The Government, with its international partners, has acted decisively to tackle the sources of instability and risk, including through a series of cuts in interest rates.

Because of the UK's tragic experience of domestic terrorism, the Government is well equipped to deal with those who seek to fund terror. UK legislation meets tough new standards agreed by the International Financial Action Task Force. The Government is working with other countries to share knowledge and provide the technical assistance needed to raise standards across the world.Action is also being taken to strengthen further the UK regime. The new Proceeds of Crime Bill provides extensive powers for the investigation and confiscation of criminal assets. The Anti-Terrorism, Crime and Security Bill, which was introduced on 12 November, has statutory provisions to permit the Inland Revenue and HM Customs and Excise to disclose information for use in criminal investigations and proceedings. Police powers to monitor accounts and seize assets will also be enhanced.Efforts to tackle the financing of terrorism have already delivered results. Because of tough domestic action, intelligence sharing and cooperation with the US and other international allies, some £70 million of assets have already been frozen in response to United Nations (UN) resolutions that target the Taliban regime and Osama bin Laden. The Chancellor has pledged that the UK will continue to do whatever is necessary to deprive terrorists of the funds they rely on.Work to stem the sources of terrorist financing is part of a broader programme of action to promote stability in the aftermath of 11 September. The Government is also contributing to international efforts to promote financial market stability and to implement a comprehensive humanitarian response to the crisis. In the crisis region itself, the Government has already provided £40 million in humanitarian assistance to Afghans, and £26 million to Pakistan to support ongoing reforms and communities affected by the refugee crisis. It continues to work closely with the UN, IMF and World Bank to implement an immediate and long-term response to the crisis.

- Public Service Agreements (PSAs) through which each department is committed to deliver challenging outcome-focused targets.

THE PERFORMANCE OF THE FRAMEWORK

2.11 The Government's frameworks for monetary and fiscal policy and for public spending have established an integrated strategy for maintaining high and stable levels of growth and employment, and minimising the impact of external shocks.

2.12 Since the reforms were introduced, the economy has experienced a period of stability and steady growth. Growth since the second quarter of 1997 has averaged 2.6 per cent on an annualised basis. Employment has risen by over 1.2 million since spring 1997, while unemployment has been at its lowest since the 1970s.

Monetary strategy

2.13 By enhancing the transparency and credibility of policy-making, the monetary policy framework has already delivered positive results. RPIX inflation has averaged 2.4 per cent since May 1997 - very close to the Government's $2^1/_2$ per cent target - and market inflation expectations suggest that low inflation is expected to continue: this has been achieved with less output and employment volatility than in the past.

2.14 The MPC has changed interest rates quickly in either direction in response to threats to economic stability. Beginning in February this year, the MPC saw the need to reduce interest rates. It also responded in a timely and considered manner to the uncertainty generated by the attacks on the US, demonstrating the flexibility of the framework. In accordance with the Bank of England Act 1998, the Governor of the Bank convened an unscheduled meeting of the MPC on 18 September 2001 to gauge the impact of, and determine a response to, the exceptional circumstances created by the terrorist attacks. In order to support UK consumer and business confidence, the MPC acted swiftly to reduce interest rates. Since then, rates have been cut on two further occasions and they are now at their lowest level since 1964.

2.15 These actions have reinforced the credibility of the monetary policy framework. This is demonstrated in the behaviour of inflation expectations, shown in Chart 2.1. Although inflation fell to levels close to 3 per cent annually in the years prior to 1997, when a target

Chart 2.1: Inflation performance and expectations

range of 1 to 4 per cent was in force, inflation expectations remained consistently outside this target range. Inflation expectations only fell to the target after the introduction of the new framework in 1997 and they have remained close to target since then. This credibility allows the MPC to react flexibly and to take account of the potential impact of global events on the UK economy without markets doubting its determination to meet the inflation target.

Fiscal strategy

2.16 On fiscal policy, the Government has taken a number of important steps over the past four years to restore the public finances to a sustainable position. These have included working within the previous Government's spending plans for the first two years, further fiscal consolidation through a series of tax changes, and using the proceeds from the auction of spectrum licences to reduce net debt. As a result of these decisions, and with the benefits of greater economic stability, over £50 billion of debt has been repaid since 1996-97 when public sector net debt stood at 44 per cent of GDP and there was an overall budget deficit of £28 billion. The current level of debt is close to 31 per cent of GDP, the lowest of all the G7 countries. This is illustrated by chart 2.2 which shows OECD projections for 2001.

Chart 2.2: OECD projections of general government net financial liabilities for G7 countries, 2001

2.17 A fiscal tightening of $4^1/_2$ percentage points of GDP between 1996-97 and 2000-01 supported monetary policy at a time when the economy was generally above trend. It has now left the public finances well placed to play their part in cushioning the effects of the global economic slowdown. Debt levels are stable and low, and strong surpluses on the current budget over the past two years provide room for manoeuvre within the fiscal rules over the remainder of the economic cycle.

2.18 The Government has also been able to release new resources for investment in public services. Budget 2000 set the spending envelope for the three years covered by the 2000 Spending Review, while ensuring the Government remained on track to meet its fiscal rules. As described in Chapter 6, within this envelope the Government has been able to release additional resources to priority services as a result of sound management of the economy and improved public finances. Savings have been made in a number of areas including:

- lower growth in spending on social security, through cutting the cost of worklessness; and
- reduced debt interest payments resulting from lower levels of debt and lower interest rates.

2.19 Even after taking into account the impact of Pre-Budget Report measures, changes in social security benefits and debt interest payments are now expected to account for only 18 per cent of the change in TME over the period 2000-01 to 2003-04. This compares with 42 per cent over the period 1978-79 to 1996-97. Table 2.1 gives an illustration of this improvement.

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

Per cent	**1978-79 to 1996-97**	**1996-97 to 2003-04**	**2000-01 to 2003-04**
Social security benefits[1]	33	25	22
Central government debt interest payments	9	-3	-4
Total change	**42**	**21**	**18**

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

Budget 2001

2.20 Budget 2001 released new resources to priority public services, including health, education and for fighting crime and drugs, on top of the 2000 Spending Review settlement, while maintaining a long-term sustainable fiscal position. The fiscal projections set out in Budget 2001 showed the Government was on track to meet its firm fiscal rules throughout the forecast period.

2002 Spending Review

2.21 The baseline year for the 2002 Spending Review will be 2003-04 and new departmental plans will be set for 2004-05 and 2005-06. As in previous Spending Reviews, the Government's aim is to release funds to spend in priority services. Chapter 6 explains in further detail.

Box 2.3: Government policy on EMU

The Government's policy on membership of the single currency remains as set out by the Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor 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. An assessment of the five tests will be made within two years of the start of this Parliament. This assessment will be comprehensive and rigorous. On the basis of the assessment, the Government will take a decision on whether the five tests have been met. If a decision to recommend joining is taken by the Government, it will be put to a vote in Parliament and then to a referendum of the British people.

In June 2001, the Chancellor explained that, before the assessment of the five tests is started, the Treasury would continue to undertake necessary preliminary and technical work to inform it. The scope of this work was set out in the original October 1997 assessment. This preliminary and technical work includes:

- the cyclical behaviour of the UK economy relative to the Euro-area and their relative responses to economic shocks;
- the mechanisms by which product, labour and capital markets adjust and how well and how quickly they work;
- the impact of the single currency on the cost and availability of capital, macroeconomic stability, the stability of the real effective exchange rate and the location, quality and quantity of investment;
- the effect of the single currency on financial services, including the changes that have occurred in this sector in the UK and the Euro-area since 1997; and
- the impact of the single currency on trade, competition, productivity and employment.

More detail was published in the Treasury paper, *Preliminary and technical work to prepare for the assessment of the five tests for UK membership of the single currency*.

The Government is actively helping UK businesses prepare for working with the euro. At the same time, preparations for possible UK entry continue under the outline National Changeover Plan. Further information is available in the Treasury's Fifth Report on Euro Preparations (see www.euro.gov.uk)

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.22 For the first time since 1974, there has been a significant and simultaneous slowdown of growth in the US, Europe and Japan. The severity of the global slowdown has exceeded expectations at the time of Budget 2001, and the recent terrorist attacks have increased uncertainty, further weakened demand and delayed the global recovery. G7 GDP growth is expected to have fallen from $3^1/_2$ per cent in 2000 to just 1 per cent in 2001. However, the scale and speed of the policy response in the US and Europe is expected to support a global recovery which gathers pace from mid-2002.

Table 2.2: The world economy

	Percentage changes on a year earlier
	Forecast

	2000	2001	2002	2003	2004
Major 7 countries[1]					
Real GDP	$3^1/_2$	1	$^3/_4$	3	$2^1/_2$
Consumer price inflation[2]	$2^1/_2$	2	$1^1/_2$	$1^1/_2$	$1^1/_2$
World trade in goods and services	$11^3/_4$	$1^1/_4$	$1^3/_4$	$7^3/_4$	7
UK export markets[3]	$11^1/_4$	1	$1^3/_4$	$6^3/_4$	6

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

[2] Per cent, Q4. For UK, RPIX.

[3] Other countries' imports of goods and services weighted according to their importance in UK exports.

2.23 The UK economy is continuing to experience its longest period of sustained low inflation since the 1960s, with RPIX inflation averaging slightly below the Government's $2^1/_2$ per cent target during 2001. Low inflation has enabled the MPC to cut interest rates to sustain domestic demand growth as the scale of the world slowdown has become apparent. Sound public finances mean that fiscal policy has been able to support monetary policy.

2.24 Nonetheless, the UK has been affected by the global slowdown. UK export markets are now expected to have grown by just 1 per cent in 2001, as a result of weaker growth abroad and the sharp slowdown in world trade growth. After a number of years of rising business investment, driven partly by the falling cost of information and communications technology (ICT) capital goods, the uncertain global outlook has also led to weaker than expected business investment. However, the strong performance of the labour market has underpinned robust growth in household consumption, which has played an important role in supporting UK growth throughout the year.

Table 2.3: Summary of UK forecast

			Forecast		
	2000	2001	2002	2003	2004
GDP growth (per cent)	3	$2^1/_4$	2 to $2^1/_2$	$2^3/_4$ to $3^1/_4$	$2^1/_4$ to $2^3/_4$
RPIX inflation (per cent, Q4)	2	$2^1/_4$	$2^1/_4$	$2^1/_2$	$2^1/_2$

Economic prospects

2.25 UK GDP growth is expected to move a little further below trend in the final quarter of 2001 and remain below trend during the first quarter of 2002. Consumer confidence in the general economic outlook has fallen during 2001, although recent interest rate cuts have supported households' confidence in their own financial position. Over the coming months, consumption growth is expected to moderate towards more sustainable levels. Business confidence, which had already weakened prior to 11 September, has deteriorated further since the attacks. Heightened economic uncertainty is likely to encourage firms to postpone investment decisions. Net trade is also expected to continue exerting a significant drag on growth in the short term.

2.26 Improving world economic conditions from the middle of 2002, supported by UK monetary and fiscal policy, should provide renewed impetus to the UK economy. Investment, trade and manufacturing output are all expected to pick up sharply during the second half of 2002, with UK growth moving temporarily above trend as the world economic recovery gathers pace. With household consumption growth expected to moderate, the UK economy is projected to return to stronger and more balanced growth.

2.27 Domestically generated cost pressures are expected to ease as the UK economy moves below potential. RPIX inflation is expected to remain slightly below the Government's $2^1/_2$ per cent target during 2002 as weaker price pressures in the supply chain feed through into retail prices. Growth is expected to move above trend during late 2002 and, with inflation forecast to be slightly below target, there is room for the economy to operate slightly above potential during 2003. RPIX inflation is therefore forecast to return to target by the end of that year.

2.28 The pick up in UK growth is supported by a sustained revival in world economic prospects. However, the outlook for the world economy remains highly uncertain. A deeper or more protracted global downturn, prompted by a further weakening of business and consumer confidence, is the clearest downside risk to UK growth. On the other hand, the decisive policy response over recent months in most of the major economies could lead to a sharper world recovery than currently anticipated, raising the prospects for stronger UK growth. Consumption growth may also be stronger in the UK as a result of weaker household saving. Although household debt is at record levels, low interest rates have ensured debt servicing costs have remained affordable. With sound public finances and low inflation in the UK, macroeconomic policy is currrently well placed to respond to either eventuality.

The economic cycle

2.29 In Budget 2001, the economy was assessed to have been at or close to trend in the first half of 1997 and again around mid-1999. Since then, most survey measures of capacity and labour utilisation have moved slightly above their long-run averages suggesting that the economy was operating slightly above trend in 2000 and the first half of 2001. This suggests that the probable shape of the UK economic cycle since 1997 has been a period above trend in 1997 and 1998, followed by a small deviation below trend in early 1999 before the economy moved back above trend in 2000 and early 2001. The impact of the global slowdown has since brought the economy back close to trend. For the purposes of assessing performance against the fiscal rules, the provisional judgement remains that a small cycle may have been completed by mid-1999 when the current cycle is assumed to have begun.

Trend growth

2.30 The judgement that the economy is currently operating close to its potential level is consistent with annual trend output growth of just over $2^1/_2$ per cent since the first half of 1997. The strong contribution of employment growth over this period since 1997 has been associated with relatively subdued productivity growth, in part because those entering work are typically less productive than the average worker. Deviations from trend are expected to be small by past standards. Adjusting for this temporary effect, the underlying rate of trend productivity growth is estimated to be broadly in line with its long-run average.

2.31 Looking ahead, the stability-oriented framework for macroeconomic policy should provide the right environment for businesses to plan ahead and invest with confidence. The UK has witnessed particularly strong growth of investment in ICT equipment over recent years and, notwithstanding the recent slowdown, there is some evidence from US experience that this may contribute to improved productivity performance. Over the longer term, the Government's reforms to boost productivity also provide upside potential to trend growth. Nevertheless, the economic forecast continues to be based on the neutral assumption of $2^1/_2$ per cent annual trend growth.

Caution and the public finance projections

2.32 The public finance projections continue to be based on the deliberately prudent and cautious trend growth assumption of $2^1/_4$ per cent. This is because the Government is determined not to repeat the mistakes of the past by assuming an improvement in trend growth before this has demonstrably been achieved and audited.

2.33 A prudent view of trend growth is one of several assumptions audited by the NAO under the three-year rolling review established in Budget 2000, which ensures they remain reasonable and cautious. An asymmetric approach to fiscal policy, which is in contrast to the symmetric approach taken to monetary policy, is particularly important to build in a safety margin against unexpected events. It gives greater certainty that, over the medium term, the Government is planning to spend only what it can afford on existing tax plans. The unemployment and oil price assumptions are scheduled for review in 2002.

RECENT FISCAL TRENDS AND OUTLOOK

2.34 The public finance projections in the Pre-Budget Report have a different status from those included in the EFSR and FSBR at Budget time. They represent an interim forecast update and not necessarily the outcome the Government is seeking.

The fiscal effects of firm decisions announced in the Pre-Budget Report and since Budget 2001 have been incorporated into the fiscal projections in accordance with the requirements of the *Code for Fiscal Stability*.

2.35 Full details of changes in tax and spending since the Budget are set out in Annex B. The sound fiscal position means that, even on cautious assumptions, the Government can let fiscal policy support monetary policy, while remaining on track to meet the fiscal rules over the cycle.

Receipts

2.36 Based on the cautious audited assumptions, receipts are expected to grow at a slower rate than forecast in Budget 2001 in the short term. The forecast for receipts has been revised down by £7 billion in 2001-02 and by £10 billion in 2002-03. In the medium term, receipts are expected to recover to the Budget profile. Table 2.4 below decomposes the change in the forecast in receipts into its component factors.

Table 2.4: Factors behind changes to receipts since Budget 2001[1]

			Projections		
	2001-02	**2002-03**	**2003-04**	**2004-05**	**2005-06**
£ billion					
GDP	-1	-2	0	1/2	1
Audited assumptions	-1 1/2	-4 1/2	-3 1/2	-2 1/2	-2 1/2
of which:					
Interest rate	*-1*	*-2*	*-1*	*0*	*0*
Equity price	*-1*	*-2*	*-2*	*-2*	*-2*
Other	*0*	*-1/2*	*-1/2*	*-1/2*	*-1/2*
Financial company profits	-3	-2 1/2	0	1	2
Other factors	-2	-1	1/2	1/2	1/2
Total change	**-7**	**-10**	**-3**	**-1/2**	**1**

[1] Figures may not sum due to rounding.

2.37 Slower growth will reduce tax receipts by about £1 billion in 2001-02 and £2 billion in 2002-03 compared with Budget 2001. The audited assumptions - especially weaker equity prices - account for a further £1 1/2 billion of the revisions to the Budget projection in 2001-02 and £4 1/2 billion of the revision in 2002-03. Financial companies have been hit by the downturn in international capital markets, reducing taxable profits. These lower profits are not directly reflected in forecasts for GDP but are expected to account for an additional £3 billion of the revisions to the Budget forecast. Weaker profits are also expected to affect income tax receipts through lower bonus payments. The remaining £2 billion change to the forecast is explained by other factors, including weaker outturn data affecting the baseline for the forecast period. These factors are set out in more detail in Annex B.

2.38 Looking forward and consistent with the audited assumptions, the overall level of receipts is expected to return to the Budget path as the economy returns to its potential level of growth over the medium term and as financial companies' profits return to a cautious view of their long-term trend.

Departmental Expenditure Limits

2.39 Projections for DEL up to the end of 2003-04 are based on the 2000 Spending Review allocations, including the targeted additions announced in Budget 2001and the additional £1 billion for the UK National Health Service in 2002-03 announced in this Pre-Budget Report.

Annually Managed Expenditure

2.40 In AME, social security spending is estimated to be slightly higher in 2001-02 than in the Budget on account of the increase to the Winter Fuel Payment announced since March. Compared with the Budget forecast, debt interest payments are expected to be £0.8 billion lower in 2001-02 and £2.7 billion lower in 2002-03 on account of lower inflation and lower short term interest rates. Table B13 gives further details, including the offset in the AME margin.

Discretionary policy changes

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

- 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.

2.42 Within these strict constraints, it has been possible to release additional resources for a comprehensive package of further support for pensioners, worth £2$^{3}/_{4}$ billion a year by 2004-05, increased assistance for disabled children and to introduce new measures to support business enterprise and promote productivity. This is in addition to other measures to promote enterprise and productivity announced since Budget 2001, the fiscal impact of which is set out in Table B4 and which are included in the Pre-Budget Report projections.

2.43 Consistent with the requirements of the *Code for Fiscal Stability*, the forecast does not take account of:

- measures proposed in the Pre-Budget Report for further consultation in the run up to Budget 2002, including the R&D tax credit for large companies; and
- other proposals where final decisions have yet to be taken on rates, including the Working Tax Credit and the Child Tax Credit.

2.44 Decisions on these and other issues will be taken in Budget 2002 and, along with revised forecasts for the economy and the public finances will impact on the final Budget forecast. In line with the convention adopted in previous Pre-Budget Reports, forecasting changes for AME programmes have been offset in the AME margin.

Fiscal position and medium-term prospects

2.45 Table 2.5 compares the medium-term projections for the surplus on current budget and public sector net borrowing (PSNB) with those produced in Budget 2001. The changes are separated into those explained by policy measures and those explained by forecasting revisions and other changes. In a change to Budget 2001,the presentation includes the impact of the windfall tax and associated spending. Table B4 sets out detail.

Table 2.5: Fiscal balances: comparison with Budget 2001[1]

	Outturn[2]	Projections

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Fiscal balances (£ billion)[3]						
Surplus on current budget						
Budget 2001	**22.3**	**16**	**14**	**8**	**9**	**9**
Effect on forecasting changes	2.8	-5.2	-10	-3	0	2
Effect of policy measures	-	-0.3	0	-2	-3	-3
PBR 2001	**25.1**	**10.3**	**3**	**4**	**7**	**8**
Net borrowing						
Budget 2001	**-15.0**	**-5**	**2**	**10**	**11**	**12**
Effect of forecasting changes	-3.8	6.8	10	3	0	-2
Effect of policy measures	-	0.3	0	2	3	3
PBR 2001	**-18.8**	**2.5**	**12**	**15**	**13**	**13**
Cyclically-adjusted budget balances (per cent of GDP)						
Surplus on current budget - Budget 2001	2.0	1.2	1.0	0.6	0.7	0.7
Surplus on current budget - PBR 2001	**2.3**	**1.0**	**0.3**	**0.3**	**0.5**	**0.7**
Net borrowing - Budget 2001	-1.3	-0.1	0.4	1.1	1.1	1.1
Net borrowing - PBR 2001	**-1.6**	**0.3**	**1.1**	**1.4**	**1.2**	**1.1**

[1] Including windfall tax receipts and associated spending.
[2] The 2000-01 figures were estimates in Budget 2000-01.
[3] Figures may not sum due to rounding.

2.46 The table distinguishes between the headline figures and estimates of the underlying structural position, adjusted for the impact of the economic cycle on the public finances. The outturn for 2000-01 shows a £2.8 billion larger surplus on the current budget and a £3.8 billion larger net repayment compared with the Budget. The headline figures for the current budget and net borrowing are weaker than forecast at Budget 2001 in the short term, reflecting the impact of the automatic fiscal stabilisers and other temporary factors. A current budget surplus of £10.3 billion is now expected for 2001-02, and public sector net borrowing is expected to be £2.5 billion. Over the medium term they are expected to return to close to their Budget profiles.

2.47 On a cyclically-adjusted basis, a current budget surplus of 1 per cent of GDP is expected in 2001-02, and net borrowing is expected to be equivalent to 0.3 per cent of GDP. The cyclically-adjusted balances are weaker in the following two years than previously forecast, but revert to close to the Budget profile by 2004-05. The underlying position therefore remains strong. Indeed, these estimates of cyclical changes understate the temporary nature of the revisions to the projections for receipts.[2]

2.48 Table 2.6 shows that, notwithstanding non-discretionary changes to receipts and spending and the release of new resources, the Government remains on course to meet its tough fiscal rules.

Table 2.6: Summary of public sector finances[1]

	Per cent of GDP						
	Outturn	Projections					
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Fairness and prudence							
Surplus on current budget	2.6	1.0	0.3	0.4	0.6	0.7	0.7
Average surplus since 1999-2000	2.5	2.0	1.6	1.3	1.2	1.1	1.1
Cyclically-adjusted surplus on current budget	2.3	1.0	0.3	0.3	0.5	0.7	0.7
Long-term sustainability							
Public sector net debt	31.2	30.7	30.6	31.0	31.1	31.1	31.1
Net worth	19.5	21.6	21.2	20.8	20.3	19.8	19.5
Primary balance	4.1	1.6	0.6	0.5	0.7	0.7	0.6
Economic impact							
Net investment	0.7	1.3	1.4	1.7	1.8	1.8	1.8
Public sector net borrowing (PSNB)	-2.0	0.3	1.1	1.3	1.2	1.1	1.1
Cyclically-adjusted PSNB	-1.6	0.3	1.1	1.4	1.2	1.1	1.1
Financing							
Central government net cash requirement	-3.7	0.6	1.3	1.7	1.3	1.2	1.3
European commitments							
Treaty deficit[2]	-2.0	0.2	1.1	1.3	1.1	1.0	1.0
Cyclically-adjusted Treaty deficit[2]	-1.7	0.3	1.0	1.3	1.1	1.0	1.0
Treaty debt ratio[3]	39.9	38.1	37.2	37.0	36.8	36.6	36.3
Memo: Output gap	**0.6**	**-0.1**	**-0.1**	**0.2**	**0.0**	**0.0**	**0.0**

[1]Including windfall tax receipts and associated spending.
[2]General government net borrowing.
[3]General government gross debt.

Golden rule

2.49 The surplus on the 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 is therefore an important indicator of the generational fairness of the finances. The table shows that the surplus on the current budget is projected to be equivalent to 1 per cent of GDP in 2001-02. After falling to 0.3 per cent of GDP in 2002-03, it is projected to increase steadily through the remainder of the forecast period.

2.50 On a cyclically-adjusted basis, the surplus on current budget is positive in every year throughout the forecast period. The average surplus since 1999-00, which on the Government's provisional judgement is the start of the current cycle, is also positive over the next five years. The Government is therefore on track to meet the golden rule.

Sustainable investment rule

2.51 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public debt at a low and sustainable level. The Pre-Budget Report projections show that, as a result of the tough decisions taken over the past four years, net debt is expected to remain close to 31 per cent of GDP throughout the forecast period and well below 40 per cent. Sound public finances and greater economic stability mean that debt interest payments as a proportion of GDP are projected to be lower in each of the three years from 2001-02 to 2003-04 than at any time since the First World War. The Government is therefore firmly on track to meet the sustainable investment rule while also freeing up resources for investment in priority public services and maintaining a cushion against further unexpected events.

2.52 Chart 2.3 illustrates the low net debt ratio and the projected cyclically-adjusted current budget surpluses. It demonstrates that the Government met its fiscal rules over the economic cycle that was probably completed between mid-1997 and mid-1999, and that it is on track to meet them throughout the forecast period.

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

2.53 Another measure of the sustainability of the Government's fiscal position is net worth, the difference between the total assets and liabilities of the Government. Net worth is projected to remain broadly stable at about 20 per cent of GDP throughout the forecast period. This is a reflection of keeping debt at a prudent level while investing to maintain the public capital stock.

Economic impact

2.54 While the key objective of fiscal policy is to ensure sound public finances, the Government recognises that fiscal policy also impacts on the economy this year and next and therefore plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing. PSNB is expected to show a small deficit of 0.3 per cent GDP in 2001-02. Fiscal policy is supporting monetary policy as lower levels of receipts compared to the Budget will support demand as the economy moves temporarily below trend.

2.55 The interim forecast for net borrowing is summarised in Chart 2.4 which shows the actual and cyclically-adjusted figures as a percentage of GDP. The chart shows the move from surplus into deficit, which is projected to peak in 2003-04. The Government is planning to borrow modestly to fund increased investment in the country's capital stock. In the coming year, rising public spending including investment spending will support monetary policy. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being held at a stable and prudent level.

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

Financing

2.56 As a result of the new projections for the fiscal balances, the forecast for the central government net cash requirement (CGNCR) for 2001-02 has been revised from £0.3 billion to £6.3 billion. Accordingly, the DMO target for debt buy-backs from the secondary market has been scaled back to £0.5 billion. Combined with the expectation that National Savings' net contribution to government financing will be £3 billion higher, the revised net financing requirement for 2001-02 is £25.6 billion, an increase of £2.5 billion from the forecast published in April.

2.57 In line with the contingency measures outlined in the Debt and Reserves Management Report 2001-02, the Government has decided to:

- increase gross gilts issuance by £0.5 billion;
- increase the planned stock of outstanding Treasury bills by £1.4 billion; and
- increase the planned run down of the DMO's net cash position by £0.6 billion.

2.58 Full details of these measures and a revised table for the government financing requirement can be found in Annex B.

European commitments

2.59 The Pre-Budget Report projections easily meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period. The projections are consistent with a prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty). Based on cautious assumptions and consistent with the Government's fiscal rules, the cyclically-adjusted Treaty deficit is projected to increase to 1.3 per cent of GDP in 2003-04 before returning to a deficit of 1 per cent at the end of the forecast period. General government gross debt, the Treaty measure, remains consistently well below the 60 per cent reference value, ensuring the public finances are sustainable.

Dealing with uncertainty

2.60 Fiscal balances represent the difference between two large aggregates and forecasts of them are inevitably subject to wide margins of error. The cautious assumptions audited by the NAO, including the trend growth assumption, take account of possible misjudgement about the trend growth of the economy in the medium term. A second important source of potential error results from misjudgement about the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be 1 percentage point lower than on the central case. Chart 2.5 illustrates the interim forecast for this cautious case.

Chart 2.5: Cyclically-adjusted surplus on current budget

2.61 The chart shows that the cyclically-adjusted current budget in the cautious case was in a strong surplus in 1999-00, the start of the current cycle and again in 2000-01. It is then projected to move into deficit in 2001-02, before heading back into surplus by 2006-07. The cyclically-adjusted current budget remains in surplus on average in the cautious case, meeting the 'stress test' of the golden rule. The Government therefore remains on track to meet the golden rule over the cycle, including in the cautious case. The fact that the margin for error has narrowed since Budget 2001 but that the projections meet the fiscal rules demonstrates the importance of taking a prudent approach to fiscal policy.

CONCLUSION

2.62 Sound economic fundamentals are enabling the fiscal and monetary frameworks to respond to the global slowdown. Low inflation prospects have enabled the MPC to react pre-emptively in order to meet its symmetrical inflation target. Tough decisions on taxation and spending have restored the public finances to a healthy and sustainable position. This is letting fiscal policy support monetary policy as the economy moves temporarily below trend, while also ensuring the fiscal rules are not breached. Together the two arms of policy are working together to maintain economic stability and a return to stronger and more balanced growth from the middle of 2002. The challenge remains, however, to move to a significantly higher level of sustainable growth in the medium term. Improving productivity is central to this aim. The next chapter outlines measures the Government is taking to close the productivity gap.

[1] Further detail is set out in the forthcoming HM Treasury book: *Reforming Britain's Economic and Financial Policy*, published by Palgrave, December 2001.[Back]

[2] The Treasury's methodology for cyclically-adjusting budget balances is set out in: *Fiscal Policy: public finances and the cycle,* March 1999.[Back]

3 Meeting the productivity challenge

The Government's long-term economic ambition is that Britain will achieve a faster rate of productivity growth than its main competitors, closing the productivity gap.

The Government believes that the productivity gap can only be tackled over the long term and through a sustained effort across the economy as a whole. Closing the productivity gap requires a broader effort from employers and employees, as well as from government. The Government welcomes progress made by the CBI and the TUC in successfully working together to identify a range of key areas for action, such as improving UK skill levels and modernising the planning system.

To support further the drivers of productivity growth - strengthening competition, enterprise, innovation, skills and investment in every community and region across the country - the Government is now:

- planning to introduce a **volume-based research and development (R&D) tax credit for large companies** in Budget 2002;
- taking further steps to modernise and reform the business tax system by **improving the capital gains tax business assets taper**, and publishing draft legislation for an exemption for capital gains and losses on substantial shareholdings and a new regime for providing relief for the costs of intellectual property, goodwill and other intangible assets;
- **piloting new measures to improve access to training** and enable employees to attain basic and level 2 skills;
- publishing a Green Paper on **planning reform** next month, setting out proposals to improve the flexibility, speed and responsiveness of the land use planning system;
- introducing **a package of measures to support small business**, improving access to finance, reducing the administrative burden of VAT and publishing Patrick Carter's review of payroll administration;
- taking further steps to support enterprise and investment in Britain's disadvantaged communities by introducing **a stamp duty exemption for all property transfers up to £150,000 in disadvantaged areas** and announcing further decisions on the new Community Investment Tax Credit;
- confirming a radical programme of **further enhancements to the UK's competition regime;**
- **enhancing Enterprise Management Incentives** by doubling the gross asset limit for companies which can qualify to £30 million. A Statutory Instrument will be laid before Parliament immediately to take effect from 1 January 2002; and
- **publishing a new analysis of Britain's regional productivity challenge.**

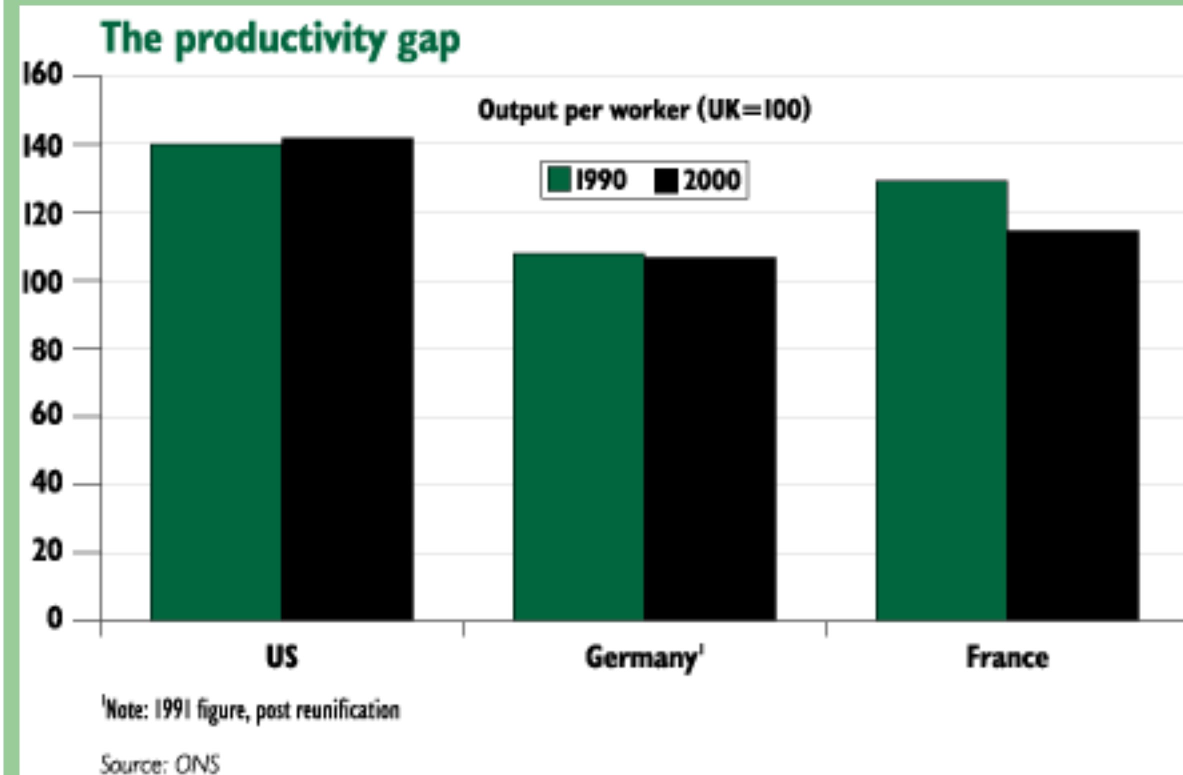
THE PRODUCTIVITY CHALLENGE

3.1 Increasing the sustainable rate of productivity growth is central to the Government's economic strategy. The nation's output depends on the number of people in work and how productive those people are. Productivity growth, alongside high levels of employment, is therefore essential to deliver rising living standards, and to achieve the Government's objectives to tackle poverty and improve public services.

3.2 The productivity performance of the UK economy has historically been weak. A legacy of macroeconomic instability and microeconomic failures has inhibited productivity growth and created a substantial productivity gap between the UK and many other advanced industrial economies. Box 3.1 describes trends in the UK's productivity performance relative to that of its main competitors.

Box 3.1: The productivity challenge

The UK has a poor track record on productivity. Using the Government's preferred measure of productivity, output per worker, US productivity is 42 per cent higher than that of the UK. Productivity in France and Germany is 14 and 7 per cent higher respectively.



International comparisons of productivity should be made over the long term. During the last decade, the productivity gap has narrowed slightly against Germany and significantly against France, but increased marginally against the US.

UK productivity grew by 2.3 per cent in 2000 across the economy as a whole and by 5.8 per cent in manufacturing. However, UK productivity will clearly be affected by the general slowdown in the world economy. Much still needs to be done to address historic weaknesses in all areas.

Meeting the productivity challenge

3.3 The Government is implementing a comprehensive strategy for delivering stronger productivity growth and closing the productivity gap. The Government's strategy addresses issues at the regional, national and international levels and involves stakeholders from across all sectors of the economy.

3.4 The Government believes that the productivity gap can only be tackled over the long term. The UK economy registered an above-trend productivity performance during 2000, with output per worker rising by 2.3 per cent across the economy as a whole and by 5.8 per cent in manufacturing. The tendency of firms to retain labour despite weaker external demand has driven a cyclical slowdown in productivity growth during 2001. However, the continued strength of UK economic fundamentals should support a resumption of stronger productivity gains beyond the near term.

The drivers of productivity performance

3.5 The Government's approach to improving the UK's long-term productivity performance rests on two pillars: delivering macroeconomic stability to enable firms and individuals to invest for the long term, and implementing microeconomic reforms to remove the barriers which prevent markets from functioning efficiently. These microeconomic reforms address historic weaknesses in five areas that affect the rate of productivity growth:

- strengthening **competition** to encourage firms to innovate, reduce costs and provide better quality goods and services to the consumer;
- promoting **enterprise and innovation** to unlock the potential of new technologies and working practices, supporting entrepreneurship, risk-taking and management in all communities across the country;
- improving the **skills** base to maximise the contribution of human capital to growth;
- encouraging **investment** to improve the UK's stock of physical capital in every sector and industry; and

- working directly to improve **public services productivity**.

Raising productivity across the economy

3.6 Government has an important role to play in creating the right environment and incentives to facilitate productivity growth within the private sector and to improve public sector productivity. However, the productivity gap cannot be closed without a wider effort across the economy as whole. The Government is therefore committed to working alongside business, trade unions and other stakeholders to raise productivity across all sectors of the UK economy.

CBI-TUC productivity campaign

3.7 In October 2000, the Chancellor invited the CBI and the TUC to work together to identify practical steps that could be taken by employers, employees and the Government to raise productivity. Four joint working groups were established and reported to the Chancellor in October 2001. The Pre-Budget Report takes forward reforms in a number of important areas identified by the CBI and the TUC for joint action:

- reflecting the conclusions of the skills group, the Government is now piloting new measures to improve access to training and enable employees to attain basic and level 2 skills;
- responding to the conclusions of the investment group, the Government is publishing next month a Green Paper setting out proposals to improve the flexibility, speed and responsiveness of the land use planning system;
- taking forward the conclusions of the innovation group and the CBI-TUC joint submission on the research and development (R&D) tax credit for large companies, the Government is planning to introduce a volume-based tax credit in Budget 2002; and
- consistent with the conclusions of the best practice group, the Government recognises the importance of supporting businesses in embracing change and learning from one another. The Government is supporting business-to-business transfer of best practice at national, regional, sector and company level.

3.8 Building on the success of joint working to date, the Government also welcomes proposals by the CBI and the TUC to create a new, permanent, CBI-TUC Productivity Group. This group will meet on a regular basis to monitor progress against the vision set out by the four working groups and to look at specific productivity issues. The Government will use the group as a sounding board for policy development on productivity.

DTI reviews

3.9 The Secretary of State for Trade and Industry last week announced further important developments in the Government's productivity strategy, with wide ranging proposals for change at the Department of Trade and Industry following reviews initiated in summer 2001. The Department's key role is to help drive the productivity and competitiveness of British business.

Working across the regions

3.10 The Government is committed to working across the regions to ensure that the benefits of improved productivity are felt throughout the country and that measures to raise productivity are designed and implemented at the level at which they have most effect - in many cases, below the national level. The Government's approach to tackling the regional productivity challenge is set out in detail in *Productivity in the UK: 3 - the Regional Dimension*, published alongside the Pre-Budget Report. The Government has set a Public Service Agreement (PSA) target to raise the rate of sustainable UK growth by increasing the trend rate of growth of GDP per capita in all regions, with a long-term regional economic ambition to reduce the persistent gap in performance between the regions.

3.11 The Regional Development Agencies (RDAs) are central to the Government's response to the productivity challenge. The RDAs operate as champions for economic development in their region, working in partnership with key regional, sub-regional and local bodies, such as Local Learning and Skills Councils (LLSCs) and the Small Business Service (SBS). RDAs are expected to exert strategic influence over the type, scale and combination of services delivered in their region from both the public and private sectors. They have drawn up regional economic strategies to cover:

- economic development and regeneration;
- the promotion of business, investment and competitiveness;
- the promotion of employment; and
- the enhancement, development and application of skills relevant to employment.

3.12 The RDAs have been given significant budgets - rising to £1.7 billion in 2003-04 - and unprecedented flexibility to deliver these objectives. From 1 April 2002, RDAs will receive a "single pot" of funding from sponsor departments rather than different streams of funding tied to specific programmes. In return for this greater flexibility, they will be expected to meet stretching targets, derived from the relevant PSA targets of sponsoring departments. Targets for 2002-03 have already been agreed with RDAs for raising the level of sustainable economic performance, reducing deprivation, promoting urban and rural regeneration, raising employment and promoting enterprise. They have also been set a specific productivity target to "work with regional partners to enable an increase in productivity measured by Gross Value Added (GVA) per hour worked in the region".

3.13 The 2002 Spending Review, described in detail in Chapter 6, will look to consolidate and build on the RDAs' funding arrangements, taking into account their new targets as well as performance against existing targets.

The European dimension

3.14 The Government is committed to raising productivity across Europe through economic reform. At the Lisbon European Council in spring 2000, Europe's leaders committed themselves to an ambitious ten-year strategy for reform. The vision agreed at Lisbon is of a dynamic, job-creating Europe that delivers on both economic and social objectives to become the leading knowledge-based economy in the world. Recognising the UK's interdependence with other EU countries, and in close co-operation with its European partners, the Government has been at the forefront of developing this new policy framework. The next step is to build on the progress made at Lisbon by:

- opening up European networks, including gas, electricity and telecoms;
- cutting the cost of investment capital, including liberalisation of financial services;
- promoting more open trade, both within the EU and with the rest of the world;
- ensuring more competition and lower prices and removing unnecessary or over-burdensome regulation, in particular through modernisation of state aids;
- creating more jobs through labour mobility and labour market reforms; and
- establishing a real stimulus to innovation, including development of patents and e-Europe.

3.15 The Government will publish a White Paper on economic reform in Europe for the Spanish presidency.

Supporting manufacturing

3.16 The Government recognises the importance of the UK's manufacturing base, which accounts directly for 20 per cent of GDP and 14 per cent of all employment. Manufacturing has a crucial role to play in the Government's ambition to close the UK's productivity gap, not least because of the sector's importance as a source of innovation in the economy. The Government is committed to supporting manufacturers in their efforts to raise productivity, and has acted to:

- introduce the R&D tax credit for small and medium-sized enterprises (SMEs) in April 2000;
- consult on extending R&D tax credits to larger companies. The Government plans to legislate in Finance Bill 2002 and will shortly be consulting on final options for detailed design, as set out later in this chapter;
- establish the Manufacturing Advisory Service to provide advice, knowledge and support to industry. Regional Centres for Manufacturing Excellence are being established in every English region and in Wales, and these will be supported by a National Network of Centres of Manufacturing Expertise;
- disseminate best practice across manufacturing and between the manufacturing and service sectors. The Fit for the Future campaign, launched in December 1998, provides a focal point for UK best practice activities, helping business to learn from business. The Government is also funding a three year programme of up to ten Industry Forum initiatives to build on the success of the Industry Forum of the Society of Motor Manufacturers and Traders; and
- support new product development in the aerospace sector, including launch investment of up to £250 million for Rolls Royce's Trent 600 and Trent 900 engines, following a commitment of £530 million to Airbus UK for wing development for the Airbus A380.

Public services productivity

3.17 As well as creating the right environment for business to increase productivity, the Government is directly responsible for a substantial part of the economy. Productivity within the public sector has a significant impact on productivity across the economy as a whole. Increasing public services productivity is also important because it gives people the public services they deserve and require, provides taxpayers with better value for money and is fundamental in laying the foundations for a high productivity economy. The Government's public spending framework lays the foundation for raising public services productivity by providing greater certainty for long-term planning, removing the past discrimination against investment and delivering a sharper focus on the quality and outcome of public services. This approach, and the range of further steps the Government is taking to improve the performance and productivity of public services, are described in Chapter 6.

Box 3.2: Productivity and sustainable development The challenge of sustainable development is to find ways of combining environmental objectives, social progress, and high and stable levels of growth and employment. The Government's sustainable development strategy, *A Better Quality of Life*, published in May 1999, sets out a range of initiatives across government to achieve a balance between these objectives.In addition, the Performance and Innovation Unit (PIU) recently published a report, *Resource Productivity: Making More with Less*, highlighting the importance of pursuing economic growth that uses natural resources and the environment more productively.The report argues that the definition of resources should include the way in which the environment absorbs waste and pollution, in what are commonly referred to as "pollution sinks", as well as natural resources such as fossil fuels, minerals and land for agriculture. These environmental resources are typically under greater pressure than most natural resources, with climate change and waste being two of the most pressing problems.Using policy to deliver sustainable development means appraising the environmental impact of policy measures and ensuring that environmental objectives are achieved in an efficient and cost-effective way. Government policy appraisal must take account of economic, social and environmental effects, even when these cannot easily be costed. Where environmental problems are identified, the Government will tackle them using the most appropriate instrument, or combination of instruments, including taxation and other economic instruments such as tradable permits.Chapter 7 describes in detail the range of Government policies designed to protect and, where possible, improve the environment.

COMPETITION

3.18 Competition is central to the Government's strategy for closing the productivity gap. Research shows that vigorous competition between firms helps to drive productivity growth by stimulating innovation and encouraging greater efficiency.[1] Competition also ensures that consumers get a good deal. In a competitive environment, firms must strive to win customers, encouraging lower prices and higher quality goods and services.

The UK competition regime

3.19 Since 1997, the Government has introduced a range of measures to improve radically the UK's overall competition regime. The Competition Act 1998 strengthened the powers of the Office of Fair Trading (OFT) to identify and address anti-competitive practices across the economy and introduced strong financial penalties for firms that breach competition law. The Government has also appointed a new Director General of Fair Trading, John Vickers, who has adopted a new mission for the OFT of "making markets work for consumers".

3.20 The July 2001 White Paper, *Productivity and Enterprise: A World Class Competition Regime*, outlined the next steps required to increase the competitiveness of the UK economy, strengthen the competition regime and ensure that those who may seek to distort markets and disadvantage consumers are effectively deterred. Following consultation on the White Paper, and in line with its principles for reform of the competition regime, the Government now intends to:

- give full independence to the UK competition authorities, so that they will take decisions free from political interference in the overwhelming majority of cases;
- give the OFT a clear proactive role to keep markets under review and enable it to refer markets to the Competition Commission where it appears they may not be working well. The Government will give legislative weight to the new right for consumer associations to bring super-complaints to the OFT where consumers are being harmed;
- make a series of improvements to the mergers and monopolies investigations regimes, giving greater certainty through clearer timetables and a more transparent decision-making process;
- replace the tests applied by the Competition Commission in merger and monopolies investigations with a more competition-focused regime, requiring the Competition Commission to identify clearly - and where appropriate take action to remedy - features of the market which have a detrimental effect on competition. In setting remedies the Competition Commission will be able to take account of consumer benefits;
- introduce new criminal penalties for individuals who engage in cartels, covering the most serious forms of anti-competitive activity - price-fixing, market sharing, limitation of production and bid-rigging - but excluding vertical agreements between firms. Only those who have acted dishonestly will be liable for the new criminal penalties. Those found guilty could face a prison sentence of up to five years. The Serious Fraud Office (SFO) will be the main prosecuting body for criminal offences, working closely with the OFT; and
- widen the remit of the Competition Commission Appeal Tribunals, enabling it to hear claims for damages brought by

harmed parties and allowing actions to be brought for damages on behalf of named consumers who have suffered harm as a result of anti-competitive behaviour.

3.21 The Secretary of State for Trade and Industry will publish further details of the outcome of consultation shortly. These changes to the competition regime, together with proposed modernisation of the rules for insolvency (described later in this chapter), will be introduced in the Enterprise Bill. Together, this package of reform will bring down barriers to enterprise, provide greater opportunity for all and help to create a truly entrepreneurial culture.

3.22 At the time of the Enterprise Statement, the Government announced that the OFT would receive additional funding in order to deliver such a radical programme of change. The OFT will receive an extra £7 million of funding for this financial year and £17.5 million for next year. This additional money underlines the Government's commitment to building a world-class competition regime in the UK. The Government has also agreed in principle to increase the Competition Commission's budget for the coming year.

Promoting competition in specific markets

3.23 The Government has acted to promote competition in a number of specific markets, including banking, the water industry and the professions.

Banking

3.24 The Competition Commission's report on banking services was delivered to the Government on 19 October 2001. The Government is currently considering the proposals set out in the report and will publish its response in due course.

The water industry

3.25 On 30 March 2001, the Government announced its intention to introduce further competition in the water industry for the benefit of consumers. The Government is developing proposals that will be the subject of consultation early next year.

The professions

3.26 Following the OFT's report into competition in the professions, the Government announced that it would act to remove Schedule 4 to the Competition Act, which provides a special regime for the exclusion of professional rules from competition law. This legislation will be repealed in the Enterprise Bill. In the meantime, the Government notes that the professions are conducting reviews of their own rules in light of the OFT report and that some bodies have already announced positive changes as a result. The Government will consider what further steps might be needed in respect of the market for legal services to ensure that the competition issues are fully addressed.

Regulatory reform

3.27 Effective and well-focused regulation has important economic benefits. Properly framed, regulation can play a vital role in correcting market failures, promoting fairness and ensuring public safety. In contrast, unnecessary or inefficient regulation imposes serious economic costs, restricting competition, stifling innovation and deterring investment. The Government is committed to maintaining high standards of regulation in the UK and throughout Europe by ensuring that regulation is transparent, accountable, well-targeted, consistent and proportionate.

3.28 As part of the process of building a more effective regulatory regime in the UK, the Government has implemented a range of major reforms in key sectors. For example, the Government has established a new framework for the regulation of electricity and gas markets and proposes to set up a single regulator for communications - OFCOM. Changes to the structure of utility regulation have been accompanied by an increasing focus on regulatory performance, with reviews conducted by W.S. Atkins for the Treasury and by the Better Regulation Task Force.

Box 3.3: The aviation industry

The aviation industry is important to the growth of the UK economy and to UK consumers. The uncertain global economic outlook and decline in global passenger traffic has intensified following the events of 11 September. The Government has worked with its European partners to minimise distortions to the single market and has supported guidelines which limit airline compensation to the exceptional impact of the four-day closure of US airspace as a direct consequence of terrorist actions on 11 September.

As with other sectors, the Government is committed to ensuring that regulation of the aviation industry is effective and well-focused, competition policy vigorously applied and market distortions minimised. The Government's aviation policy is therefore underpinned by the principles of liberalisation and normalisation. Consistent with its principles, the Government has:

- taken a lead in Europe in pressing for the regulatory barriers to structural reform in the industry to be dismantled. Airlines are responding to the new market conditions by restructuring their businesses, but progress towards consolidation is held back by obsolete international regulations, to the detriment of passengers; and
- tackled temporary market failure, by stepping in quickly and decisively to provide third party war and terrorist cover for the UK aviation industry. The Government has committed to withdrawing completely as a properly functioning market returns.

3.29 To drive forward reform of outdated, overlapping and over-burdensome regulation, the Government introduced the Regulatory Reform Act in April 2001. This gives ministers a new power to use orders to reform primary legislation and a reserve power to set codes of good practice in enforcement. Consultation exercises have been completed on nine proposed reforms with two orders already laid for parliamentary scrutiny. These measures alone could save business in excess of £40 million. In a further important reform, the OFT will play a new role in assessing the effects on competition of existing and proposed new regulations.

ENTERPRISE

3.30 In a modern economy, enterprise and entrepreneurship are key drivers of productivity. New businesses entering the marketplace increase competitive pressures and facilitate the introduction of new ideas and technologies and more efficient ways of working. In common with other European countries, the UK has failed to achieve the levels of enterprise and entrepreneurship seen in the US economy. To address this gap, the Government is therefore taking steps to promote enterprise throughout the economy, including in some of Britain's most disadvantaged areas.

Encouraging enterprise across the economy

3.31 To promote a stable and attractive environment for enterprise and investment across the economy, supporting business in a period of slower global growth, the Government has radically reformed the business tax regime, including:

- reducing the main rate of corporation tax to 30 per cent - the lowest in the history of the UK;
- introducing a 10 per cent starting rate for small companies - the lowest in the European Union - to provide an incentive for enterprising individuals to start up their own companies. As previously announced, the Government is committed to extending the starting rate in Budget 2002 to reduce further the corporation tax bills of smaller companies;
- introducing a generous capital gains tax (CGT) taper for business assets to encourage entrepreneurial investment and activity; and
- abolishing the requirement to withhold tax on interest and royalties between companies in the UK.

Modernising the business tax system

3.32 The Government is continuing to build on these reforms to ensure that the tax system recognises the realities of the modern business environment and to help UK companies compete effectively at home and abroad. Building on announcements in Budget 2001 and measures put forward in the Enterprise Statement, the Government is:

- **publishing draft legislation for an exemption for gains and losses on substantial shareholdings** to ensure that important business decisions on corporate restructuring and reinvestment are made for commercial, rather than tax, reasons. It is proposed, subject to further consultation, that this legislation will take effect for disposals from 1 April 2002;
- **publishing draft legislation for a new regime for providing tax relief to companies for the costs of intellectual property, goodwill and other intangible assets** to encourage business to take advantage of new opportunities in the emerging knowledge-based economy. It is proposed, subject to further consultation, that this legislation will take effect from 1 April 2002;
- **modernising and simplifying the tax regime for corporate debt, financial instruments and foreign exchange gains and losses for accounting periods starting on or after 1 October 2002,** to create a coherent regime governing the taxation of debt and derivative contracts. This will provide long-term stability and

transparency for business. Draft legislation will be published shortly;

- **publishing a review of Inland Revenue's links with business;**
- **seeking views on an optional scheme for companies to pay cross-border royalties without deducting tax at source;** and
- helping companies in the Construction Industry Scheme (CIS) by **making changes from 6 April 2002 to allow CIS deductions to be set-off against PAYE, NICs or CIS liabilities that companies are due to pay to the Inland Revenue**.

3.33 To encourage investment and promote enterprise, the Government is also **introducing further improvements to the CGT business assets taper for disposals from 6 April 2002.** These improvements will mean that the effective rate of tax for a higher rate taxpayer is reduced to 20 per cent after one year of holding an asset and 10 per cent after only two years, making the UK regime among the most favourable in the developed world.

3.34 The Government is considering the various proposals it has received in response to the consultation launched in June 2001 on value for money options to simplify CGT within the existing policy framework. It is also considering whether there is any case for changes to the CGT regime for non-business assets.

Supporting small business

3.35 In seeking to make Britain one of the most competitive environments for business in the world, the Government recognises the importance of helping small businesses to develop and flourish.

Easing administrative burdens on small businesses

3.36 The Government is committed to reducing regulatory and administrative burdens on small business and has consulted on proposals to reduce their compliance costs. It now intends to **consult further on the scope for minimising compliance costs through closer alignment of tax and accounts.** The aim is to identify specific proposals that offer simplification while maintaining incentives and fairness.

Payroll

3.37 The Government recognises that running payroll services can be a significant undertaking, especially for smaller businesses. In June 2001, the Government asked Patrick Carter to undertake a review of the market for payroll services in the UK, to identify ways of helping employers meet their payroll obligations. **The Government is now publishing the review.**

3.38 The Government accepts the review's conclusion that better and more consistent use of information technology is the key to enabling businesses to deal with the complexity of payroll. To advance the use of IT, the review recommends that smaller employers should receive cash incentives for electronic filing of end-of-year returns with the Inland Revenue for a period of five years. Electronic filing would become mandatory during this period for larger employers (over 50 employees), and at the end of it for all employers.

3.39 The Government considers that the review sets out a package that is challenging but that also has attractions. The Government welcomes this important contribution to the debate on payroll and endorses in principle the proposals put forward by the review. The Government recognises, however, that the proposals raise issues that would benefit from wider debate before final decisions are taken. It therefore **invites comments on the detail of the review's recommendations by 31 January 2002**.

VAT

3.40 In Budget 2001, the Government implemented a package of measures designed to allow small and newly-registered businesses to manage their entry into the VAT system, reduce the administrative burden of VAT and improve their cash flow. A consultation document, *Easing the Impact of VAT on SMEs*, was issued in June 2001 setting out further proposals. As a result of this consultation, and additional changes to HM Customs and Excise's own administrative operations, the Government is now:

- **introducing an optional flat-rate scheme in Budget 2002**, under which more than 300,000 small businesses can avoid having to account for VAT on each individual purchase and sale, cutting their compliance costs by up to £1,000 per year;
- **introducing changes in Budget 2002 that will simplify and increase participation in the VAT annual accounting scheme**, which offers improved cash flow and lower compliance costs to around 900,000 businesses;

- **pressing ahead with reforms to the VAT penalties system** to ensure that small businesses are first offered advice and support when they are late with payments, rather than facing an automatic penalty; and
- **establishing an outreach business support programme**, through which HM Customs and Excise will offer proactive advice and support to businesses before they get into difficulties. The programme will be developed in the light of the help given to businesses affected by the Foot and Mouth outbreak, described in Chapter 7.

Encouraging business start-ups

3.41 The Government recognises the importance of providing targeted help and support to facilitate the establishment of new businesses. In June 2001, it announced that the Small Business Service (SBS) would consult on a comprehensive strategy to bring together the different activities designed to support business start-ups. Development of this strategy will form a major part of the Government's cross-cutting review of services to small business in preparation for the 2002 Spending Review.

3.42 The chances of business start-ups and early stage SMEs surviving and growing will be boosted by a new £75 million business incubation fund. Business incubation provides hands-on support for small firms at a time when they are most vulnerable. The fund was opened by the SBS on 1 October 2001 and will contribute to the financing of incubation projects to help a wide variety of business start-ups.

Improving access to finance

3.43 In February 2001, the Government announced a new programme of Early Growth Funding, committing up to £50 million to help a minimum of 1,000 businesses over the next three years. This programme will stimulate the supply of risk capital for start-ups and growth firms. After consulting with major banks, the venture capital sector and RDAs, **the SBS is now issuing bidding guidance for proposals to deliver this programme**. Early Growth Funds will help provide small amounts of risk capital - for example £50,000 - in businesses' early stages, complementing the larger amounts available from the Regional Venture Capital Funds and other sources. Early Growth Funds should be up and running next year.

3.44 To help plug the "equity gap" faced by small firms seeking finance to boost growth, the Government is supporting Regional Venture Capital Funds in every English region. The funds will operate as public/private partnerships, with the Government investing up to £80 million and the European Investment Fund up to £60 million. The first two funds are expected to be launched by the end of the year, and the majority should be up and running by the end of the financial year. Together with private sector funding, the Government expects that the funds will provide up to £270 million of extra finance for small firms. The Regional Venture Capital Funds are a major step towards achieving the Government's £1 billion target for public-private venture capital funding, announced in Budget 2000 .

Investment readiness

3.45 The availability of equity finance is not the only obstacle to small firm development. Businesses also need to be aware of the potential benefits and how to access it. However, the availability of specialist advice remains patchy. The Secretary of State for Trade and Industry will shortly announce steps to improve the provision of advice in this area.

Encouraging employee share ownership

3.46 Employee share schemes align employees' interests with their employer's business, providing significant incentives for productivity improvement. Finance Act 2000 introduced a new All Employee Share Ownership Plan (AESOP), now known as the Share Incentive Plan (SIP). The Plan is designed to encourage all staff of both large and small firms to hold shares in the company for which they work. The scheme was enhanced in Finance Act 2001 with a stamp duty exemption for SIP shares. Over 220 companies already have approved SIPs, potentially involving over one million employees in share ownership.

Enterprise management incentives

3.47 Finance Act 2000 also introduced Enterprise Management Incentives (EMIs) which are designed to help smaller, higher risk companies. This scheme was improved in Finance Act 2001 by removing the limit on the number of employees who can qualify. To date, over 1,600 companies have granted more than 13,000 awards under EMI to recruit and retain high calibre employees. To build on the success of the scheme, in June 2001 the Government announced a consultation on doubling the gross asset limit, from £15 million to £30 million. Following the consultation, **the Government is now introducing measures to double the gross asset limit to £30 million. A Statutory Instrument will be laid before Parliament immediately to take effect from 1 January 2002**. The change will be of particular help to small, dynamic manufacturing enterprises, which are more likely to have assets in excess of the current limit.

Share options

3.48 Under present arrangements, businesses are not always able to deduct the cost of share options and awards against their corporation tax liabilities. To encourage more businesses to consider awarding shares and share options to their employees, the Government is considering whether a corporation tax deduction should be made available and how access to it could be streamlined.

Modernising insolvency

3.49 Many potential entrepreneurs are dissuaded from starting new businesses by the perceived costs of failure. A modern and flexible bankruptcy regime which reduces the cost of financial failure and enhances the prospects for rescue of insolvent companies can therefore play an important role in stimulating enterprise and entrepreneurship. The Government is committed to taking forward the reforms set out in the July 2001 White Paper, *Insolvency - A Second Chance*, as part of the Enterprise Bill, including by:

- replacing the current "one size fits all" approach to bankruptcy with a new regime under which the cost and stigma of failure will be substantially reduced, while the sanctions available to protect the public and wider business interests against the dishonest and unscrupulous will be reinforced;
- improving the prospects for company rescue by ensuring that company insolvency is conducted in the interests of all creditors, both secured and unsecured, and through an updated and streamlined process of administration; and
- ending Crown preference, which enables certain tax debts to be paid first in an insolvency. In future, the Government will take its place in the queue alongside other unsecured creditors. Steps will be taken to ensure that the benefit of this change goes mainly to unsecured creditors.

3.50 The Government is also committed to modernising the financial regime of the Insolvency Service. This will create a simpler, more transparent fee structure. The Insolvency Service account will be reformed so that creditors receive the maximum possible investment return and insolvency practitioners administering voluntary liquidations will no longer be compelled to use the account.

Davies review of enterprise and education

3.51 In June 2001 the Chancellor of the Exchequer and the Secretaries of State for Trade and Industry and Education and Skills appointed Sir Howard Davies, Chairman of the Financial Services Authority, to conduct a review of enterprise in schools and further education. The review is considering how to promote better understanding of business, the economy and enterprise throughout the school and further education systems and has been examining the stepping stones to careers in business and the development of enterprising attitudes more generally. Sir Howard will report to the Government by the end of January 2002.

Management

3.52 In view of the links between management and productivity performance, the Government created the Council for Excellence in Management and Leadership (CEML) at the time of Budget 2000. CEML is due to report by March 2002. The joint CBI-TUC investment working group has also identified the importance of management issues and recommended that, building on the work of CEML, "leadership and management skills in the UK are addressed specifically by a systematic survey and research to identify UK strengths and weaknesses". The Government will take this recommendation forward in the light of the CEML report.

Encouraging enterprise in disadvantaged communities

3.53 The Government is committed to encouraging enterprise, investment and wealth creation in all regions in Britain. To ensure that Britain's most disadvantaged communities are not left behind it is introducing a range of measures to encourage investment and enterprise in these areas.

Community Investment Tax Credit

3.54 The Social Investment Taskforce, chaired by Sir Ronald Cohen, reported to the Chancellor in October 2000. The report recommended a new Community Investment Tax Credit (CITC) to encourage private investment in not-for-profit and profit-seeking enterprises in under-invested communities. In response to this recommendation, the Government published a consultation document in March 2001 proposing a CITC including the following elements:

- a tax credit for those investing in enterprises in disadvantaged communities through Community Development Finance Institutions (CDFIs). The tax credit would be set against investors' tax liabilities, and be worth 25 per cent of investment, spread evenly over five years; and

- a competitive tax credit allocation process among CDFIs.

3.55 Around 100 organisations took part in the consultation process. Feedback was overwhelmingly supportive of the Government's proposal for the tax credit, although respondents suggested modifications to aspects of the scheme. In July 2001, the Financial Secretary to the Treasury announced the Government's intention to proceed with the CITC, with decisions on two major aspects of the scheme:

- individual investors as well as corporates will be allowed to benefit from the tax credit; and
- both debt and equity investments will be allowed to attract the tax credit.

3.56 The consultation document asked respondents to comment on the likely level of demand for the CITC, given the Social Investment Taskforce's aspiration of £1 billion of investment over five years. While projections in this area are highly uncertain, the consultation indicated constraints on the capacity of intermediaries and businesses to absorb this level of investment in the short to medium term. The Government's view is that the key criterion for success should be whether Government intervention enables the development of an economically and socially valuable new business model.

3.57 Alongside the adjustments already announced, the Government additionally proposes to make substantial amendments to the proposed competitive allocation process for tax credits in order to increase access to the CITC, reduce administrative costs for CDFIs and increase the efficiency of the mechanism. In particular, the Government intends to:

- **remove the overall cap on the amount of investment that can attract tax credits in any year.** This means that CDFIs will compete against a standard rather than against each other;
- **set a limit or cap on the amount of investment attracting the tax credit which any successful CDFI may raise.** This will limit the cost of the incentive should the amount of investment significantly exceed current estimates; and
- **ensure that the caps are sufficiently high to give CDFIs enough credit to raise two to three years' volume of investment.** This will minimise the bureaucratic burden involved.

3.58 **The Government also proposes that the SBS administer the accreditation process for CDFIs that wish to raise investment qualifying for tax credits, in consultation with the RDAs and devolved administrations.** The SBS has existing experience of working with the community development finance sector and administers several UK-wide schemes. Work is currently under-way on the detailed structure of the accreditation process, which is likely to include the use of an advisory panel of experts. In this work the SBS will engage fully with their counterparts in the devolved administrations.

3.59 Final decisions will be made on other issues in time for Budget 2002. The Government aims to publish draft legislation before Budget 2002 and to legislate in Finance Bill 2002, with the scheme starting thereafter, subject to state aids approval.

Community Development Venture Fund

3.60 The Social Investment Taskforce also recommended that the Government help set up a Community Development Venture Fund - a matched funding partnership between Government and the venture capital industry to provide finance for firms operating in disadvantaged areas. The Government has committed £20 million in matching funding to a £40 million fund and responses from the private sector have been positive. The Government hopes to see the fund up and running by the end of the financial year, again subject to obtaining state aids clearance.

Land and property in deprived areas

3.61 Following Lord Rogers' report, *Towards an Urban Renaissance*, the Government is implementing a number of measures described in the Urban White Paper to encourage the development of land and property in deprived areas. These will help reduce the cost to business of investing in these areas and so boost local enterprise and employment. In particular, **an exemption from stamp duty for both residential and commercial property transfers up to £150,000 will be available in the UK's most disadvantaged areas from 30 November 2001.** The intention is to raise the limit significantly or abolish stamp duty for all non-residential transfers in these areas next year, subject to state aids clearance. This will make investment in these areas more attractive and encourage households and firms to look more favourably upon them as places to live and do business. Details of further measures described in the Urban White Paper are set out in Chapter 7.

Inner City 100

3.62 The Inner City 100 project is identifying and publicising the fastest-growing 100 companies in the UK's most deprived inner cities. The Government has provided funding to the project which was launched by the Chancellor in February. More than 300 nominations have been received and final awards are being presented on 27 November.

City Growth Strategies

3.63 The SBS is supporting pilot projects for City Growth Strategies which will strengthen the links between enterprise and urban renewal. Drawing on experience from the US, the pilots will explore ways of putting business creation and development at the heart of regeneration in towns and inner cities, focusing on their competitive advantage rather than their social disadvantage. The location of the pilot projects will be Nottingham, Plymouth, St Helens and deprived areas of London.

INNOVATION

3.64 International comparisons show that the UK business sector under-invests in research and development (R&D) relative to its major competitors. This translates into lower levels of innovation, which is an important catalyst for productivity and growth. Weaknesses in the UK's innovation performance were also identified by the CBI-TUC innovation group. For the UK economy to deliver its full potential, companies must be able to compete at the cutting edge of technological change. Encouraging innovation is therefore an important part of the Government's strategy for improving the UK's productivity performance.

Chart 3.1: Business R&D as a percentage of GDP

Encouraging research and development

3.65 Despite a strong science base, UK firms are often unable to harness innovation to raise productivity and build commercial success. To address this issue, the Government has put in place a range of measures to promote commercial R&D in the UK. As part of this support, Budget 2000 introduced a tax credit to encourage investment in R&D by small companies.

3.66 Budget 2001 launched a consultation on extending this tax credit to all companies. The proposals were welcomed by a broad cross-section of industry. The design of the credit will reflect the important contributions made by companies, representative bodies and others who responded to the consultation. **The Government therefore proposes to legislate for an R&D tax credit for larger companies in Finance Bill 2002 following a second round of detailed consultation.**

3.67 The original consultation document set out a choice between a simple volume credit, which rewards all qualifying R&D expenditure, and an incremental credit, which rewards only increases in expenditure. Overwhelmingly, respondents favoured a volume approach, for the following principal reasons:

- a volume approach is more predictable than the incremental design set out in the consultation document. Many respondents saw this predictability as key to the ability of a tax credit to influence investment decisions;
- the volume approach is simpler, reducing administrative burdens on companies; and
- a volume credit incentivises those companies with already high but relatively stable levels of R&D expenditure, as well as those that are increasing expenditure.

3.68 The Government recognises the advantages of a volume-based credit over an incremental credit, and has consequently decided to adopt a version of a volume credit. However, within this broad definition, a number of choices remain that will have important consequences for the operation of the credit and its ability to target extra R&D. Building on the success of the original consultation, the Government will be seeking views on options for the design of the credit in a further consultation to begin next week, in advance of Budget 2002.

3.69 The UK benefits from some of the strongest university based research in the world. To encourage better links between business and universities, the Government will ensure that the R&D tax credit provides tax relief for companies that enter into collaborative research with universities. In this way the new credit will enhance technology transfer between universities and business, and help give companies access to the latest university-based research in developing new and better products.

The Roberts review

3.70 Businesses, universities and the public sector need to be able to recruit and retain skilled scientists and engineers to underpin their R&D activities. In Budget 2001 the Government appointed Sir Gareth Roberts to lead an independent review into the provision of skilled scientists and engineers in the UK, reporting back by February 2002.

3.71 Since Budget 2001, Sir Gareth and his review team have undertaken a wide ranging consultation with interested parties and have extended the analytical evidence base for the review. This work has revealed that, although the UK has a strong overall science base compared to other industrialised countries, more needs to be done to strengthen the future supply of scientists and engineers. In particular, Sir Gareth has indicated that the review's recommendations will seek to:

- address issues in the recruitment and retention of design and technology, maths and science teachers, and in the quality of laboratories and other factors influencing practical work in schools; and to encourage participation (particularly by women) in science and engineering study through appropriate course design and careers advice;
- examine any financial barriers to the uptake of science and engineering study at undergraduate level; and to address the quality of the learning experience, including undergraduate teaching laboratories, in science and engineering;
- address the funding and training available to postgraduate students and contract researchers; and to address issues in the recruitment and retention of academic staff through, for example, considering their remuneration in the context of the overall forces of demand and supply; and
- examine the opportunities for scientists and engineers working in R&D in industry; to improve the perception of careers in science and engineering; and to address the coherence of the communication between employers and universities.

3.72 The Government welcomes the independent assessment provided by Sir Gareth and looks forward to receiving his proposals for addressing the issues highlighted by the review.

Supporting science and research

3.73 In June 2001, the Chief Secretary to the Treasury announced a cross-cutting review on science and research. The review - which will feed into the 2002 Spending Review - will examine funding of the UK science base, including universities, and the effectiveness of government departments' own science and research programmes to ensure that they deliver long term benefits to the economy and quality of life in the UK. Details of other cross-cutting reviews ahead of next year's Spending Review can be found in Chapter 6.

Box 3.4: Broadband

The UK is one of the most connected economies in the world, with higher internet use than any other major European country. Broadband provides new opportunities and the Government's ambition is for consumers, firms and the public sector to take the fullest advantage of its potential benefits.

Take-up will undoubtedly rise as the benefits become available. The challenge is therefore primarily one for industry - to stimulate demand for innovative services, to be responsive in satisfying that demand and to offer choice. The market is the best mechanism for achieving this. The Government's broadband target is to have the most extensive and competitive broadband market in the G7 by 2005, with significantly increased connections to schools, libraries, further education colleges and universities.The Government's role is to set the right framework for that market, promoting competition where possible and regulating effectively where not. The Government also has important, but tightly defined, roles as a purchaser in its own right for public services and in helping firms and others make the most of new technology. The Government is already taking action in a range of areas:

- **teleworking**: personal benefits' taxation was relaxed in 2000 in relation to employees working at home, assisting in the provision of broadband connectivity to home teleworkers;
- **capital allowances for broadband**: small enterprises can now take advantage of 100 per cent first year capital allowances up to 2003, and SMEs permanent 40 per cent first year allowances, for capital costs of broadband connections. Firms can obtain tax relief on non-capital expenditure incurred in establishing and maintaining broadband connectivity. These rules also apply to employers paying for broadband connectivity at an employee's home;
- **regional schemes**: £30 million has been allocated to the RDAs and the devolved administrations to take forward innovative schemes to extend broadband networks and encourage the use of broadband by business and consumers; and
- **public purchasing:** the Office of Government Commerce has been asked to look at what more might be done to help government departments buy broadband more effectively.

In addition, the Government has been working with the Broadband Stakeholders Group to develop a long-term strategy based on this pro-competition, market-based approach.

Making the most of the radio spectrum

3.74 Radio spectrum is a major national asset of growing importance to the communications industry and to a wide range of public services which affect the quality of life and safety of all UK citizens. The Government has taken steps in recent years to improve the spectrum management regime, making it more responsive to market developments and creating incentives for efficient spectrum use.

3.75 In March 2001, the Chancellor of the Exchequer and the Secretary of State for Trade and Industry appointed Professor Martin Cave of Warwick Business School to conduct an independent review of spectrum management in the UK. The review launched a wide-ranging consultation process in June 2001, involving representatives from the private sector and from relevant government departments and agencies. Professor Cave intends to submit his final report to the Government by December 2001, with recommendations for what more needs to be done to ensure that all users, including non-commercial ones, are focused on using their spectrum as efficiently as possible.

INVESTMENT

3.76 Empirical studies show that levels of physical capital stock are closely correlated with productivity performance.[2] The UK has long suffered from under-investment and is today significantly less capital intensive than its main competitors. The unexpected severity of the world economic slowdown will clearly impact on investment levels in the short term, although strong economic fundamentals and a proactive macroeconomic policy response are expected to give rise to an acceleration in investment as the global economic recovery gathers pace.

3.77 In addition to maintaining macroeconomic stability, to create the conditions for future sustained increases in investment it is also necessary to address a number of market failures at the microeconomic level. The Government has introduced a range of measures aimed at remedying such failures, ensuring that funding for investment is available to those who need and can best make use of it.

The Myners review of institutional investment

3.78 At the time of Budget 2000, the Government asked Paul Myners, chairman of Gartmore Investment Management, to lead a review into potential distortions affecting institutional investment decision-making in the UK. The final report of the review was published in March 2001. The Government issued its formal response in October 2001, confirming that it would be taking forward all of the recommendations of the review. The Government now plans to launch consultations on a range of issues, including legal change to trustees' duties, and a legal duty of shareholder activism. In March 2003, the Government will conduct an assessment of progress made by the industry in implementing the changes proposed by the Myners review.

The Sandler review of retail savings

3.79 In response to the recommendations of the Myners review, in June 2001 the Government appointed Ron Sandler, former CEO of Lloyd's of London, to conduct a review of the long-term savings industry. The review is examining the markets for medium and long-term savings products purchased by retail customers, identifying the competitive forces and incentives that drive the industries concerned and analysing potential policy responses. The review issued a consultation document on 30 July which has received over 200 responses. The review will report to the Government next year.

Company law and corporate governance

3.80 The Government is committed to modernising the framework of company law so that it is up to date and promotes enterprise and productivity. The final report of the independent Company Law Review was published in July 2001. The Review's recommendations include a radical simplification of the requirements for small firms, a statutory statement of directors' duties to clarify the obligations of directors under company law, and improved transparency and accountability for large firms. The recommendations have been widely supported, including by the CBI-TUC best practice working group. The Secretary of State for Trade and Industry will be consulting on draft legislation.

3.81 The Secretary of State for Trade and Industry has also announced that the Government will legislate to require quoted companies to disclose annually the details of their remuneration policy as well as individual directors' remuneration packages. Companies will also be required to put a resolution to shareholders each year on the remuneration report. The DTI will publish next month a consultative document setting out the proposals in detail.

3.82 The Myners review highlighted the importance of non-executive directors in UK corporate governance. The Company Law Review drew attention to a growing body of evidence from the US suggesting that companies with a strong contingent of non-executives produce superior performance. The Government recognises the importance of continued progress in this area, and of developing further the role of strong, independent non-executive directors within the present best practice framework of corporate governance for quoted companies.

Modernising the planning system

3.83 Many investment decisions are closely affected by the land use planning system. Currently, the system is unable to deliver the level of speed, certainty and responsiveness that businesses need to make successful investment decisions in a modern economy. Reflecting the conclusions of the CBI-TUC investment group, the Government will reform the planning system to address its current inadequacies, which include:

- uncertainty stemming from inconsistencies between planning policies set out at national, regional and local levels;
- the complexity of national planning guidance which is set out in 25 long and opaque Planning Policy Guidance notes;
- the unresponsiveness of the system, resulting from the fact that local development plans take an average of five years to produce;
- very slow decision-making, with only 23 per cent of planning decisions on major commercial applications being made within the statutory eight week period; and
- the handling of major infrastructure projects, which currently involve delays of many years.

3.84 The Government has already announced a series of measures to improve the handling of major infrastructure projects, including new parliamentary procedures to approve projects in principle while allowing detailed issues to be considered by public inquiries, and reforms to introduce stricter timetabling and more focused terms of reference to inquiry procedures. A consultation paper setting out the Government's proposals in detail will be published shortly. To further limit unnecessary debate at inquiries, the Government will also issue national policy framework statements for projects before they are considered in the planning system.

3.85 The Government believes that wider change is necessary and will publish a Green Paper on planning reform next month, setting out proposals to improve dramatically the flexibility, speed and responsiveness of the land use planning system, while also strengthening community participation. Alongside the Green Paper, the Government will publish a consultation paper setting out options for reform of the planning obligations system.

SKILLS

3.86 In an increasingly knowledge-based economy, there is a strong link between productivity and the quantity and quality of skilled labour. A more highly skilled workforce can generate greater innovation, increase flexibility in the workplace and enable better adaptation to new technologies.

3.87 The CBI-TUC joint working group on skills identified skill shortages at the lower-intermediate level as a critical issue for the UK's productivity performance. The group concluded that "too many adults in the UK have low or no qualifications in relation to those of our major competitors". Recent work by the Performance and Innovation Unit (PIU) also highlights the particular problems the UK faces in terms of lower-intermediate skills. This analysis is supported by the international evidence summarised in Chart 3.2 which suggests that:

- the UK has relatively fewer people with intermediate skill levels than Germany, other European countries and the US; and
- a far higher proportion of the UK population lack basic skills compared with other industrial countries. The International Adult Literacy Survey, for instance, found that over 20 per cent of the adult UK population lacks functional literacy. Of the thirteen countries surveyed, only Ireland and Poland fared worse.

Chart 3.2: Employees by skill level

3.88 The UK skills base is not static. As a result of the Government's prioritisation of education, young people entering the workforce today are far more likely to have qualifications of at least level 2 (5 GCSEs A*-C or equivalent) than previous generations.

Box 3.5: Conclusions of the CBI-TUC working group on skills and the PIU study on workforce development

The joint CBI-TUC working group on skills reported to the Chancellor in November 2001, identifying a range of issues and areas for action in addressing the UK skills gap. The Performance and Innovation Unit (PIU) has also recently published a report setting out proposals for a national strategy for workforce development. Both the reports focus on the importance of training in improving the skills of the adult workforce. They conclude that:

- without basic skills, individuals cannot start to develop a career path and may be trapped in low pay/no pay cycle;
- only a joint approach by government, employers and individuals will deliver real change;
- existing training is received disproportionately by workers with higher skills. Government intervention in this area needs to focus on ensuring that more of the workforce achieves basic skills and level 2 qualifications because this is where the most significant market failures exist;
- most employees without basic skills or skills below level 2 are employed by small firms for which the market failures are more significant than for larger firms. Policy needs to focus on providing incentives for smaller firms to train their workers; and
- the Government must also take responsibility for improving the supply-side, including the accreditation of individuals' skills and Investors in People status, and ensuring that training providers are responsive to the needs of business.

However, this improvement will only have a gradual effect on overall UK skills levels. Two-thirds of today's workforce will still be in the labour market in 2020, and more than one third - over eight million people - have qualifications below level 2, with many of these also lacking basic skills. A faster improvement in the UK skills base can therefore only be achieved by updating and improving the skills of people already in the workforce.

Training

3.89 Although some data suggest that the UK has a relatively high training participation rate by international standards, training opportunities are unevenly spread, as highlighted by the PIU in their recent report on workforce development in the UK:

- people with higher qualifications are more likely to receive training than those with lower qualifications, as shown in Chart 3.3; and
- employees of small firms are much less likely to receive training than those working for large firms. Only 36 per cent of firms employing fewer than 25 people provide off-the-job training, compared with 92 per cent of firms with more than 200 employees.

3.90 The uneven spread of training opportunity reflects significant market failures in the provision of workforce training, which have been further analysed by the PIU in their recent work. For example:

- employers may under-invest in training because they may not be able to capture all the benefits of their investment, for example if trained employees leave. Unless training pays off quickly or is not very transferable, firms may therefore be reluctant to provide training to their workers;[3]

  Chart 3.3: Percentage of employees receiving training in the last four weeks by highest qualification

- information problems increase the likelihood that employees may not be able to judge the quality of their training or appreciate the benefits, therefore reducing their willingness to accept lower wages during the training period or to receive any training at all.[4] This is supported by the fact that motivation to train is higher among those with more training;[5]
- insufficient information is also likely to cause firms to provide less training if they are uncertain about the benefits of training in terms of increased worker productivity. As a result of the difficulties firms have in assessing improvements in productivity, they are more likely to offer training to those employees who have already demonstrated that they can achieve higher skill levels, meaning that those workers with the fewest qualifications receive the least training; and
- credit market imperfections can restrict training as low-paid employees are likely to be credit-constrained and unable to obtain loans to finance training. Small firms may also face credit constraints and cash flow problems which inhibit their willingness to contribute to training.

A vision for UK skills

3.91 To deliver a long-term improvement in workplace training, and to tackle the market failures that restrict training opportunities, government, employers and individuals must all play a role, as emphasised by the PIU and the CBI-TUC in their recent work. While training offers significant benefits for both individuals and employers - through higher wages for individuals and higher productivity for employers - the existence of market failures, especially at lower skill levels, and the social benefits of a more highly skilled workforce, provide a strong justification for government intervention. The PIU report on workforce development concludes, and the Government agrees, that although the top priority is to target individuals who need to aquire basic skills, the long-term ambition should be that all adults have the opportunity to achieve a level 2 qualification.

3.92 In order to realise this ambition, it is necessary to increase the demand for training. The PIU set out options for a workforce development strategy in their recent report on the subject which has stimulating demand as its key objective. The Government strongly supports this analysis, and the policy approach explored below places increasing demand at its centre. The CBI-TUC skills working group have also noted that "the importance of increasing demand [for training] cannot be overstated".[6] It is, of course, also necessary to ensure that supply is efficient and tailored to the needs of learners - this is also explored below.

3.93 The Government shares the vision set out by the PIU that: "In 2010, the UK will be a society where government, employers and individuals actively engage in skills development to deliver sustainable economic success for all". The UK needs to achieve a step-change in workforce training if it is to achieve the improvements in skills required to help close the productivity gap. The Government is committed to encouraging a culture of work where training is available to all who need it, and where workforce development is a priority for all firms.

3.94 In the Enterprise Statement, the Government made a commitment to set a new ambition for adult skills. The Government has already set a target to reduce the number of people without basic skills by 2004. In the 2002 Spending Review, it will consider what targets should be set for the future to reduce the numbers of adults in the workforce both without basic skills and who have not achieved level 2 by 2010. These targets will be delivered both through increasing the demand for training among individuals lacking basic skills and level 2 qualifications and improving the quality and efficiency of supply (the proportion of demand that is converted into skills and qualifications). In setting the targets, the Government will work closely with the Learning and Skills Council (LSC).

3.95 There is considerable scope for working towards such targets through the better use of existing resources. Demand for training can be increased through continuing to improve the effectiveness of current initiatives such as the basic skills strategy "Skills for Life", the University for Industry and Union Learning Representatives. Improving supply can be achieved through continuing improvements in the success rates (the numbers of people who reach the end of a course and obtain a qualification) of the Further Education (FE) sector. The flow of better qualified school leavers into the labour market as a result of the Government's investment in education will also have an impact, but there will remain a large percentage of the workforce without level 2 qualifications.

3.96 To make a significant difference in the number of people without basic skills and level 2 qualifications, which would allow the UK to begin to close the skills gap with its main competitors, would require the Government to introduce a new training policy that minimises deadweight through ensuring that employers and individuals also meet their responsibilities in this area.

Increasing the demand for training

3.97 In Budget 2001, the Government made a commitment to consider ways in which training for those with lower levels of skills could be encouraged, through the tax system and other mechanisms. Since then, the PIU report has been published and, building on the PIU analysis, the Government is considering the case for a range of options including a tax credit or other financial incentive as part of the pre-Budget process, alongside the continuing work of the PIU leading up to the 2002 Spending Review.

3.98 In Budget 2001, the Government also said: "the current voluntary approach has secured increased participation in workplace training since 1995, but this is not enough. The scale of the problem is significant and the Government agrees with the National Skills Task Force that tackling this 'chronic UK problem of low skilled adults' must be a priority, and that a step change on the part of all - employers, individuals and government - is required".

3.99 It is clear that, on the basis of current measures alone, the UK is unlikely to attain the levels of human capital which could provide the basis for productivity growth to close the productivity gap. This is an issue of training type and quality as well as of volume. Voluntary training policies of the past have often failed to reach those with the lowest levels of skills who need most government support to train. The Government will be especially concerned to ensure that any tax credit or other financial incentive avoids high deadweight costs by encouraging training by those individuals who would not otherwise be offered the opportunity by their employers.

3.100 Government must play its part to ensure that all workers have access to the training they need by dealing with market failures, and supporting individuals and employers in their efforts to increase skill levels. The Government has already announced, and allocated very substantial resources to, a basic skills strategy to tackle the high levels of poor literacy and numeracy among adults.

3.101 Sir Claus Moser's 1999 report, *A Fresh Start,* highlighted the UK's basic skills deficiencies. This estimated that up to seven million adults (one in five) in England have literacy skills at or below those expected of an average 11 year old, and that even more (one in four) have a problem with numeracy. To tackle this problem, the Government has introduced successful strategies to improve literacy and numeracy results in primary schools and also launched "Skills for Life", a national strategy for improving adult literacy and numeracy, in March 2001. "Skills for Life" includes a new basic skills infrastructure, extensive information and publicity and free courses for learners. In the short time that it has been in place this strategy has proved successful, with at least 70,000 learners having improved literacy and numeracy skills by the end of August 2001.

3.102 While basic skills has rightly been at the centre of the first stage of the Government's skills agenda, and must continue to be the first priority, it is right also to make a start at supporting individuals to progress onwards from basic skills. Level 2 is effectively the minimum standard that 19 year olds are now expected to have acquired. The Government wants those in the adult workforce who, possibly through no fault of their own, have not attained level 2 qualifications, to have the opportunity to do so.

3.103 In order to achieve the kind of culture shift which will be required to have an impact on training and productivity in the UK, and avoid the deadweight costs which have undermined previous policy initiatives, the Government is now considering new policy approaches to encourage training for lower-skilled workers in the UK, building on the recent work of the PIU in this area. The Government is already looking at possible fiscal measures to improve UK skills. The PIU set out a range of options to overcome barriers to training, one of which is a statutory right to time off for training and development. The Government is considering this suggestion as one of the possible ways of taking forward the commitment made in Budget 2001 and will carry out a full regulatory impact assessment and wide consultation on the development and implementation of any new policy.

3.104 One approach being considered by the Government, to follow on from the work of the PIU and build on existing basic skills policy, life-long learning initiatives, and the commitment shown to improving education since 1997, would consist of four complementary, linked elements, which would require commitments by all stakeholders - government, employers and individuals:

- financial support for employers whose staff take time off to train to acquire basic literacy, numeracy and ICT skills and to progress to level 2, with additional financial incentives for small firms. This financial incentive could be delivered through a tax credit or other mechanism. The Government will consult on these options, which will be developed jointly with DfES and alongside the wider work of the PIU;
- free learning provision and accreditation for employees without level 2 qualifications, to work towards recognised qualifications in areas which could raise productivity, up to the level 2 standard, with approved providers. This would build on the current provision of free courses for basic skills under the Government's "Skills for Life" initiative;
- some form of arrangement for individuals to take up training - such as a minimum entitlement for all employees who have not attained basic skills or level 2 qualifications to paid time off each year to train towards the standard. The Government will explore through pilots different possible time periods. Such arrangements would also help ensure the effectiveness, and minimise the deadweight cost, of any tax credit or other financial support to employers; and
- extended information, guidance and support for employers and individuals taking part in, or considering taking part in, any new system. Among other possibilities, these could include arrangements along the lines of Union Learning Representatives, which have proved successful.

3.105 No one of these four elements alone would be able to deliver a step-change in UK skills: each of the elements is interlinked. As the PIU concluded, there are many factors which limit the amount of training undertaken by workers in the UK, and different policy responses are required to deal with different barriers to training.

3.106 Alongside the wider work being done by the PIU and DfES leading up to the 2002 Spending Review, the Government will launch pilot initiatives in April 2002 (to begin in September 2002) to test out a range of approaches to increasing training levels among those lacking basic skills and level 2 qualifications. The pilots will cover a mix of basic skills alone, and both basic skills and level 2.

3.107 These pilots will test different possibilities to provide evidence with which the Government can take any decisions about a future national policy. The Government, alongside the PIU, will carry out detailed work on proposals for the pilots. The Government will consult employers and other stakeholders on the detailed design and implementation of the pilots, which will be cash limited, to ensure that they are as effective as possible. The pilots will focus on both basic skills and progression to level 2. To identify the most effective and efficient way forward, different pilots will test a number of elements:

- the level of financial support needed to compensate employers for the time their employees spend on training. Different pilots will offer compensation of 100 per cent or more of wage costs, up to 150 per cent, for small employers, with less than 100 per cent for the largest employers;
- the amount of time low-skilled employees would be entitled to devote to training on full pay. The pilots will test periods of between 35 and 70 hours of paid time off each year;
- incentives and rewards for successful completion of courses; and
- levels of subsidy, up to 100 per cent, for course and accreditation costs.

3.108 Possible structures for pilots would be:

- **pilot 1:** where all employees without basic skills were entitled to 35 hours (5 days) of paid time off each year for free courses to acquire these skills, the pilot would offer employers financial support equivalent to, say: 125 per cent of wage costs in the case of small firms; less than 100 per cent for the largest firms; and
- **pilot 2:** where all employees who have not attained skill level 2 were entitled to 70 hours (10 days) of paid time off each year for free courses to acquire these skills, the pilot would offer employers financial support equivalent to, say: 150 per cent of wage costs in the case of small firms; less than 100 per cent for the largest firms.

3.109 The Government will also be considering the other proposals in the CBI-TUC report on skills.

Improving the supply of training

3.110 If employers, government and individuals are to see an effective return on increased investment, the UK needs a network of high quality responsive training providers who can translate increased demand into successful learning outcomes. The PIU report recognised this. The Government has a responsibility to ensure that publicly funded provision offers value for money; and that learners benefit from a challenging and rewarding experience which ultimately leads to successful outcomes. The UK needs provision which encourages individuals to take control of their learning, helping to deliver the Government's objective of developing in everyone a commitment to lifelong learning.

3.111 The Government has radically reformed the framework for the provision of training. The new Learning and Skills Councils (LSCs) will be able to form regional and national strategies which ensure that the needs of employers are met by training. However, there is more that must be done. As the PIU report has emphasised, government needs to ensure that the institutions providing training are delivering high quality training and learning. The FE sector caters for around 3.8 million students studying for about 5.3 million qualifications. Of these students, around 20 per cent are aged 16-19, the rest being adult learners. The FE sector currently provides around 54 per cent of vocational qualifications, and its performance is crucial to the success of any attempt to increase training and skills in the UK workforce.

3.112 Performance in the FE sector has improved in recent years and the best FE colleges perform very well, with success rates of over 70 per cent. However, average success rates remain too low and performance is too varied. Average success rates for learners older than 19 are only 51 per cent and there are a number of colleges whose success rates are lower than 45 per cent. Achievement rates[7] vary between 63 per cent in colleges in the 10th percentile and 89 per cent in colleges in the 90th percentile. There is room for improvement in the sector if those colleges which perform less well could be brought up to the level of the rest. Variation in performance seems to be closely connected with leadership and governance, focus and mission in individual institutions, and the quality of teaching.

3.113 The introduction of the LSC makes possible a much more targeted approach to improving the supply-side, with the LSC taking a strategic role in enhancing workforce development capacity at the sub-regional level. The Government will consider in the lead up to the 2002 Spending Review how to support change in the sector, to encourage investment in modernisation, and to reinforce and spread excellence, provided that the supply-side responds to the opportunities and challenges it faces. This will help deliver the improved success rates and transformed relationships between providers and local labour markets which are needed to make the UK's workforce development system world-class.

Modern apprenticeships

3.114 Foundation and Advanced Modern Apprenticeships provide young people with a high quality, work-based route to national vocational qualifications at levels 2 and 3 respectively, increasing the supply of skills at craft, supervisory and technician levels within industry. The Government is committed to building on the strong foundations of Modern Apprenticeships by raising their status and quality: increasing the knowledge and understanding content of the scheme and offering an entitlement to a place for all those young people with the necessary ability and aptitude who meet the entry criteria.

Higher education

3.115 Higher education is central to the development of a highly skilled workforce in the long term and has wider social and economic benefits. The Government has therefore set an ambition that 50 per cent of young people will have the chance to participate in higher education by 2010. To fulfil this ambition, it is pursuing three objectives:

- **widening access to higher education:** people in lower socio-economic groups remain far less likely to go to university than those in higher groups and the discrepancy is expanding. In 1997-98 the higher education participation rate among those in Social Class 1 (professional) was 80 per cent, compared with just 14 per cent for people in Social Class 5. To address this imbalance, the Government is currently conducting a review of student finance arrangements to consider how best to support students from poorer backgrounds. The Government will consult on proposals during 2002;
- **improving teaching funding:** the current funding system restricts the ability of universities to respond to demand and to build on their comparative advantages. The Government is committed to creating a set of funding incentives which allows universities to play to their individual strengths; and
- **minimising regulation:** The Higher Education Funding Council has consulted on proposals for reducing the administrative burden on universities to ease pressures in the sector. The Government is now considering additional options for ensuring that prospective students can access comparable information on university performance and for ensuring that all universities meet minimum standards of academic quality.

Work Permits

3.116 The Government is committed to developing a modern system of managed migration that will meet the UK's labour needs in an increasingly competitive global marketplace. The number of work permits issued has risen significantly since 1997, with applications rising from 60,000 to an estimated 145,000 for this year. From January 2002, highly skilled individuals living abroad will be able to apply for a new points-based programme - the Highly Skilled Migrant Entry Programme. The Government is also consulting on lower skilled entry routes to alleviate pressures on sectors facing recruitment difficulties, and has established a Ministerial Committee on illegal working.

[1] See, for example, Geroski: *Innovation, Technological Opportunity and Market Structure*, Oxford Economics Papers 42, July 1990, and S Nickell: *Competition and Corporate Performance*, Journal of Political Economy, 104 (4) 1996.[Back]

[2] See, for example, N Oulton: *Why do foreign-owned firms in the UK have higher labour productivity?* in N Pain: *Inward Investment, Technological Change and Growth*, Macmillian Press 2000.[Back]

[3] R Cassan and G Mavrotas: *Education and Timing for Manufacturing Development,* in M Godfrey: *Skill Development for International Competitiveness*, Institute of Development Studies, University of Sussex, 1997.[Back]

[4] M Stevens: *Human Capital Theory and UK Vocational Training Policy*, Oxford Review of Economic Policy, Volume 15, Number 1, pp. 16-32.[Back]

[5]National Skills Task Force, 2000, Third Report p. 28.[Back]

[6] CBI-TUC submission to the productivity initiative, p. 20.[Back]

[7]Achievement rates express the proportion of those completing a course who achieve a qualification.[Back]

4 Increasing employment opportunity for all

The Government's long-term employment goal is that, by the end of the decade, there will be a higher proportion of people in work than ever before.

The Government has taken tough action to tackle structural weaknesses and improve the underlying strength of the UK labour market. The New Deal has helped to reduce unemployment among young people and has been extended to provide extra help for the long-term unemployed, lone parents and other disadvantaged groups. Because of this solid foundation, Britain now has a strong base from which to face challenging economic times.

The Government is determined to advance its goal and to achieve employment opportunity for all in every region - the modern definition of full employment. In times of economic uncertainty, flexible working practices and responsive employment policies are vital to ensure that the labour market is able to adapt without generating higher structural unemployment. Building on the progress it has already made, the Government is now taking steps to:

- improve support for people affected by large-scale redundancies, especially in deprived areas, **by strengthening the Job Transition Service;**
- **tackle economic inactivity in the labour market**, ensuring that all working age benefit recipients are given work-focused support via a new organisation, Jobcentre Plus, that will radically change the way in which the Government helps working age citizens;
- provide further help for communities with concentrations of long-term unemployment, ensuring that employment opportunity is extended via **pilots of a transitional employment scheme;** and
- tackle poor work incentives and persistent poverty among working people by **introducing a new Working Tax Credit from 2003** that will extend in-work support to people on low incomes without children.

INTRODUCTION

4.1 The Government's long-term employment goal is that, by the end of the decade, there will be a higher proportion of people in work than ever before.

4.2 Worklessness, particularly on a long-term basis, represents an unacceptable waste of human resources. The long-term workless are at risk of becoming detached from the labour market. Reintegrating them back into the labour market is central to increasing the effective supply of labour. Alongside measures designed to raise productivity - increasing the amount of output produced per worker - expanding the supply of labour is vital to improve the economy's long-term growth potential.

4.3 Worklessness is also an unnecessary source of misery and degradation for those affected and is one of the most important causes of child poverty and persistent poverty - 61 per cent of all poor households with children are workless. The Government's objective of halving child poverty in ten years and eliminating it within a generation is therefore supported by measures designed to deliver a substantial reduction in the number of families with no one in work. Extending employment opportunities for these families will help break the cycle of deprivation that puts their children at greater risk of detachment from the labour market in adulthood.

4.4 Poor work histories are also likely to lead to poverty in retirement. Enhanced employment opportunities will therefore enable more individuals to build up pension assets to support themselves in old age, contributing to the Government's objective of tackling pensioner poverty.

Delivering employment opportunity for all

4.5 To achieve its goal of full employment in every region, the Government is pursuing a comprehensive strategy to deliver employment opportunity for all - the modern definition of full employment.

4.6 Macroeconomic stability is a prerequisite for achieving this aim. Chapter 2 describes how the Government is working to maintain stability, avoiding the cycle of boom and bust that destroys jobs and leaves people detached from the labour market. But stability alone is not enough. In an uncertain global economic environment, it must be supported by flexible working practices and by responsive employment policies to ensure that the labour market is able to adapt without generating higher structural unemployment.

4.7 To advance its long-term goal the Government is therefore also implementing a broad-based microeconomic strategy designed to address structural weaknesses in the labour market and ensure that individuals throughout the country are able to compete effectively for jobs. The main elements of this strategy are:

- Welfare to Work policies that help unemployed people search and compete effectively for jobs, and help re-attach the long-term unemployed and economically inactive to the labour market;
- reforms to make work pay. Unemployed people are understandably reluctant to take up work if it makes them worse off, or not much better off. The introduction of the Working Families' Tax Credit (WFTC) and reforms to national insurance contributions (NICS) and income tax have increased the returns to working compared with remaining on welfare. Alongside the minimum wage, these reforms mean that the Government can guarantee a minimum income in employment for all individuals; and
- help with the return to work, by removing barriers to work and ensuring that people are financially secure when moving from welfare to work.

4.8 Labour market policies build on the foundations of education and training measures, as set out in Chapter 3, which seek to provide individuals with the skills they need to obtain work and to make progress once they are in work.

4.9 This strategy has helped to deliver a substantial improvement in Britain's labour market in recent years. Around $1^1/_4$ million more people are in work today than in spring 1997, with recent Labour Force Survey (LFS) employment rates close to historic highs. Structural unemployment has also fallen sharply. At just 5.1 per cent, International Labour Organisation (ILO) unemployment is currently close to its lowest level since the 1970s, while the claimant count measure remains below one million - the first time this has been achieved since the mid-1970s. Employment rate has risen and unemployment fallen in every UK region.

Chart 4.1: UK employment and ILO unemployment rates

4.10 The robust performance of Britain's labour market has been underpinned by improvements in its underlying strength. Since 1997, the New Deal programmes have helped to reduce long-term unemployment among young people by more than three quarters and among the over 25s by more than two thirds[1]. The extension of the New Deal to lone parents and other disadvantaged groups has helped to address the structural barriers to work faced by the economically inactive in the labour market. Because of this groundwork, Britain now has a strong base from which to face challenging economic times and a solid platform from which to advance the Government's long-term goal.

4.11 Despite this progress, significant challenges remain. Too many people still face obstacles in returning to work, and opportunities in the labour market remain unequal. In particular, the employment rates of lone parents, people with disabilities, ethnic minorities and the over 50s are well below the overall average. Pockets of high unemployment also persist in certain deprived areas and in six per cent of local authority districts, employment is at least ten percentage points below the national average.

4.12 The Government is therefore determined to continue its work to dismantle the barriers that discourage and prevent people from finding and succeeding in work. This chapter explains how the Government is now:

- continuing to **tackle unemployment**, preventing newly unemployed people from becoming detached from the labour market and providing targeted and tailored assistance for the long-term unemployed;
- **helping the economically inactive**, by taking action to address the difficulties faced by certain disadvantaged groups, including lone parents and disabled people, as they seek to rejoin the labour market;
- **tackling regional worklessness**, addressing the barriers that prevent local people taking up the supply of local jobs in some of the most deprived areas of the country; and
- **making work pay**, improving work incentives by tackling the poverty and unemployment traps and **easing the return to work**.

TACKLING UNEMPLOYMENT

4.13 There are currently around 950,000 unemployed people claiming Jobseeker's Allowance (JSA), but around three million new claims are made every year. This dynamic pattern in the labour market means that worklessness is a short-term experience for most people who become unemployed. Indeed, 75 per cent of JSA claims end within six months, and over 90 per cent end within one year.

Job Transition Service

4.14 However, those who remain unemployed for longer periods risk becoming detached from the labour market. The Government's Welfare to Work strategy is therefore designed to combat long-term unemployment, providing people with the skills and opportunities they need to find and remain in work.

4.15 Even in a strong economy, it is inevitable that redundancies will occur, and the majority are naturally absorbed by a healthy labour market. However, some redundancies can have a devastating impact on local economies, especially when they occur in areas of high unemployment or where the local economy is overly dependent on one industry. To coordinate and enhance support for such areas, the Government has introduced a new Job Transition Service (JTS). The JTS provides support for communities affected by large-scale redundancies, focusing on the needs of individuals, and works closely with employers who are able to offer new jobs.

4.16 In recognition of the increased risks to global growth and recovery, and in order to enhance further the strategic work of the JTS, **the Government is allocating additional resources to strengthen the Job Transition Service over the next two years.** The Government is also bringing together the Job Transition Service with the Rapid Response Fund, which seeks to equip people affected by large-scale redundancy with new skills where a potential new employer has identified the skills required for such people to be offered new jobs.

Tackling long-term unemployment

4.17 To prevent newly unemployed people from becoming distanced from the labour market, jobseekers attend mandatory fortnightly interviews with Jobcentre advisers. After six months a variety of more intensive help becomes available. This extra help includes a range of training options, as well as work trials and business start-up advice. For many, this provision is sufficient to secure a return to work.

New Deal

4.18 For those who experience greater difficulty, the New Deal provides additional help to find jobs, progress within employment and increase long-term prospects. The New Deal is central to the Government's Welfare to Work strategy for the long-term unemployed and is unique in the continuity and support offered by personal advisers to each participant in the scheme. This tailored assistance has contributed significantly to the success of the programme.

4.19 The New Deal for young people (NDYP), for 18 to 24 year olds, and the New Deal for 25 plus (ND25+) provide help and support for people seeking employment. These programmes offer a structured Gateway period, involving regular contact with personal advisers, access to job search support, and help in addressing basic skills gaps. At the end of the Gateway period, each scheme offers a range of options, including access to training and subsidised employment. For those who are unable to find work, a follow through period provides more intensive help with job search, building on the skills and experience obtained under the New Deal.

Chart 4.2: Long-Term Unemployment, Youth and 25+

4.20 The New Deal for young people has been a success in its first four years of operation. Over the course of the last Parliament, the NDYP surpassed its target of helping 250,000 long-term unemployed 18 to 24 year olds back into work. The ND25+ has also helped nearly 75,000 long-term unemployed people to find jobs. To build on this performance, the Government is now introducing further measures to increase the effectiveness of the New Deal programmes, including:

- **piloting greater flexibility in the Options section of NDYP from November 2001** to give personal advisers more freedom to tailor the provision of support to meet the needs of individual clients, local employers and local labour markets; and
- **establishing a pilot mentoring scheme from January 2002** to assess how mentoring can best be used to improve employment chances and job retention under the New Deal. To improve take-up, the pilot scheme will run on an opt-out, rather than an opt-in, basis.

Employment Zones

4.21 The Government is continuing to test new methods of helping people to find work. Employment Zones (EZs) are testing an alternative approach to helping long-term unemployed people aged 25 and over. EZs differ from ND25+ in that jobseekers and their personal advisers are able to set up Personal Job Accounts to make more flexible use of the funds available to overcome individual barriers to work. EZs are currently being tested in 15 areas of England, Scotland and Wales.

Over 50s

4.22 People over 50 often face specific barriers to work. They may have been without work for a substantial length of time and may therefore be particularly remote from the labour market. For most of the 1980s and early 1990s, the employment rate of men aged over 50 fell, while women over 50 failed to experience the marked increase in labour market participation seen among younger women. While their overall employment position has improved in recent years, at 68 per cent the employment rate of people aged between 50 and state pension age is still well below the national average.

4.23 The New Deal for the over 50s (ND50+) seeks to combat this trend, offering a package of personal advice, help with job search, an Employment Credit (EC50+) and in-work training and support. By autumn 2001, around 51,000 people had returned to work via ND50+. The EC50+ was found to increase job search activities for around half of programme participants, and evidence suggests that 42 per cent of claimants would not have taken the job they are in without the credit. The Government is now building on the success of the EC50+ with a new Working Tax Credit (see Box 4.3).

Strengthening partnership with employers

4.24 Employer involvement is crucial to the success of all employment programmes, including the New Deal. Many sectors have high levels of vacancies that could be filled through New Deal and other programmes. Matching the needs of employers with the skills and experience of jobseekers therefore requires a partnership between labour providers and employers themselves. To strengthen relationships with local employers, and ensure that their needs are met through local provision, the Government is creating Local Account Managers for all Jobcentre Plus Offices. They have already taken up post in 15 of the Jobcentre Plus pathfinder offices, with full national rollout planned for April 2002.

Box 4.1: Retention and advancement

Retaining a job and advancing in work can be particularly difficult for those who have just moved off welfare. This is especially true for women, lone parents and people without qualifications. Of those people who move off Jobseeker's Allowance into work, 25 per cent return to benefits within three months, and 40 per cent return within six months. The wages that people return to work on are also typically lower than for those already in work.

Low wages are of less concern if people face them for short periods of time and are able to progress up the earnings ladder out of in-work poverty. However, some people experience a 'low pay-no pay' cycle, moving from a low-paid job into unemployment, and re-entering work in another low paid job. Duration of unemployment seems to have a proportional, and permanent, effect on earnings. Repeated lengthy spells of unemployment may badly affect earnings. Keeping people in work is therefore a precondition to their achieving wage progression and avoiding a return either to unemployment or to the low pay-no pay cycle.

Over the next three years, the Government will run demonstration pilots to learn more about how best to improve job stability and advancement among low-paid workers, helping people to remain, and progress, in work. As described in Chapter 3, the Government is also proposing to pilot new opportunities for low-skilled employees to train towards basic or level 2 skills.

HELPING THE INACTIVE

4.25 High levels of economic inactivity are a waste of human resources and a constraint on Britain's long-term economic growth potential. The Government is publishing shortly a new paper, *The Changing Welfare State: Employment Opportunity for All*, which examines current labour market inactivity in detail.

4.26 There are currently around 7.8 million people of working age who are economically inactive - neither working, nor looking for work. In part, this reflects the serious problems and challenges faced by certain groups in society including ethnic minorities, the long - term sick and disabled, the over 50s and lone parents. Chart 4.3 compares the inactivity rates for these groups with that for the labour force as a whole.

4.27 Tackling the causes of inactivity is central to the Government's strategy for achieving employment opportunity for all. It is a vital challenge. Some 2.7 million people of working age currently claim out-of-work sickness and disability benefits, while numbers of Incapacity Benefit (IB) claimants and lone parents on benefit have trebled in the last 20 years. The Government is committed to taking steps to address the difficulties faced by these groups and to help them rejoin the labour market.

Chart 4.3: Inactivity Rates of Selected Groups in the Population of Working Age (spring 2000)

Jobcentre Plus

4.28 In October 2001 the Government launched Jobcentre Plus, a new business to deliver work-focused support to all benefit claimants of working age, both unemployed and inactive. Starting in 49 pathfinder offices across the country, Jobcentre Plus is at the heart of the Government's strategy for an "employment-first" service, with rights and responsibilities balanced at every stage. It marks a radical change in the way in which the Government helps working age citizens, delivering an active service to help people become independent and move from welfare into work.

4.29 Jobcentre Plus brings together the Employment Service and those parts of the Benefits Agency dealing with working age people. It aims to help unemployed people and inactive welfare recipients who can work to fulfil their responsibilities by making available
high-quality job vacancies, information, advice, training and support, while ensuring security for those who cannot work. Anyone making a claim for benefit at a Jobcentre Plus office, unemployed or inactive, will receive an interview with a personal adviser to discuss the opportunities available for taking up work. This will put an end to the old system under which inactive benefit recipients received little, if any, help with finding work.

Helping lone parents

4.30 Lone parents face particular difficulties in seeking to balance work and caring responsibilities. During the 1980s the employment rate of lone parents fell significantly. In 1979, two-thirds of children in lone parent households lived with a parent who was in work. By 1996 this proportion had fallen below one half. The employment rate of lone mothers has also failed to keep pace with the general rise in female employment, falling far short of the 71 per cent employment rate of mothers in couples.

4.31 In more recent years, lone parent employment rates have increased significantly, from 44.7 per cent in 1996 to 51.5 per cent in 2001 - their highest level in 20 years. This has been accompanied by a fall in the number of lone parents on Income Support by over 150,000 since 1996 to the current level of 888,000. But there remains much to do. Helping lone parents into work is key to reducing child poverty and the Government has therefore set a target for 70 per cent of lone parents to be in work by 2010.

Chart 4.4: Employment rate of lone parents and numbers on Income Support

New Deal for lone parents

4.32 The New Deal for lone parents (NDLP) provides a comprehensive package of support to enable lone parents to improve their prospects and living standards through employment. The programme provides a personal adviser, assistance with training, education and childcare, and advice on benefits, in-work financial support and self-employment. From November 2001, eligibility for NDLP was extended to include all lone parents who are not working, or who are working less than 16 hours a week, whether or not they are on Income Support, which has made NDLP support available to an additional 106,000 lone parents.

4.33 Evaluation evidence indicates that the NDLP is having a real and positive effect. By the end of August 2001, over 225,000 lone parents had participated in the New Deal, and over 96,500 had found employment through the programme.

Personal Adviser meetings

4.34 The Government is committed to enhancing the choices open to lone parents in the labour market. To ensure that they are offered the opportunity to work, and the support they need to do so, the Government has introduced personal adviser meetings for lone parents across the country. From April 2001, lone parents on Income Support with children over the age of five have been required to attend a meeting to discuss the choices available to them. These choices, which were enhanced from April 2001, now include help with education and training, the opportunity to try work of less than 16 hours a week while remaining on benefit, and extra financial support for those working more than 16 hours. Feedback from the pathfinder meetings suggests that many lone parents have found the programme valuable as a direct catalyst to work.

Assistance with childcare

Childcare and employment

4.35 Lack of access to suitable childcare can be a significant barrier to parental employment. This is particularly the case for women and lone parents, whether they are entering the labour market for the first time or returning after having children. It is reflected in lower economic activity rates among mothers compared with fathers (partly due to the uneven burden of childcare responsibilities), and among mothers with young children compared with women without children.

4.36 Access to childcare also has an impact on work retention and career progression, and is therefore important in tackling in-work poverty. A large proportion of mothers work part-time. While many choose to do so, many others would prefer to move towards full-time work if they had access to suitable childcare, since part-time work often means lower earnings potential and fewer opportunities for career progression. The Women and Equality Unit and H.M. Treasury are currently examining the implications of these patterns for UK productivity performance.

National Childcare Strategy

4.37 The Government's National Childcare Strategy aims to ensure the provision of affordable, accessible and good quality childcare in every neighbourhood. The Strategy seeks to remedy existing shortfalls in childcare provision by:

- making childcare more affordable for lower and middle-income working families through the childcare tax credit component of the Working Families' Tax Credit and the Disabled Person's Tax Credit; and
- providing time-limited, supply-side grants where there may be market failures - for example, in disadvantaged areas.

4.38 The Strategy is providing significant investment to expand the number of childcare places available across the country. Between April 1997 and June 2001, new childcare places have been created that have helped 773,000 children. Taking account of turnover in existing places, this has allowed an extra 455,000 children to benefit. By March 2004, the Strategy will have created additional places benefiting around one million extra children in England alone.

4.39 The Government has also set an ambition to offer a childcare place to every lone parent entering employment in the most disadvantaged areas. The Neighbourhood Childcare Initiative will create 45,000 new day care places in up to 900 Neighbourhood Nursery Centres in these areas. The Initiative will also support the establishment of 25,000 new Neighbourhood Childminder places as part of a 145,000 increase in places nationwide.

4.40 In addition to making childcare more affordable and creating new childcare places, Budget 2001 extended eligibility for the Adviser Discretion Fund to lone parents who have been on Income Support for over six months. This will provide help with the up-front childcare costs that many lone parents face in seeking to move from welfare to work.

Help for partners

4.41 Over the past 20 years, polarisation of employment opportunities has led to a significant rise in the proportion of workless households. In couples with one unemployed or economically inactive partner, the probability of the other being in work is greatly reduced. In Britain, less than 40 per cent of partners of benefit claimants are in work. The majority of these workless households have children and are in poverty.

New Deal for partners

4.42 The New Deal for partners is a voluntary personal adviser service to help partners of people on benefit move into work. Since April 2001, childless partners of unemployed people born after 1976 have become joint Jobseeker's Allowance claimants, subject to the rights and responsibilities of the JSA regime. **Budget 2001 announced that, from October 2002, joint claimant status will be extended to all childless partners of the unemployed born after 1957.**

4.43 To ensure that all partners of benefit claimants are offered the help and support they need to return to work, **the Government will also be legislating to introduce compulsory work-focused interviews for partners of benefit claimants with children** in line with those being provided to lone parents.

Help for disabled people

4.44 People with disabilities or long-term ill-health are among the most disadvantaged in the labour force and account for 30 per cent of the economically inactive population.

4.45 Over the last 20 years, the employment rate of people with disabilities (including those with long-standing health problems) has fallen significantly compared with that of the rest of the population. Despite a rise since 1998, the employment rate of disabled people, at 47 per cent, remains substantially below the rate for those without disabilities, of 81 per cent. Although the proportions of the working age population reporting limiting longstanding illnesses have risen only slightly over the last 20 years, the proportion of people who are out of work and claiming Incapacity Benefit has more than doubled over this period. The number of IB claimants now stands at 2.3 million.

4.46 According to the Labour Force Survey, as many as 1.4 million people with disabilities are currently without work but want to work. The Government believes that people with disabilities who can work should be provided with the support they need to return to work and to fulfil their potential.

Chart 4.5: Percentage of working age population on an incapacity-related benefit

New Deal for disabled people

4.47 Since October 1998, the New Deal for disabled people (NDDP) has been testing a range of approaches to determine what works best in helping disabled people search effectively for, and find, work. By the end of June 2001, over 20,000 disabled people had taken part in NDDP pilot schemes and over 8,000 had found work as a result. Following this success, the Government began extending NDDP to all areas of the UK in July 2001. The national extension of NDDP will provide a gateway to engage those moving onto Incapacity Benefit, and a network of innovative job brokers to help disabled people find secure employment.

4.48 In addition to NDDP, the Government is taking further steps to help disabled people make the transition from inactivity to work. As announced in the Employment Green Paper, the Government is modernising and expanding supported employment programmes for the disabled. The Government is also ensuring that benefit rules ease the transition from inactivity to employment by **introducing new permitted work rules for those on Incapacity Benefit. From April 2002, people on IB will be able to try small amounts of work without affecting their benefit entitlement.** New rules will allow claimants to undertake up to 12 months of permitted work, for up to 16 hours a week, and earn up to £66 each week. This includes the £20 a week all claimants will be allowed to earn with no hours or time-limit.

Retention and Rehabilitation Pilots

4.49 **To support disabled people already in employment, a series of regional Retention and Rehabilitation pilots will be launched from 2002.** These pilots will focus on workers at risk of losing their job because of illness or disability, testing integrated health and employment interventions to maximise the retention in work of sick and disabled employees.

TACKLING REGIONAL WORKLESSNESS

4.50 While every region in Britain has experienced sharply falling unemployment and rising levels of vacancies in recent years, pockets of high unemployment persist in certain deprived areas within every region. Particular groups within the population also continue to experience high, and in some cases rising, levels of worklessness.

4.51 Employment and unemployment rates vary from area to area. Geographic differences in work and worklessness are much wider within regions than between them, with areas of particularly low employment usually evident at local authority district, ward or even sub-ward level. In a few cases, groups of adjacent local authority districts all have particularly low employment rates - East London, areas of Merseyside, the South Wales valleys and a strip of areas along the coast in the North East. In a small number of districts - 26 out of 408 - employment rates remain at least ten percentage points below the national average. Chart 4.6 below shows employment rates across UK local authority districts.

Chart 4.6: Employment rates by local authority district ranked from lowest to highest

4.52 Local authority districts with low employment rates do not simply lack jobs. Many areas experiencing high levels of worklessness are found alongside others with large numbers of vacancies. In such instances, measures to boost local labour demand alone will not address labour market difficulties. Policies need to address the barriers that prevent local people taking up the supply of local jobs.

4.53 Areas with low employment rates also often contain a high proportion of people on sickness and disability related benefits, or a significant proportion of people with no or few qualifications. People from ethnic minorities, who suffer much higher rates of worklessness than the population as a whole also tend to live in inner city areas which have low employment rates. The Government's commitment to the goal of full employment in every region therefore requires measures to deliver an inclusive distribution of employment, covering the groups and areas that have in the past been allowed to fall behind the rest of society.

Action Teams

4.54 To tackle the obstacles to employment in some of the worst affected regions in Britain, the Government has established Action Teams for Jobs in 53 areas of England, Scotland and Wales that suffer from particularly high levels of inactivity and long-term unemployment. Action Teams are a dynamic and innovative resource to tackle some of the UK's most deep-seated and protracted employment problems. They set out to help increase employment in disadvantaged areas by:

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

Ethnic minorities

4.55 Focusing assistance through Action Teams will also help significant numbers of people from ethnic minorities, whose unemployment rates can be up to three or four times higher than those for the rest of the population. Some 85 per cent of Britain's ethnic minority population live in four main conurbations - Greater London, the West Midlands, West Yorkshire and Greater Manchester. All four are targeted by Action Teams. To help close the gap further, the Government will work with the Commission for Racial Equality to encourage employers to create more diverse workforces, Jobcentre Plus will maintain a clear focus on parity targets across all areas, and the Government will invest £15 million in ethnic minority outreach over the next three years, through voluntary and community bodies.

4.56 The Cabinet Office Performance and Innovation Unit will report in summer 2002 on the labour market disadvantages faced by black and Asian people, making recommendations for tackling inequalities in the labour market.

Transitional employment

4.57 For the majority of people who enter the New Deal, the programme proves beneficial, with many participants leaving it to enter into employment. However, in areas of deprivation and high unemployment, there are a small number who have multiple barriers to work. While New Deal provision has started the process of overcoming these barriers, there is a need for further assistance to enable these clients to compete effectively in the open labour market. **The Government therefore intends to put in place provision that will build upon their New Deal experience, and will include piloting transitional employment opportunities for these hardest to help groups.** The Secretary of State for Work and Pensions will announce details of this new provision shortly.

Funding for Welfare to Work

4.58 The Welfare to Work programme was originally funded through the receipts of the one-off Windfall Tax on the excess profits of privatised utilities, totalling £5.2 billion. Since April 2001, the programme has been funded from the Employment Opportunities Fund, which brought together the remaining Windfall Tax receipts and additional resources allocated in the 2000 Spending Review.

4.59 The formation of the Department for Work and Pensions (DWP) means that the majority of programmes covered by the Employment Opportunities Fund (EOF) are now delivered by the DWP and its agencies. Most of these resources have therefore been moved into the Departmental Expenditure Limit for DWP. Consequently, the Government will only report on the Windfall Tax element of the Employment Opportunities Fund in this and future Pre-Budget Reports and Budgets. EOF expenditure, both past and planned, will be presented in DWP's Annual Report, in line with the arrangements for other Government departments.

Table 4.1: Allocation of the Windfall Tax

£million	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04[2]	TOTAL

Spending by programme[1]								
New Deal for young people[3]	50	200	310	300	360	300	50	1570
New Deal for 25 plus	0	10	90	110	220	220	50	700
New Deal for over 50s	0	0	5	20	20	20	5	70
New Deal for lone parents	0	20	40	40	100	140	20	360
New Deal for disabled people[4]	0	5	20	10	60	70	10	175
New Deal for partners	0	0	5	10	20	30	5	70
New Deal for Schools[5]	90	270	260	750	450	0	0	1820
Childcare	0	20	10	5	0	0	0	35
University for Industry[6]	0	5	0	0	0	0	0	5
Workforce development pilots[7]	0	0	0	0	0	10	15	25
ONE pilots[8]	0	0	0	5	5	0	0	10
Action Teams	0	0	0	10	60	50	10	130
Enterprise Development	0	0	0	10	20	10	0	40
Modernising the Employment Service	0	0	0	40	0	0	0	40
Total Expenditure	**140**	**530**	**740**	**1300**	**1310**	**850**	**160**	**5030**
Estimated Windfall Tax Margin								**170**
Windfall Tax receipts	**2600**	**2600**						**5200**

[1] Rounded to the nearest £10 million, except workforce development pilots (which are rounded to the nearest £5 million) and where expenditure is less than £5 million. Constituent elements may not sum to totals because of rounding.
[2] Windfall Tax expenditure is significantly reduced in 2003-04 as WT resources are exhausted. Remaining in year expenditure will be topped up with general Government revenues.
[3] Includes funding for the Innovation Fund.
[4] Includes £10million in 1999-00, an element of the November 1998 announcements on Welfare Reform.
[5] Capital spending on renewal of school infrastructure, to help raise standards.
[6] Start up and Developments costs. Other costs of the UfI are funded from within Departmental Expenditure Limits.
[7] The workforce development pilots, described in Chapter 3, are budgeted to cost £40m, of which £25m will come from the Windfall Tax, with the remaining £15m provided by the DfES. Profile of expenditure may be subject to change.
[8] Funding for repeat interviews. Other funding comes from the Invest to Save budget.

MAKING WORK PAY

4.60 Policies designed to help individuals compete in the labour market, such as the New Deal, need to be supported by policies that provide incentives for people to move into work or to take a better paid job. The Government's reforms to help improve work incentives are designed to tackle two key problems:

- the unemployment trap, when those without work find that the difference between in- and out-of-work incomes is too small to provide an incentive to take a job; and
- the poverty trap, when those already in work may be discouraged from working longer hours or taking a better paid job because it may leave them little better off, as in-work support is reduced and they pay more income tax and NICs.

4.61 The Government is committed to tackling these problems by making sure that work pays more than welfare and by improving incentives to move up the earnings ladder.

National Minimum Wage

4.62 The National Minimum Wage, introduced in April 1999, ensures fair minimum standards of pay, thereby underpinning the Government's tax and benefit reforms. From October 2001, the National Minimum Wage rose to £4.10 an hour for workers aged 22 and over and to £3.50 an hour for workers aged 18-21. **Subject to economic conditions, these rates will be increased to £4.20 and £3.60 respectively in October 2002.**

Making work pay for all

4.63 The Government has introduced a series of reforms to help make work pay at all levels of the labour market, but especially for those on low incomes. From April 2000, the basic rate of income tax was reduced to 22 pence - the lowest level for 70 years. The introduction of the 10 pence starting rate of income tax in April 1999 and the subsequent widening of the band in April 2001 have halved the marginal tax rate for nearly two million people in low paid work.

4.64 In addition to reducing income tax rates, the Government's reforms to employees' NICs have helped to ensure that jobs at the lower end of the earnings distribution now pay better. From April 2001, the threshold above which employees pay NICs was increased to align it with the income tax personal allowance. This means that around one 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 new "primary threshold" has been protected.

4.65 From April 2001, employer NICs were reduced by 0.3 percentage points and will be reduced by a further 0.1 percentage points in April 2002. This ensures that all revenue from the climate change levy and the aggregates levy is recycled back to business (see Chapter 7 for details of the climate change levy and the aggregates levy). The Government has also reformed employer NICs to encourage employment.

Box 4.2: The income tax personal allowance, NICs threshold, and WFTC/ DPTC rates for 2002-03

In April 2001, the threshold above which employees begin to pay national insurance was aligned with the income tax personal allowance. **Rising in line with indexation, the income tax personal allowance for 2002-03 will be £4,615 and the NICs threshold will be £89 a week. In addition, the main rates and income thresholds in the Working Families' Tax Credit and the Disabled Person's Tax Credit will be increased in line with indexation from April 2002, the details of which will be announced shortly.**

Additional targeted support

4.66 Families with children have, in the past, faced particularly difficult work incentive problems. To address these problems, the Working Families' Tax Credit (WFTC) was introduced in October 1999. Nearly 1.3 million families are now receiving WFTC - over 400,000 more than received Family Credit at its peak. These families are on average receiving around £35 a week more compared with Family Credit.

4.67 The WFTC includes a generous childcare tax credit component to help working families. The credit is worth 70 per cent of eligible childcare costs up to limits, which were increased in June 2001 to £135 a week for a family with one child and £200 for a family with two or more children. Currently around 145,000 families are benefiting from the childcare tax credit in WFTC, over three times the number that received the Family Credit disregard at its peak.

4.68 The Disabled Person's Tax Credit (DPTC), launched alongside the WFTC, helps to provide support for workers with disabilities. Currently, over 29,000 disabled workers are benefiting from the DPTC by an average of £73 per week - nearly 60 per cent more than received the Disability Working Allowance in July 1999. The DPTC is open to people who work 16 hours or more a week, have an illness or disability which puts them at a disadvantage in securing a job, and who are either receiving, or have recently been receiving, one of a number of qualifying benefits. It is also open to people who satisfy the special rules which govern the "Fast Track" route to DPTC.

Equal Pay

4.69 The Government is committed to driving forward action on equal pay and has commissioned a review into Women's Pay and Employment which will report in December. The review is assessing a range of non-legislative and cost-effective proposals to deliver improvements to womens' employment prospects and participation in the labour market. To provide more effective settlement of pay disputes, the Government is also taking forward measures to speed up and simplify the employment tribunal process.

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

4.70 The Government can now guarantee a minimum level of income for people with children moving into employment. These guaranteed minimum levels of income are set out in Table 4.2, for a family with one child with one person working at the National Minimum Wage.

Table 4.2: Weekly minimum income guarantee

	October 2000	April 2001	October 2001
WFTC family (working 35 hours)	£208	£214	£225
WFTC family (working 16 hours)	£152	£154	£166
DPTC family (working 35 hours)	£240	£246	£257
DPTC family (working 16 hours)	£184	£186	£198

4.71 The Government's reforms are helping to ensure that work pays more than welfare to address the problem of the unemployment trap. The gain to work has increased, while security for those out of work has been maintained and enhanced. Chart 4.7 shows how the gains to work have improved for different households as a result of the measures over the last Parliament as a whole.

Chart 4.7: The gains to work for different households

4.72 These measures have also helped to lessen the poverty trap. Many low income families, who often face very high marginal deduction rates, now keep more of each additional pound that they earn, losing less through reduced benefits and higher taxes. In 1997, almost 750,000 families faced marginal deduction rates of over 70 per cent. As a result of measures introduced by the Government, this number has fallen by nearly half a million.

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

Marginal deduction rate[1]	Before Budget 1998[2]	After Budget 2001[2]

100 per cent or more	5,000	0
90 per cent or more	130,000	40,000
80 per cent or more	300,000	210,000
70 per cent or more	740,000	255,000
60 per cent or more	760,000	900,000

[1] *Cumulative figures for working households.*

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

Box 4.3: the Working Tax Credit: extending in-work support to those without children

The Working Families' and Disabled Person's Tax Credits (WFTC and DPTC) have helped to make work pay for families with children and workers with disabilities. As part of the next steps in tax and benefit reform, the principle of the WFTC will be extended to those without children or disability through the new tax credit for work - the Working Tax Credit.vThe Working Tax Credit is designed to help tackle poor work incentives and persistent poverty among working people. For families with children or people with disabilities, it will replace the support for adults provided through the WFTC and the DPTC. The childcare tax credit, which recognises the extra costs faced by working parents with childcare needs, will also be available to those receiving the Working Tax Credit, just as it is available to those receiving the WFTC and DPTC.

In the past, the problem of poor work incentives has often been of particular concern to families with children. However, people without children can also face poor work incentives and may also experience persistent in-work poverty. For example, moving into work at a typical entry wage, a workless couple with one child would be nearly £50 a week better off in work than on benefits, but a couple without children would only be around £20 a week better off. Equally, to be £40 a week better off in work, a couple with one child need to earn around £160 a week, while a couple without children need to earn £215, well above the typical wage that someone in these circumstances would normally command on moving into work. The Working Tax Credit will therefore also provide support to working households without children.

The Working Tax Credit will be complemented by the new Child Tax Credit, described in Chapter 5. A consultation document, **New Tax Credits: Supporting Families, Making Work Pay and Tackling Child Poverty**, was published by the Inland Revenue in July 2001. The proposals that were consulted on included:

- assessing the Working Tax Credit on an annual basis, in line with the Child Tax Credit and the rest of the tax system;
- targeting the Working Tax Credit for those without children on people aged over 25, working 30 hours or more a week, in order to help individuals at greatest risk of persistent poverty and with the lowest work incentives;
- making the 30 hour element of the Working Tax Credit available to couples with children who jointly work 30 hours or more a week, even if neither of them individually works 30 hours;
- paying the childcare tax credit component to the main carer, alongside the new Child Tax Credit; and
- simplifying the arrangements for payment of tax credit via the employer to help both recipients and employers.

The consultation period ended formally on 12 October and the Government has received over 170 representations. These have been considered carefully, and the Government will issue a response to the consultation when the necessary primary legislation is published later this month. The rates and thresholds for the new tax credits will be set in Budget 2002.

Increasing labour supply

4.73 One of the overall objectives of the Government's reforms to the tax and benefit system is to increase the supply of labour by encouraging those who are workless but not looking for a job actively to seek work. The Treasury has estimated the impact of the entire package of measures to make work pay since 1997, including the reductions in income tax and NICs as well as WFTC and DPTC. Cautious estimates show that labour supply may increase by 160,000 people as a result of the changes to the tax and benefit system.

EASING THE RETURN TO WORK

4.74 The return to work can be a difficult period, especially for those who have been out of work for long periods. Managing until the first pay cheque and covering additional expenditure, such as buying work clothes, can lead many to prefer the certainty of benefits to the uncertainties of work. In addition to the enhanced assistance now available to help families find affordable childcare, the Government is taking steps to address a range of other obstacles to moving into work and to provide the additional security many people need to move into employment.

Housing Benefit

4.75 Housing costs are of particular concern to many people moving into work. Evidence suggests that worklessness is concentrated among tenants, especially in social housing - 46 per cent of those in local authority housing are workless compared with less than 8 per cent in owner-occupied housing. Easing the return to work for tenants is therefore an important strand of the Government's strategy to increase employment.

4.76 Housing Benefit is available to tenants both in and out of work. However a number of recent reports have highlighted the work disincentives created by the structure and administration of Housing Benefit. In particular, delays in processing a Housing Benefit claim when a person moves into work can make it hard for tenants to be sure that they will be better off working and can lead to rent arrears and debt.

4.78 The Government's strategy for reducing the work disincentives created by Housing Benefit has had a number of elements:

- boosting in-work income through the Working Families' Tax Credit, which has floated 70,000 off Housing Benefit;
- improving and simplifying the rules of the Housing Benefit Extended Payments scheme. This allows maximum benefit to continue for the first four weeks of work for people moving off Income Support or Jobseeker's Allowance, reducing the possibility of rent arrears building up while claims for in-work support are processed;
- helping local authorities to improve the administration of Housing Benefit. This includes the establishment of a help team to provide direct support to local authorities, and granting local authorities access to a Help Fund where the main barrier to employment is a lack of funding; and
- working in partnership with other organisations to improve administration. The Government has begun a pilot scheme using registered social landlords to verify entitlement to Housing Benefit. If successful the scheme could be introduced nationally during 2002.

4.79 The Government is examining the case for longer-term reform of Housing Benefit.

[1] Long-term youth unemployment is defined as people aged between 18 and 24 who have been unemployed for more than 6 months. Long-term unemployment among the over 25s, in this example, is defined as people aged between 25 and state retirement age who have been unemployed for more than 18 months.[Back]

5 Fairness for Families and Communities

The Government is committed to building a stronger, fairer Britain in which everyone can contribute to, and benefit from, rising prosperity.

In challenging economic times, the Government is determined to continue taking action to meet its long-term goals of eradicating child poverty and providing security for all pensioners. To build security in uncertain times, the Government is:

- **introducing a new Child Tax Credit** from 2003 to provide a seamless system of support for families with children and tackle child poverty;
- **introducing the Pension Credit**, at a cost of £2 billion in the first full year, to reward pensioners on low and modest incomes for their savings; guaranteeing a rise in the basic state pension of £100 for a single pensioner and £160 for pensioner couples in 2003-04; and maintaining the winter fuel payment at £200 over the lifetime of this Parliament. These measures will help to ensure that all pensioners can share in rising prosperity;
- **providing financial support through the Disability Income Guarantee** and promoting equal opportunities for disabled people through the work of the Disability Rights Commission and enhancements to the Disability Discrimination Act;
- **introducing Saving Gateway pilots** and consulting further on the Saving Gateway and the Child Trust Fund to extend the benefits of saving, especially to those on lower incomes; and
- **building strong communities** to address the problems faced by those in disadvantaged areas of Britain, through the National Strategy for Neighbourhood Renewal and by improving the delivery of local public services.

The Government is also applying the principles of economic reform and social justice to its international efforts to **tackle global poverty** and help to achieve the challenging Millennium Development Goals set by the international community for 2015.

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 a strong and productive economy must also be underpinned by fairness and inclusion so that every individual can 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. Employment brings independence for workers and their families. But while those who can work have a responsibility to do so, those who cannot, and their families, have a right to security and support. Moreover, opportunity should be dynamic, and repeated, rather than one-off. Support must be available at the right time in people's lives, to tackle problems before they take root and to prevent opportunities from being denied.

The poverty challenge

5.3 This means continuing to tackle child poverty. The Government's long-term goal is to halve child poverty by 2010 and to meet the Prime Minister's commitment to eradicate it within a generation, extending opportunity for all children and ensuring that people's life-chances are no longer unfairly determined by their childhood circumstances.

5.4 The scale of the challenge is significant. Over the past two decades, while the economy has grown, the proportion of children living in low-income households has more than doubled, while the proportion living in workless households has shown a similar steep rise. This has denied opportunities and impeded the life chances of many, creating long-term problems and damaging the economy as well as society. By the mid-1990s, the UK had the highest rate of relative poverty in the EU and the highest proportion of children living in workless households.

5.5 Tackling child poverty requires a comprehensive strategy, with work for those who can and financial support for the families who need it most. It also requires access to excellent public services for children and young people, their families and the wider community.

5.6 A fair society also guarantees security for people in their old age. The challenge is an urgent one. In 1997 the gap between rich and poor pensioners was as wide as it had been for around 30 years. While average pensioner incomes have risen, improvements have not been evenly distributed, with the poorest having the smallest real increases in incomes. Today, while around one in four pensioner couples retire on at least £20,000 a year, too many have not had the opportunity to build up a decent second pension. Around one quarter of pensioners live in low-income households, depriving them of the security and comfort to which they should be entitled.

5.7 This challenge requires a comprehensive new system of support for pensioners, which targets the greatest help on the poorest pensioners, rewards those who have saved for retirement and which is sustainable in the long-term.

5.8 This chapter describes how, in challenging economic times, the Government is working to deliver a fairer society, strengthening its efforts to tackle poverty and social exclusion and to extend security and opportunity to all. It sets out the Government's approach to:

- supporting families and tackling child poverty;
- providing help for people with disabilities;
- delivering security for pensioners and tackling pensioner poverty;
- supporting saving and asset ownership;
- strengthening community life; and
- creating a modern and fair tax system.

SUPPORT FOR FAMILIES AND CHILDREN

The challenge of child poverty

5.9 The Government's aim is for every child to have the best possible start in life. Children who grow up in poverty experience disadvantage and lack of opportunity that affects not only their own childhood and their experience as adults, but also the life chances of their children. [1]

5.10 The Government recognises the importance of addressing both the current needs of children and of working to break the cycle of poverty and deprivation that could otherwise persist in later life. This requires support through income and services. It also requires support at local and national levels. The Government has therefore put in place a strategy designed to:

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

5.11 The Government's third annual anti-poverty report, *Opportunity for All*[2] was published in September 2001. The report shows progress against a range of poverty and social exclusion indicators linked to child poverty, including low-income, worklessness, health, education and housing. For example:

- since spring 1997, the percentage of children in workless households has fallen from 17.9 per cent to 15.3 per cent. Around 300,000 fewer children are now living in a household where no one works; and
- the proportion of 11 year-olds achieving the expected standards in literacy has risen from 63 per cent in 1997 to 75 per cent in 2001, and in numeracy from 62 per cent to 71 per cent.

5.12 The Government has a Public Service Agreement target to reduce the number of children in poverty by at least a quarter by 2004. Personal tax and benefit reforms announced in the last Parliament mean that families with children in the poorest fifth of the population are now, on average, £1,700 a year better off. As a result, there are now 1.2 million fewer children in relative poverty than there would otherwise have been.

5.13 As the Government works to achieve its long-term objective of abolishing child poverty in a generation, it is seeking to learn from existing research and international experience, through discussions with academics and others, to inform both policy and targets. The Government will shortly publish a new paper outlining its strategy for tackling child poverty, the progress already made, and setting out a range of issues to inform Budget 2002 and the 2002 Spending Review.

Financial support for families with children

5.14 Alongside the rise in the number of children in low-income households, overall, families with children have taken a decreasing share of national income. Between 1979 and 1995-96, average incomes after housing costs rose by 43 per cent for working households without children, but by only 35 per cent for those with children. The Government's approach to tax and benefit reform for families with children is therefore based on 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 a baby.

5.15 Building on these principles, over the course of the last Parliament the Government introduced a number of changes to help provide decent family incomes, including:

- increasing Child Benefit, with a 26 per cent real terms rise for the first child. Child Benefit is now worth £15.50 a week for the first child and £10.35 for subsequent children;
- introducing the Children's Tax Credit in April 2001 as a replacement for the Married Couple's Allowance. The Children's Tax Credit provides around 5 million families with up to £10 extra a week;
- introducing the Working Families' Tax Credit (WFTC) which benefits nearly 1.3 million families - over 400,000 more than previously received Family Credit. On average, these families are now receiving £35 a week more under WFTC than they did under Family Credit; and
- increasing the children's allowances in Income Support and other income-related benefits, raising rates for children under 11 by 80 per cent in real terms.

5.16 The Government has also taken action to improve the affordability, accessibility and quality of childcare, reducing the barriers to parental employment. Further details of the Government's National Childcare Strategy are set out in Chapter 4.

Support in the early years of a child's life

5.17 The birth of a child places considerable financial pressure on families as new responsibilities and commitments are often combined with a fall in family income. Low-income families face particularly difficult challenges as they strive to help their children in the early months. In the past, the tax and benefit system has not provided adequate support for people with very young children. Financial help has been insufficient and not available quickly enough after the birth of a child.

5.18 To address these problems, and to provide additional help to new parents on low incomes, the Government announced in Budget 2001 that it would:

- **increase the flat rate of Statutory Maternity Pay (SMP) and Maternity Allowance from £62.20 to £75 a week from April 2002 and to £100 a week (or 90 per cent of previous earnings if that is lower) from April 2003.** In addition, **paid maternity leave will be extended, at this enhanced rate, from 18 to 26 weeks from 2003.** Good maternity provision enables women to stay at home during the crucial first months of a baby's life, and can ease the choice over whether to return to work afterwards;
- **grant working fathers the right to two weeks of paid paternity leave, paid at the same flat rate as SMP, from 2003;**
- **introduce paid adoption leave from 2003 to support adoptive parents in the vital first months after adopting a child.** This will be paid for the same period and at the same flat rate as SMP, starting when the child is first placed with the family. Adoptive parents will be able to choose which of them takes time off work and receives the payment;
- **increase the Sure Start Maternity Grant to £500 from April 2002** - five times the level in 1997 - which will benefit over 200,000 families receiving income-related benefits, WFTC and DPTC each year; and
- **increase the Children's Tax Credit to £20 a week for families in the year of a child's birth from April**

2002.

5.19 Building on this increased level of financial support, **the Government recently announced a further range of measures to simplify arrangements for maternity leave and pay from 2003, including changes to notification arrangements, the sickness trigger and the timing of unpaid leave.** The measures will remove much of the uncertainty from the current system for women and employers alike.

Effects of measures to increase support for families with children

5.20 Chart 5.1 shows that, since 1997, financial support available through the tax and benefit system has increased for all families with children, while the greatest increases have been targeted on families on lower incomes.

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

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

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

5.22 As a result of the Government's personal tax and benefit reforms since 1997:

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

New tax credits

5.23 Over the course of the last Parliament, significant steps were taken to support families with children, to tackle child poverty and to make work pay. **Building on these foundations, as announced in Budget 2000, the Government will introduce in 2003 a new system of tax credits to make further progress towards its goals.**

5.24 The new simpler system will separate support for adults from support for the children in a family, provide a common framework for assessing entitlement and rationalise administration. Two new tax credits will therefore be created:

- the Child Tax Credit, discussed below, will provide a single seamless system of support, integrating all the existing, income-related elements of support for children; and
- the Working Tax Credit, discussed in Box 4.3, will extend the principle of in-work support to those without children as well as providing support to working people with children.

Chart 5.3: The new and old systems of support for families with children

Box 5.1: The new Child Tax Credit - an improved framework of support for families with children.

Income-related support for families is currently provided through several different instruments, which are administered by different parts of government. The financial help for children that parents receive also depends on whether they are in or out of work.

The Child Tax Credit will be a single, seamless system of income-related support for families with children. It will build on the foundation of universal Child Benefit, bringing together the support for children currently provided through the child elements

of the Working Families' Tax Credit, Disabled Person's Tax Credit, and Income Support or Jobseeker's Allowance, as well as the existing Children's Tax Credit. It will deliver:

- a secure stream of income for families with children which does not depend on the employment status of the parents, creating a stable income bridge when families move into work. It will also extend eligibility to some who are currently excluded from all but Child Benefit, such as students and student nurses;
- a system in which all support for children is paid direct to the main carer, in line with Child Benefit;
- a more transparent system which brings together all income-related child payments into a single, payable tax credit administered by the Inland Revenue;

- greater flexibility, enabling families to access support for children from one system, even as they move into or out of work; and
- a common framework for assessment, so that all families are part of the same inclusive system and poorer families do not feel the stigma associated with more traditional forms of support.

The Child Tax Credit will be complemented by the new Working Tax Credit discussed in Chapter 4. A consultation document, *New Tax Credits: Supporting Families, Making Work Pay and Tackling Poverty,* was published by the Inland Revenue in July 2001.

The consultation period formally ended on 12 October and the Government has received over 170 representations. These have been considered carefully, and the Government will issue a response to the consultation when the necessary primary legislation is published at the end of November. The rates and thresholds for the Child Tax Credit and the Working Tax Credit will be set in Budget 2002.

Public services to tackle child poverty

5.25 The Government is committed to tackling the underlying causes of poverty and social exclusion. This means providing world class public services and harnessing the support of the voluntary and community sectors. Chapter 6 describes the Government's approach to building high quality public services throughout the UK. This section sets out how the Government is providing targeted public services to ensure that opportunities are available for everyone at all stages of their lives, and especially during childhood.

Sure Start

5.26 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. Sure Start programmes are managed by local partnerships between parents, private and voluntary organisations and statutory services, and offer a coherent and integrated service that addresses local needs.

5.27 Over 430 Sure Start programmes have already been announced and 200 are now operational. By March 2004, 500 programmes across the country will be reaching 400,000 children and around one third of young children in poverty. In addition, 20 Sure Start Plus programmes will provide personal, coordinated support for pregnant teenagers and teenage parents as part of the Government's strategy to reduce conception rates among under 18s by 50 per cent by 2010.

5.28 To help children and families living in smaller areas of deprivation, the Government announced in October 2001 the development of 50 programmes in rural areas and small towns. Working closely with Neighbourhood Nurseries and Early Excellence Centres, these programmes will coordinate the delivery of health and educational services to a further 7,500 children.

Children's Fund

5.29 The 2000 Spending Review announced £450 million of resources for a new Children's Fund over the three year period to 2003-04. Part of the Fund - £70 million over three years - is being used to provide small scale grants to support projects for children run by voluntary organisations in local communities.

5.30 The remainder of the Fund is being used to support Children's Fund partnerships to provide improved, coordinated local preventative services for 5-13 year olds at risk of social exclusion. The first 40 partnerships have now received full or partial approval for their plans, and the first grant payments were made in October 2001. Around one third of these partnerships are led by voluntary organisations and almost one half by non-statutory organisations. The partnerships provide a range of services including mentoring, learning support, parent training and support, sports and creative art activities, and counselling. The Fund will be rolled out across the country by 2003-04.

The importance of a good start in education

5.31 Education is an important influence on a child's life chances. A decent education builds employment opportunity and enhances the well-being of people throughout their lives. The Government is determined to remove educational barriers that prevent equal life chances for all.

5.32 Strong numeracy and literacy, together with good communication and technology skills are key to opportunity in the modern economy. The Government has set challenging targets to increase the proportion of pupils with good literacy and numeracy skills by the age of 11. Recent test results suggest that the Government remains on course to ensure that 80 per cent of 11 year olds will meet the targets for literacy and 75 per cent will meet those for numeracy by 2002.

5.33 The Government is also working to develop skills in the early years of secondary school and has set further demanding targets for fourteen year olds in literacy, numeracy, science, and information and communications technology (ICT) for 2004 and 2007. It has also set a series of minimum attainment targets to ensure that the schools system pays more attention to the barriers faced by certain groups of pupils.

5.34 Closer links between schools and the business sector can provide for a more effective learning environment. Chapter 3 describes the role of the Davies Review of Enterprise and Education and the Roberts Review of Scientists and Engineers, both of which will report to the Government in 2002. In addition, the Government is developing a new vocational route for 14 to 19 year olds that will offer young people the option of developing their skills in a more diverse learning environment, with closer links to business. This will complement the technology, engineering and enterprise elements of the specialist schools programme.

Connexions

5.35 The Connexions personal adviser service provides support to enable young people aged between 13 and 19 to remain in education or undertake training. Some 15 Connexions partnerships are now in operation and have provided advice on a quarter of a million occasions. The programme will be rolled out across England by 2003.

Education Maintenance Allowances

5.36 Education Maintenance Allowances (EMAs) enable young people from poorer families to pursue education beyond the age of 16. An EMA pilot programme has been running for two years and now covers 30 per cent of the country. Initial evidence from the evaluation programme has been positive. Since the programme began, educational participation has increased, on average, by 5 percentage points among those eligible for support. Young people from the poorest families have shown the strongest results, with participation among this group increasing by 7 percentage points.

5.37 While these early signs are encouraging, success can only be measured by considering the long-term impact of EMAs on retention and achievement. The Government will continue to review the performance of EMAs over the longer-term and, as reiterated in the November 2000 Pre-Budget Report, will consider whether EMAs should eventually replace Child Benefit for young people over 16 years of age.

FAIRNESS FOR PEOPLE WITH DISABILITIES

5.38 The Government is determined to increase opportunities for people with disabilities to live fulfilling and independent lives. The New Deal for Disabled People (NDDP), described in Chapter 4, is providing tailored advice and support to help those who can and wish to work, make a successful return to employment. The Disabled Person's Tax Credit (DPTC), also described in Chapter 4, has increased the gains to work for people with disabilities, easing the transition from welfare to work, and providing support for people with disabilities in low to middle-income households.

5.39 People with disabilities who are unable to work should also benefit from financial security and support. The Disability Income Guarantee, introduced from April 2001, ensures that severely disabled people under 60 years of age on income-related benefits receive a guaranteed income of at least £142 a week for single people, and £186.80 a week for couples. Since April 2001, reforms to Incapacity Benefit have provided up to £26.40 a week extra for people who were disabled before the age of 20. **The Secretary of State for the Department for Work and Pensions will shortly be announcing details of further measures to help disabled children.**

5.40 Helping carers is one of the best ways of providing support to many disabled people. In April 2001, the earnings threshold in Invalid Care Allowance was raised from £50 to £72 a week, and the Carers' Premium in Income Support raised to £24.40. As soon as is practicable, the Government will extend eligibility for Invalid Care Allowance to carers over 65 and introduce an 8 week run-on after the death of the person being cared for.

5.41 Delivering fairness for disabled people also requires action beyond financial support. Discrimination against people with disabilities, in the workplace and more widely, must also be prevented. The Disability Rights Commission is working to eliminate discrimination, promote equal opportunities for disabled people and encourage good practice. The Government has consulted on proposals to strengthen further the Disability Discrimination Act and is considering the responses received [3].

FAIRNESS FOR PENSIONERS

5.42 A fair society guarantees security for people in their old age. The Government is therefore committed to developing policies which enable pensioners to share in the country's rising prosperity and which tackle pensioner poverty. This means:

- targeting extra financial support on the poorest pensioners through a minimum income guarantee;
- rewarding today's low and modest-income pensioners who have saved for their retirement through the new Pension Credit;
- helping all pensioners by guaranteeing a rise in the annual basic state pension of £100 for a single pensioner and £160 for pensioner couples in 2003-04, and setting the winter fuel payment at £200 for the Parliament; and
- creating a sustainable system of support which enables today's workforce - tomorrow's pensioners - to plan ahead and make decent provision for their retirement, protecting themselves against poverty in the future.

Tackling pensioner poverty

5.43 The Government's first priority has been to help those in greatest need. The pattern of pensioner incomes today reflects that of earners. Like earners, the richest fifth of pensioners are now three times better off than the poorest fifth. Too many pensioners have not shared in the rising prosperity of the country.

Minimum Income Guarantee

5.44 To address this growing divide, the Government has reformed Income Support for pensioners by introducing a more generous Minimum Income Guarantee (MIG). From April 2001, the capital rules were reformed to reward those who have saved, and the age-related lower rates were abolished so that everyone on the MIG is entitled to the highest rate of support. The Government is committed to raising the MIG in line with earnings throughout this Parliament, to ensure that pensioners can share in rising prosperity.

5.45 Around two million pensioners currently benefit from this extra support and the Government is determined to promote further take-up. The introduction of the Pension Service next April and the Pension Credit in 2003 will encourage more people to claim the support to which they are entitled.

Security for all pensioners

5.46 All pensioners are entitled to security in retirement, not just the poorest. Free TV licences for households with someone aged 75 or over, and free eye tests for those over 60, have helped all pensioners, regardless of their income.

5.47 In addition, the winter fuel payment currently benefits around 8 million households with someone aged 60 or over each winter. The Government has already announced that the winter fuel payment for this year will be set at £200. **To ensure that these households continue to receive help, the winter fuel payment will be maintained at £200 for the remainder of this Parliament.** This will provide extra reassurance and security for all pensioners over the coming years.

5.48 To increase further the level of financial support offered to all pensioners, from April 2001 the full basic state pension was increased by £5 to £72.50 a week for single pensioners and by £8 to £115.90 a week for couples. As confirmed in Budget 2001, **the Government will increase the basic state pension by a further £3 to £75.50 for single pensioners, and by £4.80 to £120.70 a week for couples in April 2002.**

5.49 Next year the Government will be spending around £6 billion extra in real terms on pensioners as a result of policies since 1997. This will ensure that the poorest third of pensioners receive an additional £2.5 billion next year - three times more than an earnings link in the basic state pension would have given them.

Chart 5.4: Overall gains for pensioner families from pensioner policies including Budget 2002 changes

5.50 The Government's measures form a comprehensive package of support to tackle pensioner poverty and help all pensioners. By April 2002, as a result of the Government's tax and benefit reforms compared with the 1997 system:

- on average pensioner households will be £840 a year better off - more than £16 extra a week; and
- around 1.8 million of the poorest pensioner households will be over £1,000 a year better off - a real terms rise in living standards of at least 23 per cent. Younger couples on the MIG will have seen a gain of over £1,800 a year.

5.51 Building on this support, the Pre-Budget Report guarantees that the annual basic state pension will rise by £100 for a single pensioner and £160 for pensioner couples in 2003-04. Subsequently the basic state pension will rise each year by 2.5 per cent or the increase in the September Retail Price Index, whichever is higher.

The Pension Credit: rewarding low and modest income pensioners

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

5.53 Last year, the Government published proposals to introduce the Pension Credit. The proposals were widely welcomed by respondents and **the Government has decided to proceed with the introduction of the Pension Credit in 2003 at a cost of £2 billion in the first full year**. The Secretary of State for Work and Pensions will publish shortly a response to the consultation setting out details of how the Pension Credit will work, alongside legislation to introduce it.

5.54 The Pension Credit will ensure that millions of pensioners who have saved modest amounts - whether through an occupational scheme, a stakeholder pension, the State Second Pension or other savings - will gain from having done so and be rewarded for their thrift and effort.

5.55 The Pension Credit will work in two ways. First, it will bring pensioners up to a guaranteed minimum income. Second, it will reward those who have saved for retirement to ensure that it pays to have saved even quite modest amounts. Box 5.2 provides more detail on the Pension Credit.

Box 5.2: The Pension Credit

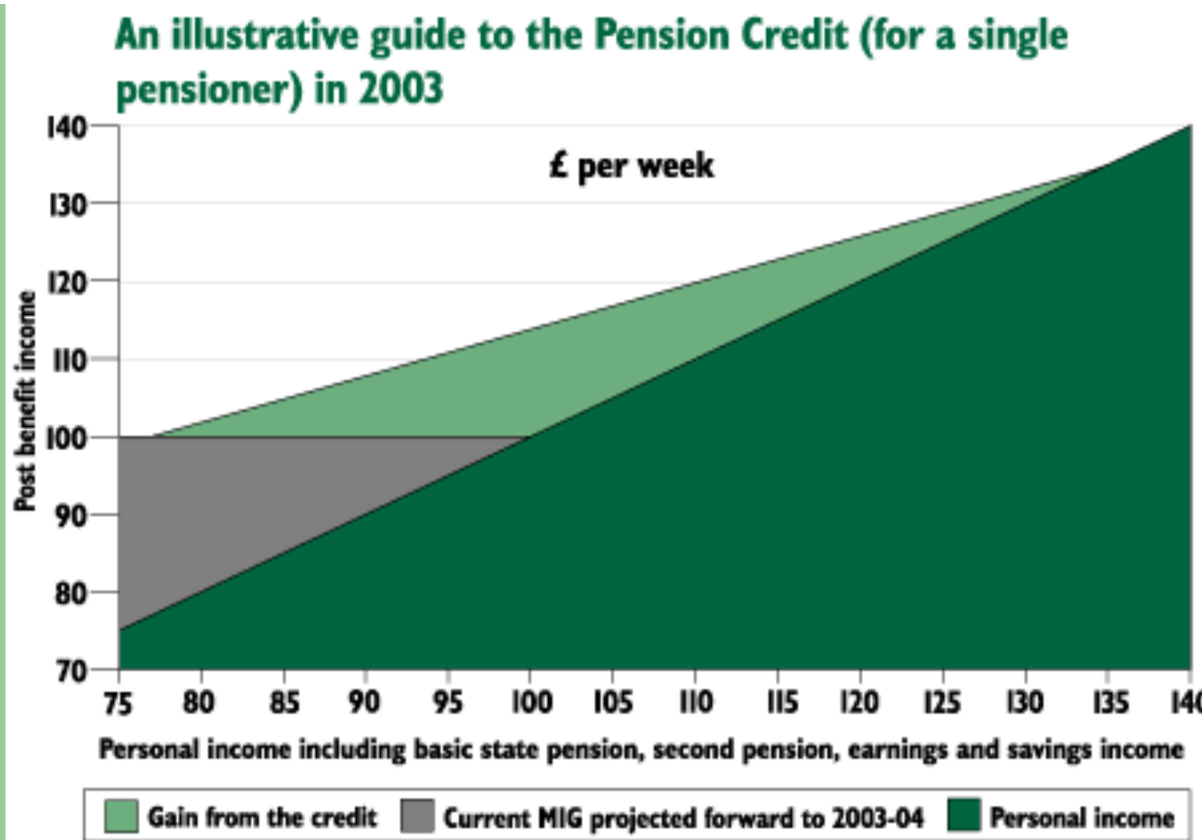
The Pension Credit, to be introduced from 2003, will provide a fair deal for pensioners, tackling the unfairness and complexities of the current system. It will reward pensioners who have built up modest savings or second pensions during their working lives.

Under the current system, pensioners on the MIG lose a pound of benefit for every extra pound of their second pension or earnings income. Many also see their benefit dramatically reduced, or are excluded from benefit altogether, simply because they have small amounts of capital. To address these problems the Pension Credit will:

- guarantee a minimum income for pensioners;
- reward saving for retirement;
- revise the current capital regime;
- abolish the weekly means test; and
- protect the position of people on Housing Benefit and Council Tax Benefit.

The guaranteed minimum income level will be linked to the growth in average earnings throughout this Parliament. This means that all pensioners receiving the Credit will gain, year-on-year, a larger increase from the state than they would receive from an earnings link in the basic state pension. Around half of all pensioner households will be entitled to the Pension Credit.

To illustrate, under current arrangements a pensioner in 2003 with a basic state pension of £77 a week and an occupational pension of £14 a week would have their income topped up by £9 to the level of the MIG, at £100 a week. They would see no gain at all from their occupational pension. Under the new arrangements they would receive £17.40 a week of Pension Credit, taking their income to £108.40 a week. Full details of the Pension Credit will be set out by the Secretary of State for Work and Pensions shortly.



5.56 Based on current assumptions about future growth in prices and earnings, and taking into account the further changes the Government intends to make, on its introduction in 2003 the Pension Credit will:

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

Support for pensioners who pay tax

5.57 In the same way that the Pension Credit will deliver year-on-year increases to low and modest income pensioners, so the Government intends to help better off pensioners too. Most pensioners have no income tax to pay. But for those who do, **the age-related personal allowances will be raised at least in line with earnings rather than prices from 2003-04 and for the remainder of the Parliament.**

Helping tomorrow's pensioners

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

- SERPS reform, which will provide more support than in the past for moderate and lower-paid workers, and for carers and the disabled. Some 18 million people stand to gain from the introduction of the State Second Pension in April 2002; and
- the introduction in April 2001 of stakeholder pensions, which provide a safe, flexible and low-cost way to save for retirement for moderate earners.

SUPPORTING SAVING

The Government's savings strategy

5.59 Saving and asset-ownership provide people with security if things go wrong, with comfort in retirement and with long-term independence and opportunity. The Government's strategy to encourage saving is based on three pillars:

- creating the right environment for saving, including a stable economy and a well regulated and efficient market in financial services. Chapter 3 describes a review of the medium and long-term retail savings market launched by the Government in July 2001;
- creating the right incentives for people to save, including extending tax advantaged savings to more groups and by raising the 10 pence starting rate of income tax by £300 above indexation in Budget 2001, benefiting around 1 million savers; and
- providing information and education to help people make the right saving choices for themselves, including introducing financial education into the National Curriculum for schools.

5.60 In addition to these measures, the Government is also consulting on two new targeted policies - the Saving Gateway and the Child Trust Fund - designed to extend the benefits of saving and asset-ownership to all, and particularly to lower income earners and families. Initial details of the Government's proposals were published in April 2001 in a consultation document, *Saving and Assets for All*. A wide range of stakeholders have been involved in the consultation process, and the response has been very positive. **Results of the consultation are being published today in *Delivering Saving and Assets*, which also presents further issues for consultation.**

Saving Gateway

5.61 The Saving Gateway would be an account targeted at individuals from low-income groups, providing a Government-funded match for all money saved, up to a limit. It would offer individuals a valuable and transparent financial incentive to develop a regular saving habit and provide tailored financial information to inform saving choices. Building on the results of the consultation exercise, **the Government now intends to launch a number of Saving Gateway pilot projects** to assess how best to integrate and deliver the local outreach, financial account management, and educational services that would be needed to make the Saving Gateway work.

Child Trust Fund

5.62 As well as supporting saving, the Government also wants to spread the benefit of asset-ownership to all. The Child Trust Fund (CTF) is a proposal for a universal account, with endowments paid to all children at birth and at ages 5, 11 and 16, with children from the poorest families receiving the most help. Parents, family, friends, and children themselves would be able to make their own contributions to the account and benefit from targeted and relevant financial education.

5.63 *Delivering Saving and Assets*, sets out the full range of responses to the Government's proposals and provides answers to the specific questions raised by the consultation. It also consults on two detailed proposals for delivering the CTF:

- an open-market model, in which the CTF would be delivered by financial service providers, like ISAs and stakeholder pensions; and
- a preferred panel model, with a more limited number of providers offering the CTF in partnership with the Government.

5.64 The Government encourages and looks forward to continued input into the development of these initiatives.

Individual Savings Accounts

5.65 Individual Savings Accounts (ISAs) have continued to attract high volumes of saving, despite the downturn in global equity markets. Around 12 million investors have contributed £60 billion to ISAs in their first two years. In the first quarter of 2001-02, subscriptions to mini cash ISAs - which have attracted relatively more low income and younger savers[4] - rose by 40 per cent to £6.5 billion, compared with £4.6 billion for the same period in 2000-01.

5.66 The Government has re-affirmed its commitment to the ISA as a key element of its saving strategy. Budget 2001 extended the £7,000 contribution limit for five years, together with the higher £3,000 limit for cash contributions. Overall, the introduction of ISAs means that in 2005-06 savers will be receiving £800 million a year more in tax relief than if the old Personal Equity Plan and Tax-Exempt Special Savings Account regime had remained in place.

Stakeholder pensions

5.67 A principal aim of the Government's savings strategy is to help people provide for financial security and comfort in old age. As well as providing generous tax relief for pensions, since April 2001 the Government has also extended the benefits of pension saving to previously excluded groups through the launch of stakeholder pensions.

5.68 Stakeholder pensions are particularly suitable for moderate earners without a current pension. Since 8 October 2001, employers without pension schemes who employ five or more people have been required to offer access to a stakeholder pension to eligible employees. Those without earnings are also able to contribute at least £3,600 a year to a stakeholder pension, so that, for the first time, people caring for children, on a career break or studying have access to a tax-favoured retirement savings product. Members of employers' schemes earning less than £30,000 per year are also able to contribute to a stakeholder pension alongside their occupational scheme.

5.69 There are currently 48 registered stakeholder pension schemes available. Figures suggest that around 210,000[5] employers had designated stakeholder schemes by the end of September. Many of the schemes available exceed the minimum requirements set by the Government and low stakeholder charges have had a wider effect in exerting downward pressure on pension charges.

Annuities

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

5.71 In Budget 2001, the Government expressed concern that some people may not be exercising their open market option - to purchase an annuity from a provider other than that with whom they invested their pension. Pensioners in particular could be substantially worse off for not shopping around when buying their annuities. The Financial Services Authority (FSA) will announce early next year the results of a recent consultation on proposals to ensure that policyholders are informed when they approach retirement that their annuity may be purchased from a life office other than their present pension provider.

5.72 The annuities market has continued to develop the product range available, giving pensioners more choice. **The Government plans to publish a consultation document on how better to promote competition in this market and thereby improve the benefits to customers.**

STRENGTHENING COMMUNITY LIFE

5.73 Conditions in Britain's most disadvantaged communities are unacceptably poor. In England's most deprived wards, over 60 per cent of children live in poverty, compared with only 6 per cent of children in the least deprived wards. Those living in poorer neighbourhoods must also cope with a run-down physical environment, limited opportunities and often the poorest public services too.

5.74 Chapter 3 describes the measures the Government is taking to promote enterprise in disadvantaged areas and Chapter 7 sets out the Government's strategy to improve the urban environment and stimulate urban regeneration. This section describes additional steps the Government is taking to build stronger communities across Britain and to tackle social exclusion.

Public services to tackle social exclusion

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

Neighbourhood Renewal

5.76 The National Strategy for Neighbourhood Renewal sets out the Government's vision to narrow the gap between Britain's poorest neighbourhoods and the rest of the country so that, within 10 to 20 years, no one should be disadvantaged by where they live. As part of this Strategy, the Neighbourhood Renewal Fund is providing £900 million over three years to the 88 most deprived areas in England, giving additional support to local authorities and other key partners in these areas. Local groups in these areas will also benefit from Community Chests, which will offer a further £50 million over three years to support specific community projects.

Local Strategic Partnerships

5.77 Local Strategic Partnerships (LSPs) bring together public, private, community and voluntary sector partners to develop neighbourhood renewal strategies at a local level. LSPs will ensure that the delivery of public services meets the needs of local residents and will coordinate solutions to tackle social exclusion. Given the importance of community involvement to the success of LSPs, the Community Empowerment Fund will provide £36 million to support participation in the same 88 most deprived local authority areas.

New Deal for communities

W**5.78** The New Deal for Communities is investing £2 billion over 10 years in 39 neighbourhoods around the country. These funds are being used by local partnerships to reduce crime, improve health, increase employment, raise educational achievement and improve housing and the physical environment. The Government is also providing a further £43 million to fund Neighbourhood and Street Wardens and £45 million to support Neighbourhood Management pathfinders.

Strengthening rural communities

5.79 The recent Government White Paper, *Our Countryside: the Future*,[6] set out a vision of a countryside in which people have access to the jobs and services they require as part of a diverse and successful rural economy. To deliver this vision, the 2000 Spending Review allocated £1 billion over three years to help secure improvements in health, education, housing and transport for rural communities. This is in addition to £600 million available over the same period through the Rural Development Programme. These resources will have a real impact on the development of the countryside, helping to build 3,000 affordable houses a year in small rural communities, establishing a £15 million fund to meet the transport needs of parishes, injecting £37 million into market town regeneration, and providing improved rural services such as new primary health care centres with internet and tele-links to local hospitals.

Strong communities and the voluntary sector

Community amateur sports clubs

5.80 The Government recognises the positive contribution community amateur sports clubs (CASCs) make to their local communities, including improvements to people's health and by contributing to reductions in crime. In Budget 2001, the Government stated that it would look into ways in which tax relief could support CASCs that make a positive contribution to their local communities. **The Government intends to publish a consultation document shortly, seeking views from interested parties before finalising decisions on the best way to support CASCs.**

Giving Campaign

5.81 The Giving Campaign - an independent national campaign launched in 2001 - aims to increase the amount of money and time given to charitable causes. The Campaign has successfully increased awareness of planned tax efficient giving among charities, the public and financial advisers. The Government is working in partnership with the Campaign, providing support through funding and civil service secondments.

Gift Aid

5.82 The tax rules for gifts to charity were reformed in 2000 to improve incentives for giving and make the system work better for charities. The changes were welcomed by charities and, for the first time, Gift Aid provides a 28 per cent addition on every donation by individual tax payers to recognised charities. Appeals to contribute foreign currency to charity can receive this top-up. In addition, the Inland Revenue will consult charities on whether to allow tax payers to donate directly to their designated charities on the annual tax form and to gain tax relief for doing so.

A MODERN AND FAIR TAX SYSTEM

5.83 The Government is committed to the prudent management of the public finances based on a tax system in which everyone pays their fair share.

Modernising VAT

VAT and Museums

5.84 The Government is committed to universal free access to the main national museums and galleries. Budget 2001 announced the introduction of a new scheme to refund national museums and galleries the VAT they incur on their purchases when they allow the public free admission, thereby removing the main barrier to free entry. As a result of this scheme, which came into effect in September, those main national museums and galleries which have been charging for admission will allow free entry by the end of the year.

Betting

The Gross Profits Tax

5.85 In Budget 2001, the Government announced that the tax on betting stakes would be replaced with a tax on bookmakers' gross profits. These reforms were introduced on 6 October 2001, three months ahead of schedule. As a result, the largest bookmakers have relocated their offshore operations to the UK and removed the 9 per cent deduction previously charged on stakes, making it possible for them to develop their domestic and international business from a UK base, and to compete from a position of strength in the growing global market for telephone and internet betting.

Taxation of pools betting

5.86 Building on these reforms, the Government now intends to introduce significant changes to the tax treatment of pools betting. **In Budget 2002, the current pools betting duty will be abolished and replaced by a 15 per cent tax on pools companies' gross profits.** As a result of these steps, the leading football pools companies have agreed to extend their funding of the Football Foundation and the Foundation for Sports and the Arts for a further two years until April 2004. This funding - equivalent to 4 per cent of the pools companies' gross profits - will help these Foundations to continue their vital work in supporting grass-roots sports clubs and community arts projects.

Excise duties

Small brewers

5.87 Britain's several hundred small breweries make a valuable contribution to the nation's cultural heritage, particularly in rural communities where the majority are located. To support this industry, the Government announced in Budget 2001 that it was minded to introduce reduced rates of duty on the beer produced by smaller breweries. The Government is considering the scope for introducing such a scheme in close consultation with the brewing industry, and will announce its decision in Budget 2002.

Tackling tobacco smuggling

5.88 It is widely recognised that tobacco smuggling not only undermines the Government's health objectives, but also involves widespread and serious criminality. In March 2000, the Government announced its *Tackling Tobacco Smuggling* strategy, designed first to slow the upward trend in tobacco smuggling and subsequently to put it into decline within three years. The strategy included a target for 2000-01 to hold the share of the UK cigarette market taken up by smuggling to 21 per cent. To help achieve this, the Government provided £209 million for investment in extra staff and scanning equipment.

5.89 The first full year of the strategy has brought a number of encouraging results. More than 2.8 billion cigarettes destined for the UK market were seized in 2000-01: 1.9 billion in the UK itself and 900 million through joint operations with overseas enforcement agencies. HM Customs and Excise investigators have also broken up dozens of major organised crime gangs involved in smuggling huge volumes of illicit cigarettes. As a result of this action, smuggling is estimated to have accounted for 21 per cent of the UK cigarette market in 2000-01, in line with the Government's target.

Cross-Channel smuggling

5.90 Significant action has also been taken to tackle cross-Channel smuggling of alcohol and tobacco, leading to a 76 per cent overall reduction in the revenue lost from this type of smuggling in 2000-01, well in excess of the 10 per cent target set by the Government for this period. HM Customs and Excise also seized more than 10,000 vehicles used by smugglers in 2000-01 - almost double the number seized in the previous year.

Tackling fraud and smuggling

5.91 The Government is today publishing a new paper, *Tackling Indirect Tax Fraud*, which sets out the strategic principles underlying its approach to tackling fraud, and shows how the effectiveness of this approach has been demonstrated by the progress of the *Tackling Tobacco Smuggling* strategy. The paper also outlines the steps being taken to tackle fraud in other areas and sets out a number of new proposals for consultation.

PROMOTING INTERNATIONAL POVERTY REDUCTION

5.92 The Government remains focused on its long-term goal of helping to tackle global poverty and achieve the internationally agreed Millennium Development Goals (MDGs) by 2015. These goals include halving the proportion of people living in extreme poverty, providing universal access to primary education, reducing child and maternal mortality and reversing the spread of HIV/AIDS, malaria and other killer diseases.

5.93 To advance these goals, the Government is working in partnership with developed and developing countries, the international financial institutions, the private sector and civil society to relieve the burden of debt on poor countries, strengthen social systems in developing countries and ensure that developing countries can participate in, and benefit from, the global financial system. The Government is promoting four important steps to increase global prosperity and promote social justice:

- an improvement in the terms on which the poorest countries participate in the global economy and their capacity to do so, through new codes and standards that all countries can sign up to;
- the adoption by business of high corporate standards of engagement as reliable and consistent partners in the development process, including the creation in developing countries of investment forums between the public and private sectors;
- building on the progress made in Doha, the development of an improved trade regime in which developing countries can participate on fair terms ; and
- a significant increase in development aid from all donor countries and international institutions to build capacity and address the long-term causes of poverty in the poorest countries. The Government has proposed an international development trust fund to pool contributions and build on the work of the World Bank, the IMF and the Regional Development Banks.

Debt relief

5.95 The Government continues to be a leading advocate of debt relief, through the Heavily Indebted Poor Countries (HIPC) initiative, and has encouraged other countries to adopt the UK's practice of providing 100 per cent bilateral relief, and holding payments in trust for countries yet to receive debt relief. The Government recognises the need to take into account the deterioration in global growth prospects and the decline in terms of trade when considering possible additional assistance and updating debt sustainability analyses.

5.96 So far, 24 countries have started to receive debt relief worth $56.4 billion under the HIPC initiative, while three countries have now completed the process. The Government stands ready to write off £1.9 billion of bilateral debt owed to the UK by HIPC countries. It has already provided £118 million of bilateral debt relief and has pledged US $375 million to the multilateral institutions in support of the HIPC initiative. The Government has also granted interim debt relief of over £575 million, which will become irrevocable when countries complete the HIPC process. For the remaining 18 HIPCs, the Government stands ready to write off a further £1.3 billion.

Global Health Fund

5.97 Every year almost 6 million people die from HIV/AIDS, malaria and tuberculosis, almost all in the world's poorest countries. To step up the fight against these diseases, the Government has taken a lead in the development of a new Global Fund to fight HIV/AIDS, tuberculosis and malaria. The Fund will provide resources to purchase medicines and create a market to stimulate research into new treatments for the diseases of poverty. The Fund has so far received international commitments totalling $1.8 billion, of which the Government has pledged $200 million. The Government is continuing to work with its international partners to ensure the effective operation of the Fund.

5.98 In addition, the Government has established a High Level Working Group on Access to Medicines, chaired by the Secretary of State for International Development. The purpose of the group is to work in partnership with key stakeholders to increase access to essential medicines by poor people in developing countries.

5.99 As announced in Budget 2001, the Government is consulting with the UK pharmaceutical industry on a new tax credit to reward research and development (R&D) into drugs and vaccines to treat diseases threatening lives in the least developed countries. Only 18 per cent of the world's pharmaceutical market is in developing countries that make up 80 per cent of the world's population. Within these countries, the poorest spend a high proportion of their income on often unsuitable treatments. The current R&D pipeline for effective drugs and vaccines is negligible.

5.100 The new tax credit will be additional to existing incentives. For companies undertaking research into specified diseases, it could provide an extra 50 per cent relief on qualifying expenditure. In Budget 2001, the Government challenged the pharmaceutical industry to respond to these new incentives with a new commitment to increase R&D into HIV/AIDS, tuberculosis and malaria.

5.101 The Government is also investigating options for increasing the incentives for pharmaceutical companies to donate drugs, vaccines and suitable equipment in support of developing countries' health strategies.

Commonwealth Education Fund

5.102 Today, around 75 million children in Commonwealth countries lack access to basic education, destroying life chances and threatening to lock in a cycle of poverty and deprivation. The Government is committed to working with its international partners to making progress towards the 2015 goal of ensuring every child has access to primary education. To raise public awareness of this issue, the Government has announced that a new Commonwealth Education Fund will be launched in the Queen's Jubilee Year to which the private and public sectors are expected to contribute.

5.103 Taken together, these measures will help to improve health and education outcomes and reduce poverty in the poorest countries. But they are only a start. To make progress toward the MDGs, they need to be supported by sustained, long-term investment in healthcare and education systems in developing countries. Since 1997, the Department for International Development (DFID) has agreed new bilateral commitments worth over £1 billion to help improve the provision of basic healthcare in poor countries. Over the same period, DFID has also agreed new bilateral commitments worth over £600 million to support sustainable education systems in those developing countries that are able to provide high-quality primary education for all children.

Box 5.3: Financing for Development

In March 2002, in Monterrey, Mexico, UN Secretary-General Kofi Annan will bring together developed and developing countries, multilateral institutions, non-Governmental organisations and the private sector, for a major conference on Financing for Development. The conference is an opportunity for all relevant stakeholders to agree concrete steps towards the achievement of the Millennium Development Goals for 2015 - through a focus on sound domestic policies and good governance, a better climate for investment, and an increase in the level and effectiveness of international development assistance.

Led by the Department for International Development the Government is actively involved in preparations for the conference. The government's objective is to secure a broad-based consensus on a new approach to development, in which:

- developing countries commit to pro-poor policies, including economic stability, good government, and support for health and education - through the new Poverty Reduction Strategies;
- developed countries open their markets to developing country exports, improve the effectiveness of their aid (including through better coordination, and the untying of aid from commercial contracts), and make progress towards the 0.7 per cent target for the proportion of GNP devoted to aid; and
- the international community as a whole continues to develop a framework for economic growth and stability, in particular through the new focus on poverty reduction being pursued by the IMF and World Bank.

The Chancellor set out the UK's approach to globalisation and development issues in his 16 November speech to the New York Federal Reserve and proposed a new $50 billion international development fund to increase development aid from all donor countries and institutions. The subsequent meeting of the International Monetary and Financial Committee, chaired by the Chancellor, concluded that "advanced economies must also be prepared to meet their special responsibility in providing increased development assistance and debt relief to tackle the increased challenges of poverty reduction, and to achieve the Millennium Development Goals".

1 *Supporting children through the tax and benefit system, the modernisation of Britain's tax and benefit system, number 5,*
HM Treasury (1999).[Back]

2 *Opportunity for All,* Third Annual Report 2001, Cm 5260.[Back]

3 *Towards Inclusion - Civil Rights for Disabled People,* Department for Education and Employment, March 2001.[Back]

4 Inland Revenue analysis of the NOP Financial Survey for 1999-2000 and 2000-01.[Back]

5 Figures calculated by the Association of British Insurers (ABI).[Back]

6 Cm 4909, published November 2000.[Back]

6 Delivering High Quality Public Services

The Government's long-term goal is to deliver world-class public services through investment and reforms to ensure that taxpayers receive real value for money. Through its action to maintain macroeconomic stability and ensure that the fiscal rules are met, it has delivered significant and sustained increases in the resources available to strengthen Britain's public services.

By maintaining economic stability and sound public finances in challenging economic times, the Government is now laying the foundations for further sustainable increases in public spending and investment. It will expand opportunity through high standards of education, ensure the National Health Service (NHS) provides high quality care on the basis of clinical need and not ability to pay, deliver an efficient and sustainable transport system, and promote secure and prosperous communities. This chapter sets out:

- **the Government's framework for public spending** and how it is delivering real improvements in public service delivery;
- how the Government's approach has freed up additional resources for key public service priorities;
- **an additional £1 billion for the National Health Service in the UK in 2002-03;**
- **the developments to the public spending framework** being introduced as part of the 2002 Spending Review;
- the Government's **wider goals and priorities for the 2002 Spending Review**; and
- **cross-cutting reviews in the 2002 Spending Review** to find coordinated solutions to cross-departmental challenges.

INTRODUCTION

6.1 The Government's long-term goal is to deliver world-class public services through sustained increases in investment and reforms to ensure that taxpayers receive real value for money. Strong and dependable public services are vital to extend opportunity, tackle social exclusion and improve people's quality of life. They are also fundamental in laying the foundations for a stronger economy.

6.2 Through its action to maintain macroeconomic stability and ensure that the fiscal rules are met, the Government has already been able to deliver significant and sustained increases in the resources available to strengthen Britain's public services.

6.3 To advance its long-term goal, the Government will build on the foundations laid over the course of the last Parliament. The Government is currently conducting a Spending Review, to be completed next year. The 2002 Spending Review will determine how departments' programmes can most effectively deliver investment and modernisation in priority services and will set new departmental spending plans for 2004-05 and 2005-06.

6.4 This chapter describes the main features of the new framework for public spending and how it has helped free valuable resources for investment in, and modernisation of, priority public services. The chapter also describes how next year's Spending Review will take forward further important reforms to promote good policy-making, the goals and priorities for the Review, and how the Government is working across departments to deliver coordinated solutions to shared challenges.

THE PUBLIC SPENDING FRAMEWORK

6.5 A modern and effective framework for the planning and control of public spending is vital to deliver improvements in the quality and cost-effectiveness of public services. The Government's public spending framework is underpinned by four important principles:

- consistency with a long-term, prudent and transparent regime for managing the public finances as a whole;
- judging success by policy outcomes rather than resource inputs;
- good incentives for departments and their partners in service delivery to plan over several years and plan together where necessary; and
- the proper costing and management of capital assets, providing the right incentives for public investment.

Public spending and the fiscal rules

6.6 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. The Government's fiscal rules, described in detail in Chapter 2, are the foundation of the Government's public spending framework and have important consequences for the structure of the budgeting regime. In particular:

- **the golden rule** increases the efficiency of public spending by ensuring that growth-enhancing public investment is not sacrificed to meet short-term current pressures. To ensure adherence to the rule, departments are given separate allocations for resource and capital spending in each Spending Review and these budgets are monitored and controlled separately; and
- **the sustainable investment rule** ensures that borrowing for public investment is conducted in a responsible way and sets the context for the Government's public investment targets. The Government's objective is that public sector net investment should more than double to over £18 billion by 2003-04. With public sector net debt at the historically low level of 31 per cent of GDP, the Government is able to pursue this goal while comfortably meeting the sustainable investment rule.

Public Service Agreements: focusing government on delivery outcomes

6.7 The delivery of high quality public services depends not only on how much the Government spends but also on how effectively it spends it.

6.8 Public Service Agreements (PSAs) were introduced following the 1998 Comprehensive Spending Review. PSA targets set out, for each department, the key outcomes that the Government is committed to achieve - including better health, educational attainment, and crime reduction - rather than the inputs which make them possible. By linking funding to the delivery of service improvements, key reforms and modernisation, they are central to the Government's strategy for improving public services. PSA targets are also an important input to the Spending Review process: funding is agreed in advance for the target period, so that departments have certainty that the resources will be available to ensure delivery and can plan accordingly.

Ensuring delivery of PSAs

6.9 Setting the right targets is necessary to the delivery of public service improvements, but it is not sufficient. To ensure that targets can be met, PSAs must be underpinned by an effective delivery mechanism. This means:

- **departments must secure ownership by those responsible for delivery**, by consulting the individual delivery bodies - including agencies, local authorities, schools, hospitals, the police, and private and voluntary sector organisations - about the targets before they are set;
- establishing robust **performance management systems** which set out how PSA targets will be translated into real service improvements, enable effective monitoring of progress, and identify and take account of risks to delivery. For key departments, the Prime Minister's Delivery Unit is providing important and rigorous support to aid delivery (see box 6.1);
- rigorously **monitoring progress**, both within departments and centrally. At the centre, the Cabinet Committee on Public Services and Public Expenditure (PSX), chaired by the Chancellor of the Exchequer, meets regularly with Ministers in charge of departments to discuss progress against targets and the steps needed to secure delivery; and
- ensuring that those responsible for delivery are **accountable for their performance**. Under the PSA approach, the Minister in charge of each department is responsible for delivering the Government's objectives in the area of that department's activities. To strengthen transparency, both the indicators used to measure performance against PSA targets, and assessments of performance themselves, are published so that the public and Parliament can judge how the Government has performed.

Principles for public service reform

6.10 Delivering improvements in public services also requires change and reform in management culture and systems. The Prime Minister has set out the Government's four principles of public service reform:

- a national framework of standards and accountability;
- within that framework, devolution of power to the local level, with the ability to innovate and develop new services in the hands of local leaders;
- better and more flexible rewards and conditions of employment for frontline staff; and
- more choice for the pupil, patient or customer and the ability, if provision is poor, to have an alternative provider.

6.11 To strengthen the capacity and performance of the public services, the Prime Minister has established the Office of Public Services Reform (OPSR) within the Cabinet Office. The OPSR will contribute to taking forward the Prime Minister's four principles of public service reform. It will work with key stakeholders across the public sector to support the Government's vision for modern public services, and in particular to:

- articulate a positive vision for local government and its role in community leadership and service delivery;
- transform the approach of the civil service to project and programme management;
- keep the focus of public services on customers and tangible service improvements; and
- act as a centre of expertise, gathering and disseminating good practice.

6.12 The OPSR is working closely with the Delivery Unit and the Treasury in delivering Public Service Agreements.

Box 6.1: The role of the Prime Minister's Delivery Unit in public service delivery

The Delivery Unit reports to the Prime Minister under the day-to-day supervision of Lord Macdonald, Minister for the Cabinet Office. The Unit was set up in summer 2001 to concentrate on the areas of health, education, law and order, and transport. Working closely with the Treasury, its role is to strengthen the capacity of the responsible departments to deliver effectively on particularly challenging targets. This way, the Unit aims to ensure that the Government's ambitious programme of public service reform is translated into real improvements on the ground.

In pursuing its goal, the Unit is reviewing whether departments have the right arrangements, people and skills in place to deliver on their targets, and is monitoring progress towards them through regular meetings involving the Prime Minister. The Unit is also represented at the monitoring meetings of PSX Committee, helping to ensure that PSX and the Unit complement each others' work.

Achievements from the PSA system

6.13 The Government's approach to setting and delivering key outcome targets for public service improvements has already had a real impact. For example:

- in education, the percentage of children reaching level 4 or above in key stage 2 tests in English has risen to 75 per cent - a 10 per cent increase since the start of the literacy strategy in 1998. In mathematics, 71 per cent of children achieved level 4 or above compared with 59 per cent in 1998;
- every hospital trust is now offering patients booked appointments in at least two specialties, on the way to meeting the PSA commitment to introduce full booking by 2005, thereby treating patients at a time that suits them in accordance with their medical need;
- recent data on youth justice shows that the average delay between arrest and sentence for persistent young offenders was 66 days in August 2001 - the lowest monthly average so far recorded and the third consecutive month at or below the 71 day target. The average delay in 1996 was 142 days; and
- following the creation of the Rough Sleepers Unit there has been a 62 per cent reduction in the number of people sleeping rough compared with 1998.

6.14 The Government also believes that targets should focus on ensuring that the performance of services in the most disadvantaged areas rises faster than the average. The 2000 Spending Review therefore set departments a number of targets designed to focus attention on service outcomes in poorer communities. For example, the Department for Work and Pensions (DWP) has been set a target to ensure that, by 2004, the 30 local authority districts with the worst labour market problems achieve higher employment rates, narrowing the gap with the national average. Similar targets for health, education, crime and housing ensure that national improvements are not achieved without substantial progress in the most deprived areas. In November 2001, the Government published the first of its implementation strategies to achieve these targets, with the remainder following over the next two months.

6.15 The Government continues to develop the PSA approach to ensure that it delivers effective results. As a first step, the 2000 Spending Review reduced the number of targets from around 300 to 160, focusing effort clearly on the Government's priority areas for action. Targets will be reviewed and, where necessary, improved as part of the 2002 Spending Review.

Delivering incentives for effective planning

6.16 The Government recognises that public services need a medium-term planning horizon if they are to deliver the reforms that are expected of them. Under the old system of planning and expenditure control, budgets were considered and set on an annual basis. This made it difficult for departments to plan and resource longer-term projects, such as major programmes of investment.[1]

6.17 To overcome this problem, the Government has introduced a system of firm and fixed plans for departmental services spending stretching over three years, and reviewed every two. These Departmental Expenditure Limits (DELs) provide departments with greater certainty over their budgets and give incentives to plan over the medium-term.

6.18 Some items are not included in DELs. In general these are large, potentially volatile and demand-led items of expenditure, which would be difficult for departments to absorb within their normal budgets. Examples include social security benefit expenditure, payments under the Common Agricultural Policy and public service pensions payments. These items are collectively known as Annually Managed Expenditure (AME) and are subject to tough annual scrutiny as part of the Budget process to ensure that spending in these areas does not threaten fiscal stability. Taken together, DEL and AME add up to Total Managed Expenditure (TME).

6.19 This system means that the Government is controlling spending in the areas where it can sensibly be controlled, and giving departments planning certainty over a longer time-frame than they have enjoyed previously or is common internationally. To complement this reform the Government has also introduced full End-Year Flexibility (EYF) across departmental programmes, allowing departments to keep resources not fully spent at the end of the year. This is designed to engineer a lasting change in the traditional "use it or lose it" mind-set of public sector budget-holders.

Improving decision-making and asset management through budgeting

6.20 Creating a cultural change in the public sector's approach to asset management and the costs of decisions requires:

- plans to improve, maintain and rationalise the asset base through capital investment, set out in Departmental Investment Strategies;
- a thorough and transparent inventory of what central government owns, in the National Asset Register; and
- a budgeting system which provides incentives to utilise assets efficiently in service delivery.

Departmental Investment Strategies

6.21 The Government's fiscal framework establishes a firm division between capital and resource budgets, ensuring that funding for critical long-term investment cannot be used to resource current pressures. Building on this, the Government has also published Departmental Investment Strategies detailing how increases in capital budgets will be used to improve the asset base, and how estates will be rationalised or enlarged to offer the best possible support to service delivery objectives.

6.22 All departments have now published a Departmental Investment Strategy, explaining how they intend to use their increased capital budgets to support the modernisation and reform of public services. Implementation of these plans is subject to ongoing scrutiny by teams of experts from across departments, coordinated by the Treasury. This will ensure that vital capital projects remain on track and that taxpayers receive good value for their money.

National Asset Register

6.23 The Government has also improved the way in which the public sector asset base, valued at £480 billion, is managed and used. This represents 10 per cent of the total UK tangible asset stock, and its good management is therefore critical to wider economic objectives. The publication of the National Asset Register in July is a vital part of the Government's drive to improve efficiency in the public sector. For the first time, it provides a complete list of the main assets held by central government and their value, helping departments to use their assets effectively and to judge whether individual assets are still required. The Register shows that departments disposed of £1.3 billion of assets in 1999-2000, releasing important resources for reinvestment in public services. No other country in the world has access to a register of this kind, making the UK the world leader in this area of public accountability.

Resource budgeting

6.24 This financial year is the first in which departments are budgeting and accounting for their actions on a private sector style basis, rather than using the old cash system. The introduction of Resource Accounting and Budgeting (RAB) across government marks a major reform in financial planning and reporting, allowing the real economic costs of decisions to be reflected in public sector financial information, rather than simply the cash consequences. The 2002 Spending Review will complete the transition to resource budgeting, unlocking a series of important benefits, including:

- **better incentives on assets:** in resource accounts, the full cost of holding an asset is recognised within departmental budgets, including depreciation. This gives departments an incentive to maximise the utilisation of assets and to dispose of those which are surplus to requirements. Departments are already benefiting from the better information on assets provided by RAB and new flexibility in the budgeting system. For example, in 1999-2000, the Ministry of Defence disposed of assets worth over £230 million. By April 2002, it plans to have disposed of estate worth a total of £700 million under the Strategic Defence Review. Under rules introduced by the Government, proceeds from asset sales can be recycled to fund new investment priorities;
- **budgeting for the future impacts of decisions**: the public sector manages a considerable range of liabilities, such as early retirement costs for former employees and clinical negligence. Cash-based budgeting captures the costs only when these liabilities are paid out, which could be over many years. Resource budgeting means that the full consequences of the activity or event are taken into account when the costs are incurred. This provides incentives to minimise future costs, as well as present ones; and
- **a more commercial budgeting system for public corporations:** the resource budgeting framework allows remaining public corporations like the Ordnance Survey greater commercial freedom to invest for future benefits. Provided that a minimum rate of return on capital is returned to the Government, these companies will be able to retain and invest any additional profits from 2003-04.

Box 6.2: Improving the productivity of public services

Improving public services is not just a matter of expenditure. Resources also need to be allocated and used efficiently. Increased public service productivity is desirable not only because it gives people the public services they deserve and require, but also because more efficient services give taxpayers better value for money. Better health, education and transport are also fundamental in laying the foundations for a high productivity economy. The Government's approach to increasing public service productivity has three key strands:

- **allocating resources effectively**: the Government's public spending framework provides greater certainty for long-term planning, removes discrimination against investment, and delivers a sharper focus on the quality and outcome of public services;
- **making the most of resources**: PSA targets and improved lines of accountability help to fulfil the potential of staff by clarifying their roles and responsibilities. Effective incentives, such as higher pay thresholds and "golden hellos" for teachers, are needed to recruit, retain and motivate public sector employees to meet their objectives. To make the most of the capital stock the Government is strengthening incentives to use assets effectively and is introducing greater flexibility in budget management, enabling departments to adapt to unforeseen circumstances. The Government is also working to inject stronger customer focus and choice into service delivery, including through reforms to give people more information to help them choose a GP. Greater diversity in service provision and procurement is also vital in helping to deliver better value for money; and
- **enhancing performance over time**: the Civil Service reform programme has identified a number of areas for improving the skills and expertise of public sector staff, while Departmental Investment Strategies will deliver improvements in the capital stock. The Government is also providing £1 billion to enable public services to be delivered electronically, transforming the way the public sector does business by enabling better, faster and more responsive services. Finally, steps are being taken to grant new freedoms and flexibilities to local public service managers in return for high standards and commitments to deliver outcomes, as demonstrated in programmes like the Building on Success in Schools initiative.

DELIVERING RESOURCES TO PRIORITIES

6.25 By maintaining economic stability and meeting the fiscal rules, the Government was able to deliver significant increases in resources for frontline public services in the 2000 Spending Review. As a result of significant savings on social security and debt interest, the Government has been able to plan departmental spending on services which will be £50 billion higher in

2003-04 than it was in 2000-01.

6.26 Chart 6.1 shows the growth in DEL and AME expenditure over the period of the 2000 Spending Review. Social security payments, even including tax credits for the purpose of comparison, will together grow on average by 2.6 per cent a year in real terms, compared with 4 per cent a year between 1992-93 and 1996-97 and 1.6 per cent a year between 1996-97 and 2003-04. Debt interest payments, which rose by over 6 per cent between 1991-92 and 1996-97, will fall by over 6 per cent over the 2000 Spending Review period. This means that less taxpayers' money is being spent on these areas as a proportion of Total Managed Expenditure (TME), releasing more money for frontline public services within DEL.

Chart 6.1: Releasing resources for public service priorities over the period covered by the 2000 Spending Review

6.27 Some 75 per cent of the additional resources released through the 2000 Spending Review have been devoted to spending plans for the priority areas of health, education, transport, law and order and housing. Chart 6.2 shows the average annual growth in key budgets between 2001-02 and 2003-04. Spending on education is programmed to increase by an average of 5.5 per cent a year in real terms over this period. Real terms spending on transport is planned to rise by 14 per cent a year on average, compared with an annual fall of 4.2 per cent on average between 1991-92 and 1996-97. Between 2001-02 and 2003-04, expenditure on health will increase by an average of 5.4 per cent a year in real terms.

Chart 6.2: Spending growth in key public services by function

6.28 The focus on delivery driven by PSAs is underpinned by the Government's record spending plans for investment in crucial services. The spending plans set in the 2000 Spending Review provided further resources needed to deliver long-term improvements in the nation's infrastructure, including a doubling of public sector net investment over the next three years and a real terms increase of more than 25 per cent in investment in transport in each year from 2001-02 to 2003-04. Over the same period, capital expenditure on education and health will grow by over 9 per cent a year in real terms. Chart 6.2 shows the importance of increasing capital investment within the Government's overall commitment to public services.

6.29 The Government is now delivering on those plans. Net investment increased by a third last year in real terms. Although it will take time to reverse the years of decline, results are already beginning to show: 245 modernisation schemes for Accident and Emergency departments are now complete and 17,000 schools will have received funds for repairs by March 2002.

THE 2002 SPENDING REVIEW

6.30 The Government continues to examine how resources are allocated across its priorities. The 2002 Spending Review will look closely at the effectiveness of existing programmes, and how departments are delivering their current PSA targets alongside their future strategic priorities. As in previous Spending Reviews, the Government's aim is to release funds to spend on priority services.

6.31 The baseline year for the 2002 Spending Review will be 2003-04 and new departmental spending plans will be set for 2004-05 and 2005-06. The main developments in this Spending Review compared with previous exercises will be:

- a greater concentration than previous Spending Reviews on assembling a substantial and relevant evidence base. Departments and the Treasury are currently establishing a number of areas for particularly close joint study, and performance against PSA targets will be factored into eventual decisions on resources and reforms;
- the Review will be conducted and published on a full resource budgeting basis; and
- consideration will be given to the need to plan beyond the three year horizons of firm DEL plans in specific areas, building on the Transport 10 Year Plan and the NHS Plan.

6.32 The emphasis of this Spending Review will be on ensuring that departments have the resources and plans to deliver the stretching priorities that the Government has set itself. Ministers will be looking closely at the evidence base for existing policies and at performance against the delivery of agreed priorities. Links between departments will be scrutinised to ensure that services are being designed for citizens and customers rather than for providers. Seven cross-cutting reviews of policy issues spanning several department's responsibilities will be central to this element of the Review (see Box 6.7). Proposals for new spending will also need to be accompanied by stretching targets and clear plans for effective delivery. Where that requires change, investment will be conditional on reform. All departments are expected to identify old programmes to be wound down to make room for new priorities.

PRIORITIES FOR THE 2002 SPENDING REVIEW

Aim of the Review

6.33 The aim of the 2002 Spending Review will be to determine how best departments' programmes can contribute to the achievement of the Government's priorities, including:

- delivery of high quality, efficient and responsive public services through investment linked to reform and modernisation;
- raising productivity, in the public sector and outside, through improved skills, research and infrastructure;
- spreading opportunity and prosperity more widely, and tackling child poverty and social exclusion;
- improving the quality of life in both urban and rural areas; and
- securing a modern international role for Britain through cooperation with our European and international partners.

Outputs from the Review

6.34 The main outputs of the Review will be:

- new Departmental Expenditure Limits rolling forward the existing plans for 2003-04, and setting new plans for 2004-05 and 2005-06;
- Public Service Agreements rolling forward and, in some cases, being developed further in line with priorities;
- a series of cross-cutting reviews of policy areas spanning several departments' responsibilities; and
- revised and published Departmental Investment Strategies and Service Delivery Agreements, linking PSA targets to capital plans and delivery strategies.

Specific goals for public services in the 2002 Spending Review

Health

6.35 Budget 2000 announced the largest sustained increase in resources for health in the history of the National Health Service (NHS). The spending plans underpin the 10 year NHS Plan for investment and reform announced by the Prime Minister and the Secretary of State for Health in July 2000. The Plan sets out key priorities including shorter waiting times, clear national standards to tackle the major killer diseases, action to reduce health inequalities and improved care for the elderly. To deliver these priorities the NHS is now recruiting more doctors and nurses and investing in modern buildings and equipment. New ways of working and systems are being introduced to reform outdated practices, empower frontline staff, improve incentives and ensure that the NHS is accountable to patients.

The Wanless Review of Long-Term Health Trends

6.36 At the time of Budget 2000, the Chancellor announced an assessment of the long-term trends that may affect the UK health service over the next 20 years and their implications for funding and other resource requirements. In Budget 2001, the Chancellor asked Derek Wanless, former Group Chief Executive of NatWest Bank, to undertake this work.

6.37 Following widespread consultation, within the UK and overseas, Derek Wanless' interim report to the Chancellor is now being published. A Health Trends Conference was held in October to inform the Review, and the conference proceedings are published alongside the report.

Box 6.3: The Terms of Reference of the Wanless Review

The Terms of Reference given by the Chancellor of the Exchequer to the Wanless Review of Long-Term Health Trends are:

1. to examine the technological, demographic and medical trends over the next two decades that may affect the health service in the UK as a whole;

2. in the light of (1), to identify the key factors which will determine the financial and other resources required to ensure that the NHS can provide a publicly funded, comprehensive, high quality service available on the basis of clinical need and not ability to pay; and

3. to report to the Chancellor by April 2002, to allow him to consider the possible implications of this analysis for the Government's wider fiscal and economic strategies in the medium term, and to inform decisions in the next public spending review in 2002.

The report will take account of the devolved nature of health spending in the UK and the devolved administrations will be invited to participate in the Review.

6.38 The Health Trends Review has identified four main factors that are likely to have a significant impact on the health service: changing health care needs arising from demographic changes, patterns of morbidity and trends in health seeking behaviour; patient expectations of the range and quality of health care; technology and medical advances; and workforce development, pay and productivity.

6.39 The report sets out the analysis which has been undertaken in each of these areas, alongside the evidence base. The aim is to encourage feedback over the next two months to assist the Review in producing its final assessment of the resources required for the health service over the next 20 years. The report sets out key issues and questions for consultation. A number of events will be held in England, Scotland, Wales and Northern Ireland to hear the views of patients and NHS and social care practitioners.

6.40 The Review will produce a final report to the Chancellor before the conclusion of the 2002 Spending Review. The Government will consider the implications of the analysis for the Government's fiscal and economic strategies as part of the 2002 Spending Review.

6.41 The Pre-Budget Report allocates an additional £1 billion to the National Health Service in the UK in 2002-03 by reallocating resources from lower debt interest payments. The Secretary of State for Health will announce how the money will be used shortly.

Education

6.42 Education is the foundation of a modern and competitive economy. The 2000 Spending Review provided significant new investment for education and training, coupled with modernisation and reform. An additional £1.5 billion will be spent on renovating and improving the schools capital stock in 2003-04 compared with last year. Features of the education plans set in the 2000 Spending Review included ambitious new literacy and numeracy targets, a doubling of direct payments to schools to encourage local innovation and responsibility, and a new emphasis on raising standards in the most deprived areas. In addition to this funding, the Secretary of State for Education and Skills will announce new projects to be funded from the Capital Modernisation Fund.

6.43 In the 2002 Spending Review the Government will examine its strategy for delivering education and training objectives in the following crucial areas:

- providing high-quality early education and childcare for more children. Details of the Government's approach to childcare are set out in box 6.4 and in Chapter 4;
- continuing the progress already made in primary education, focusing on achieving rapid improvements in schools in the most deprived areas;
- transforming secondary education and modernising the 14-19 phase along more flexible and challenging lines, in parallel with the reforms outlined in the recent Education White Paper[2];
- increasing and broadening participation in higher education, serving the needs of the economy and society at large; and
- developing workforce skills, especially adult basic skills, so that existing workers are ready to face the challenge of uncertain economic times. Chapter 3 describes the importance of the UK skills base to the productivity and performance of the wider economy.

Box 6.4: Childcare

The Government is undertaking a cross-departmental review of childcare as part of the 2002 Spending Review. The review aims to deliver a ten year vision and strategy for childcare, taking into account its contribution to employment, education and quality of life. The review will enhance the evidence base for childcare, particularly in the areas of supply and demand, and examine delivery options and the outcomes for children, paying special attention to those at risk of exclusion.

Transport

6.44 Transport is of huge economic, social and environmental importance. Poor transport infrastructure is a key factor in restraining potential growth. Tackling congestion and improving the reliability of transport can help to increase productivity, sharpen the competitiveness of British industry, and boost the economic development of all regions. Improving public transport can also help to tackle social exclusion, improving access to public and community services and extending work opportunities. Regeneration is unlikely to occur without high quality integrated transport systems, linked to land-use planning policies.

6.45 To reverse years of under-investment in Britain's transport infrastructure, the Government has introduced a Ten Year Plan for Transport, backed by £180 billion of public spending. The plan aims to reduce congestion, deliver better and more reliable trains, and foster a renaissance in public transport and a significant improvement in transport in London. Following the 2000 Spending Review, spending in 2003-04 will be £4.2 billion higher than in 2000-01. Public investment will rise to £6 billion a year in 2003-04.

6.46 Important steps have already been taken. Some 50 national road schemes have begun, and local authority financing has doubled in the last year, allowing 70 major new local schemes to be approved as well as thousands of smaller schemes. The 2002 Spending Review will build on this progress, ensuring that transport continues to receive the investment needed to meet the targets of the Ten Year Plan. Railtrack is however in administration, with a successor company expected to take over next year. The Strategic Rail Authority's forthcoming plan, under its new chairperson, will set out how the planned additional investment in the railways will deliver new upgrades and service improvements.

Local government

6.47 Local government provides key public services, such as schools and care for the elderly, which play a vital role in improving the lives of local communities. It spends more than £60 billion each year, financed by government grant, non-domestic rates and council taxes. The Government is committed to modernising local government to ensure that high quality and cost-effective services are provided throughout the country.

6.48 To strengthen the delivery of local public services, local Public Service Agreements have been negotiated with 20 pilot authorities that have committed to deliver more stretching outcomes in return for greater flexibilities, freedoms and financial rewards if they succeed. Local PSAs are a new way for local and central government to work together. They provide help for local authorities to deliver, while ensuring that national priorities are met. They have won widespread support in local government and will now be rolled out to 130 larger councils over the next two years.

6.49 The Secretary of State for Transport, Local Government and the Regions will set out in the forthcoming Local Government White Paper how the Government will build on these foundations. The White Paper will explain how central and local government will work closely together to improve local services and enhance the community leadership role of local authorities. The Government will also look at whether more should be done to streamline the number of plans and funding regimes, consent regimes, and the burden of inspection.

6.50 Local PSAs will continue to provide an opportunity to challenge the need for statutory and administrative requirements where an authority is convinced they stand in the way of achieving greater improvements in delivery of services. The Local Government White Paper will go further to strengthen local government's capacity for service delivery and increase their accountability. For instance, the capital finance system will be reformed, restoring local accountability and financial freedom through a prudential borrowing regime.

Box 6.5: Local services

The Chief Secretary to the Treasury has commissioned additional work on local services as part of the 2002 Spending Review. One part of the review will focus on local government finance issues and seek to develop plans for local government grant and capital spending. The rest of the reveiw will look at the development of targets and incentives for local service providers, including targets for delivery in deprived areas. The review will take forward relevant recommendations made in the forthcoming Local Government White Paper.

Housing

6.51 Local authorities and housing associations manage over four million properties for rent. Social housing is therefore one of the principal public services.

6.52 Housing matters because of its links with wider economic and social policy. In some parts of the country, high housing demand, rising prices and scarcity are important social costs: social landlords find it difficult to house vulnerable people suitably, while private and public employers have difficulty recruiting and retaining the people they need. In other areas, low demand and abandonment are serious obstacles to the renewal of deprived neighbourhoods and to the social and economic well-being of wider communities. The complex systems through which poor and vulnerable people receive assistance with finding housing and paying for it are crucially important for tackling poverty and encouraging workless people to find jobs.

6.53 The Government has already taken significant steps to address these issues. In the 2000 Spending Review, the Government announced plans to spend £39 billion over the period to 2003-04 on investment in new housing, the maintenance and renewal of existing stock and support for tenants with their housing costs. The 2002 Spending Review will lay the foundations for further Government action to tackle housing problems - achieving additional improvements in the delivery of housing, and ensuring that housing policy and programmes make the right contribution to regional economic performance, the fight against poverty and social exclusion, and reducing worklessness.

Security at home and abroad

6.54 The current international situation has directed attention toward a new sort of warfare. Britain's armed forces are actively engaged in the campaign against international terrorism. The Spending Review will examine a range of issues, including Britain's capabilities to counter terrorist threats, the manning of the armed forces, the medium-term equipment programme, the implementation of the Defence Training Review, and efficiency and business improvement in the Ministry of Defence. The timing of measures will need to reflect the needs of the evolving situation.

Crime and the police

6.55 Reducing crime is a high priority for the Government. In the 2000 Spending Review, the Government announced plans to spend an additional £1.6 billion on the police by 2003-04 - an increase of more than 12.4 per cent in real terms over the period. While police numbers have now begun to rise, evidence points to significant variations in performance between different forces. The 2002 Spending Review will therefore focus on raising the performance of forces in return for this new investment and the Home Secretary will shortly be publishing a White Paper on police reform. The Spending Review will also focus on tackling the causes of crime, addressing the factors which lead to persistent criminality, and promoting a better and safer environment in public spaces.

Spending and the regional dimension

6.56 As described in Chapter 3, the Government has set a long-term regional economic ambition to reduce the gap in performance between the regions. To advance this ambition, the 2002 Spending Review will assess how departments' policies impact on different regions and seek to ensure that spending is fairly distributed and targeted at those areas where it is needed most and will be most effective. This will include an examination of rural priorities to ensure an equitable balance in resource allocations.

6.57 The Review will also look carefully at the key regional institutions, including the Regional Development Agencies (RDAs), to ensure that they have the tools they need to achieve their objectives and to assess their performance against them. Regional institutions, such as the RDAs and the Government Offices, are being asked to consider the key strategic priorities for their regions to bring about increased productivity. This analysis will feed into departmental allocations and geographical priorities emerging from the 2002 Spending Review.

Box 6.6: Electronic service delivery

The Chief Secretary to the Treasury has commissioned additional work on electronic service delivery as part of the 2002 Spending Review. This work, which will be taken forward alongside the work of the Office of the e-Envoy, will seek to develop a strategy to maximise the impact of electronic public service delivery over the next five years. It will aim to identify the areas in which electronic delivery, in conjunction with the re-design of traditional service delivery systems, can have the largest beneficial impact on services. Working closely with the Office of the e-Envoy, the work will also include an assessment of the impact of e-Government on the size and shape of the public sector workforce over the next 5 to 10 years.

Sustainable development

6.58 The Government's Sustainable Development Strategy seeks to promote a better quality of life for everyone, today and for generations to come. The 2002 Spending Review will be an opportunity to take forward the Government's commitment to sustainable development. Spending departments and the Treasury will both use the Sustainable Development Strategy as the foundation for considering the social, economic and environmental impact of the Spending Review. The Strategy sets out the principles underlying the Government's approach and the indicators against which progress is measured. Further detail on the Strategy is given in Chapter 7.

Cross-cutting reviews

6.59 The 1998 Comprehensive Spending Review introduced cross-cutting reviews of policy areas spanning several departments' responsibilities. The range of cross-cutting reviews was increased in the 2000 Spending Review. The goal of cross-cutting reviews is to ensure that effective solutions are found to solve the biggest challenges facing public services, through coordinated departmental policies, resources and implementation efforts. By looking at issues across departments, the reviews aim to avoid wasteful duplication, identify and fill gaps in services, and ensure that resources are used effectively and efficiently.

6.60 The 2002 Spending Review will assess progress across the range of reviews initiated as part of the 2000 Review. It will also take forward work on seven additional reviews, to be completed in early 2002. The outcome of the reviews will be reflected in individual departments' spending plans, pooled budgets and PSA targets where appropriate. Box 6.7 describes the goals of these additional reviews.

Box 6.7: Goals of the cross-cutting reviews in the 2002 Spending Review

Health inequalities: this review will address the range of factors contributing to health inequalities, such as access to care, education, employment, housing, the environment, and nutrition. Its aim is to devise an integrated approach to addressing these factors to narrow the health gap across socio-economic groups. The review will advance the Government's ability to track and deliver its targets in the areas of infant mortality and life expectancy.

Children at risk: this review will take forward the Government's commitment to tackle poverty and social exclusion across the country by examining the range of programmes and initiatives designed to help children at risk. It will propose solutions to tackle current barriers to delivering services, make recommendations on targets for children's outcomes and identify activities across departments that could be rationalised to eliminate duplication and gaps.

The public sector labour market: public sector employers must be able to recruit, retain and motivate qualified staff to ensure the delivery of public services. This review will identify the trends affecting the size and composition of the public sector workforce over the next five years, and assess how best to improve recruitment and retention, enhance work flexibility and career opportunity in the public sector, and ensure that the skills of staff are used effectively.

The role of the voluntary sector in public service delivery: the voluntary and community sector makes an important contribution to the delivery of public services. The aim of this review is to explore further ways in which central and local Government can work in partnership with the sector to deliver high quality services. It will build on the principles set out in the 1998 Compact on Relations between Government and the Voluntary and Community Sector in England, and identify existing barriers to voluntary sector participation.

Public space: tackling local environmental problems is key to creating stronger communities and improving local quality of life. This review is examining how Government policies, funding and targets can produce improvements in the safety and attractiveness of public space, including how Government can support effective local partnerships between public services, communities, and businesses.

Services to small business: the aim of this review is to improve and streamline interaction between small business and government. The review will identify opportunities to improve the delivery of services to small businesses and the scope for integrating different service providers. It will address barriers to entrepreneurship among disadvantaged groups and propose options for reducing them. It will also evaluate the role, resources and capability of the Small Business Service.

Science and research: this review will examine the funding of the UK science base and the effectiveness of departments' science and research programmes. It will make proposals to improve funding mechanisms, enhance knowledge transfer, and improve recruitment to the research profession. It will also map departments' current and future research plans to improve coordination and value-for-money, and ensure that research priorities are aligned with the Government's overall strategic objectives.

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

[2] *Schools Achieving Success*, Department for Education and Skills, Cm 5230, September 2001. [Back]

7 Protecting the environment

Sustainable development is vital to ensure a better quality of life, consistent with higher and stable levels of economic growth and employment. The Government is committed to protecting and, where possible, enhancing the environment. Sustainable development is a global challenge, and there can be no relaxation in efforts to achieve it. Action is needed globally, nationally and locally.

The Government is committed to a long-term strategy to deliver its goals of tackling climate change, improving local air quality, regenerating Britain's towns and cities, and protecting Britain's countryside. It is announcing new steps and reporting on progress, including:

- **business energy-efficiency**: by implementing the climate change levy package from April 2001, including successful implementation of 44 negotiated agreements with energy-intensive sectors; and the launch of the world's first economy-wide emissions trading scheme in April 2002;
- **the Green Technology Challenge**: by proposing further tax incentives in the form of enhanced capital allowances for environmentally-friendly investments;
- **tax incentives for future vehicles and fuels**: by considering further tax incentives for low-carbon vehicles and fuels in the context of the Government's draft strategy, *Powering Future Vehicles*, and fuel duty exemptions for pilot research projects into future road fuels as part of the Green Fuel Challenge;
- **modernising road haulage taxation**: consultation on options to introduce a lorry road-user charge so that lorry operators contribute to the costs that they impose irrespective of their nationality, while ensuring that overall costs to the UK haulage industry are not increased; and previously announced changes to vehicle excise duty to begin in December 2001; and
- **the aggregates levy**: by launching the aggregates levy in April 2002. The Government is proposing to phase in the levy for aggregates used in processed products in Northern Ireland.

INTRODUCTION

7.1 Sustainable development means a better quality of life for everyone, today and for generations to come. It can be achieved by balancing social, economic and environmental progress. The Government is using tax and other economic instruments to put sustainable development at the centre of policy-making and is pursuing a comprehensive and proactive course of action to:

- **tackle climate change.** There is strong evidence that global temperatures are rising, affecting the world in unpredictable and potentially extreme ways. Temperature changes, drought, floods and rising sea levels all threaten and disrupt people's lives. Poor countries make the smallest contribution to climate change but are often the most severely affected when it happens. The Government has therefore set a long-term goal to tackle climate change, delivering its commitments under the Kyoto Protocol and - critically, given the international nature of this problem - encouraging others to meet theirs;
- **improve air quality.** Poor air quality damages health and can lead to debilitating illness and premature death. Often it is the most vulnerable people in society - the elderly and children - who are most at risk;
- **regenerate Britain's towns and cities.** A derelict and under-developed physical environment has a detrimental impact on the social and economic fabric of communities. Population movement out of urban areas makes it difficult to sustain good services and leads to pressure for new development in the countryside. If 45 per cent of new homes continue to be built on greenfield land, within 20 years an area the size of Exmoor would be built over and the quality of life in both urban and rural areas would suffer; and
- **protect Britain's countryside.** Unsustainable use and disposal of natural resources threatens biodiversity and the natural physical characteristics of the countryside, impacts on human health and has a negative impact on local communities' quality of life.

Indicators

7.2 Progress towards sustainable development is carefully measured through headline indicators covering environmental protection, economic growth and social progress. While global environmental problems, such as climate change, pose significant risks for society as a whole, local environmental issues also have an important effect on people's standard of living. Sustainability indicators therefore address people's everyday concerns, including health, jobs, crime, air quality, traffic, housing and educational achievement. Many indicators are referred to in this chapter to demonstrate the role of specific policy measures. Table 7.1 sets out the sustainability indicators that are relevant to the policies described in this chapter.

Instruments

7.3 The Government uses the full range of instruments to address environmental issues, including public spending, voluntary agreements, regulation, taxes, and other economic instruments, such as permit trading. The choice of economic instrument depends on the nature of the market failure to be addressed. Where the full social and environmental costs of an activity are not incorporated in prices, the Government can allow the market to adjust to efficient levels of production by levying appropriately set taxation.

Statement of Intent on Environmental Taxation

7.4 The use of taxation follows the Government's Statement of Intent on Environmental Taxation, set out in the July 1997 Budget. The Statement describes how the Government is using the tax system to promote sustainable growth, by shifting the tax burden away from goods, such as employment, towards bads, such as pollution. Environmental taxes must also meet universal tests of good taxation: they must be well designed, meet objectives without undesirable side-effects, keep deadweight compliance costs to a minimum, have an acceptable distributional impact, and take account of any implications for international competitiveness. The Government will continue to use and develop environmental taxes where these criteria are met.

7.5 Where there are other market failures it may be necessary to use other policy instruments to overcome them, either in conjunction with a tax or separately. For example, tax reliefs and public spending can encourage behaviour with environmental benefits, and trading schemes can enable the market to determine the least costly method of securing efficient reductions in pollution.

Box 7.1: Tax incentives

The tax system can be used to promote better environmental behaviour, both by taxing environmentally damaging activities and by offering tax relief for activities which benefit the environment. Circumstances where tax reliefs - such as capital allowances for investment in energy-saving technologies - can be appropriate include:

- when taxes alone are not the most effective method of changing behaviour. Tax incentives, in the form of reliefs, may be used to complement and accelerate the desired behavioural effect of environmental taxes - for example, where there are specific targets to be met;
- when market or other circumstances make it difficult to attribute specific environmental damage to individual polluters or to identify the correct base for an environmental tax; and
- when social considerations mean that it is not considered equitable to tax the polluter or to tax the polluter at the full rate implied by the environmental damage caused.

7.6 This chapter describes recent developments and new announcements in support of environmental sustainability. It covers three broad areas of environmental objectives:

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

TACKLING CLIMATE CHANGE AND IMPROVING AIR QUALITY

The challenge of tackling climate change

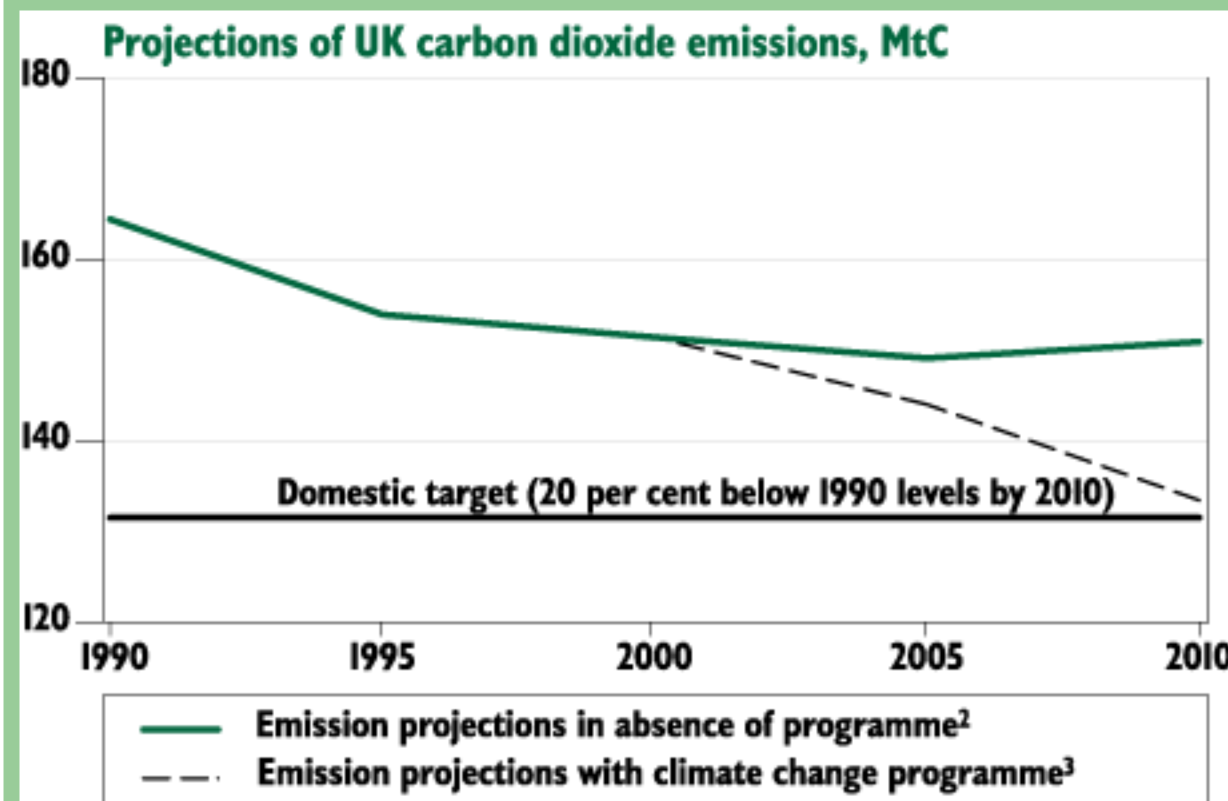
7.7 There is strong evidence that global temperatures are rising. The 1990s are likely to have been the warmest decade for the past 1,000 years. The most recent estimate of the extent of global warming for the 21st century (of 5.8 degrees Celsius) is double that estimated in 1995.[1] Climate change will affect the world in unpredictable and potentially extreme ways. Emerging evidence suggests that severe weather events are becoming more frequent and that the situation is likely to get worse. The problems are felt across society - by businesses, households and governments - and cause harm to the natural environment. The Government is therefore taking important steps to address this challenge, controlling and reducing emissions of the gases responsible for global warming.

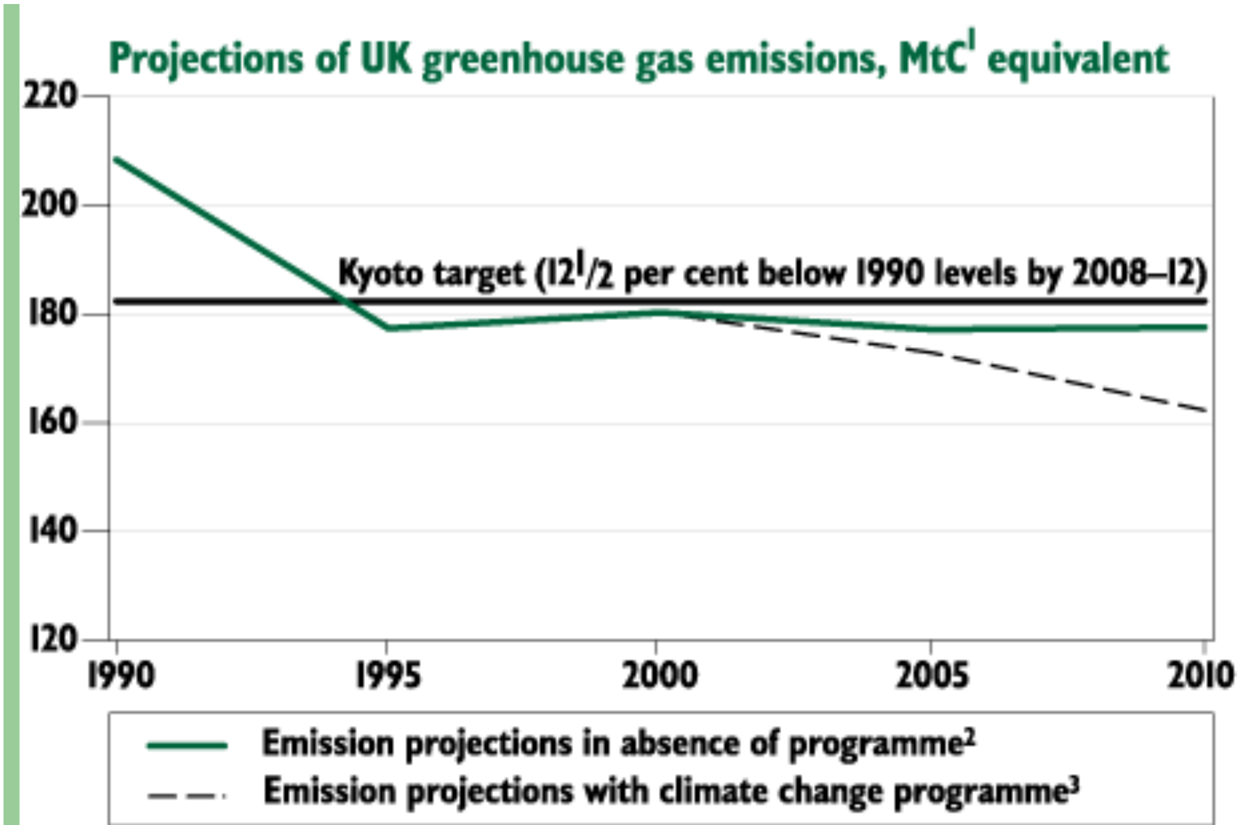
Climate change targets

7.8 The Kyoto Protocol commits the UK to cut greenhouse gas emissions by 12.5 per cent below 1990 levels between 2008 and 2012. Significant progress has been made towards reaching this target: by 1999, emissions had already fallen 14.5 per cent below 1990 levels. This puts the UK well on course to deliver its international commitments under the Kyoto Protocol and marks a positive step towards fulfilling the Government's domestic goal to cut carbon dioxide emissions by 20 per cent below 1990 levels by 2010. Box 7.2 shows projections for UK emissions.

Box 7.2: Emission projections and targets

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





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

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

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

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

7.9 The Government's programme for reducing emissions is challenging. Designed to take the UK well beyond its Kyoto target, it demonstrates a clear commitment by the Government and the devolved administrations to tackle the causes of global warming. The Government estimates that the policies and measures included in the programme could reduce the UK's emissions of the basket of greenhouse gases covered by the Kyoto Protocol to 23 per cent below 1990 levels by 2010. Alongside other measures, such as public awareness campaigns, it could also bring down carbon dioxide emissions by 20 per cent from their levels in 1990, in line with the Government's goal.

The challenge of improving air quality

7.10 Poor air quality poses risks to human health, quality of life and the natural environment. It affects everyone and particularly elderly people and children. Each year in the UK, 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 cardio-vascular problems. Emerging evidence suggests that the health effects of exposure to long-term air pollution are even greater.

Air quality targets

7.11 The Government's Air Quality Strategy (AQS) for England, Wales, Scotland and Northern Ireland[2] aims to ensure that everyone can enjoy a level of ambient air quality in public places that poses no significant risk to health or quality of life. The strategy includes targets for carbon monoxide, lead, nitrogen dioxide, particles, sulphur dioxide, benzene and 1,3-butadiene. In

September 2001, the Government launched a consultation on adopting new, tighter objectives for some AQS pollutants. These will cut air pollution further and deliver greater health benefits, while avoiding unreasonable costs. In addition, 95 per cent of local authorities have completed assessments of air quality and some 60 authorities have designated air quality management areas. Local authorities will be drawing up action plans to improve local air quality over the next 12 to 18 months.

7.12 In general, air quality in the UK is improving. The number of days of poor air quality in urban areas in the year 2000 was the lowest since the series began in 1993[3], consistent with the overall downward trend of air pollution over the last seven years.

Meeting the challenges

7.13 All sectors of the economy share in the responsibility of tackling climate change and air quality. To achieve its domestic and international goals, the Government has put in place a range of policies relating to business, households and transport.

Business

7.14 Business has a central role in helping to meet the challenging targets for climate change and air quality. The Government has therefore introduced:

- the climate change levy (CCL);
- additional energy-efficiency advice;
- support for investments in energy-saving technologies;
- support for renewable energy and the development of new low carbon technologies; and
- an emissions trading scheme.

Climate change levy

7.15 Introduced in April 2001, the CCL and its associated package of measures are designed to encourage the non-domestic sector to become more energy efficient, reducing carbon emissions by around 5 million tonnes a year by 2010. Broadly revenue-neutral for business, the CCL package of measures includes:

- the levy itself, and important exemptions for new sources of renewable energy and for fuel used by good quality combined heat and power (CHP) systems;
- a 0.3 percentage point reduction in employers' national insurance contributions;
- 80 per cent discounts for eligible energy-intensive users that have signed up to negotiated agreements and agreed challenging targets to increase energy-efficiency;
- support for business energy-efficiency and renewable energy technology through the Carbon Trust; and
- enhanced capital allowances for business investments in energy-saving technologies.

Negotiated agreements

7.16 Energy-intensive sectors of industry have already entered into 44 negotiated agreements with the Government to meet challenging energy-efficiency targets in return for 80 per cent levy discounts (see box 7.3). Progress will be reviewed every two years, with the first review in early 2003. Sites that fail to meet their targets will lose the benefit of their discount. The Department for Environment, Food and Rural Affairs (DEFRA) is administering the agreements and will review their operation with sector associations early next year. The targets will be subject to renegotiation during 2004-05.

Box 7.3: Industry sectors benefiting from negotiated agreements

Forty-four agreements are currently in place, covering 5,000 operators at 13,000 individual sites. The table below lists the ten sector agreements that cover the largest energy users and account for between 85 and 90 per cent of the total energy use of the industries with negotiated agreements. The agreements cover a range of other smaller sectors including intensive agriculture, leather production, brewing and distilling. Together, these agreements are expected to deliver a carbon reduction of at least 2.5 million tonnes (MtC) a year by 2010.

Negotiated Agreements

Sector association	*Coverage of agreement*
Aluminium Federation	**Production, melting, refining and treating of aluminium**
British Cement Association	**Manufacture of cement**

British Ceramics Association	**Manufacture of ceramics**
British Glass Manufacturers Confederation	**Manufacture of glass**
Chemical Industries Association	**Chemicals**
Food & Drink Federation	**Manufacture of food and drink products (not preparation of food)**
Non-Ferrous Alliance	**Non-ferrous metals**
Target 2010	**Foundries**
The Paper Federation	**Manufacture of paper**
UK Steel Association	**Steel**

The Carbon Trust and energy-efficiency

7.17 The Carbon Trust was established in April 2001 to take the lead on low-carbon technology and innovation in the UK. The Trust operates as an independent company and its funding of £50 million a year principally comes from recycled CCL revenues. The Trust will take over responsibility for the Energy Efficiency Best Practice programme, which provides businesses with independent information to help them save energy, cut waste and reduce carbon emissions. Companies can receive tailored advice and site energy surveys from the Environment and Energy Helpline. The Trust will also have responsibility for managing the lists of technologies and products that qualify for enhanced capital allowances (ECAs) and will be introducing programmes to support the development of new low-carbon technologies.

Investment in energy-saving technologies

7.18 ECAs for investments in approved energy-efficient technologies were introduced in April 2001 as part of the CCL package of measures. The present scheme covers eight groups of energy-efficient technologies and over 1,800 approved products and is estimated to be worth up to £70 million in 2001-02 and £130 million in 2002-03. Applications for new technologies, including ideas submitted through the Green Technology Challenge, are currently being considered and further additions to the scheme will be made in 2002-03.

Combined heat and power

7.19 The Government recognises the difficult market conditions now facing operators of combined heat and power (CHP) systems as a result of recent changes in energy prices. The DTI is consulting on the impact of the first few months of the New Electricity Trading Arrangements (NETA) on smaller generators and on the means by which the Government could address concerns. Subject to legal and other constraints, the Government will also consider the environmental case for providing more favourable treatment for CHP within the CCL, taking account of the role which CHP might play in meeting the UK's climate change targets.

Emissions trading

7.20 As previously announced, the Government is launching the world's first economy-wide greenhouse gas emissions trading scheme in April 2002. The emissions trading scheme is a major new initiative, putting the UK at the forefront of trading. Trading will allow participants to meet their targets at the lowest cost, either by reducing their own emissions or, if it is cheaper, by buying emissions allowances from other participants who have found it worthwhile to beat their targets. Consequently, the scheme will enable environmental targets to be met as cost-effectively as possible.

7.21 A framework document for the scheme was published in August 2001. Entry is open to any organisation responsible for emissions in the UK, including companies in CCL negotiated agreements which will be able to use trading as a way of reducing the costs of meeting their agreed targets. A pre-registration for potential participants is operating until 1 February, after which participants will bid into an auction to establish voluntary five-year emissions reduction targets and allocate incentive funds of up to £30 million after tax in the first year. A first trade of UK allowances has already been completed on a forward basis. The Government hopes that the first round of entrants to the scheme will deliver annual reductions of around 0.8 million tonnes of carbon (MtC).

Renewable energy

7.22 The Government is supporting renewable energy with a mixture of economic instruments. The Renewables Obligation will require all licensed electricity suppliers to acquire a specified proportion of electricity from renewable generators. Comparable mechanisms exist for Scotland and Northern Ireland. The climate change levy exemption applies to most renewable generation. Existing commitments made under the Non-Fossil Fuel Obligation - funded by a levy on electricity generators used to support otherwise non-competitive renewable electricity production - will continue to apply. As shown in chart 7.1, the Government is also spending £267 million directly supporting renewables over the next three years.

Chart 7.1: Renewable Energy

Green Technology Challenge

7.23 As announced in Budget 2001, the Government has consulted on setting up a Green Technology Challenge (GTC), with the intention of offering enhanced capital allowances (ECAs) to encourage investment in a broader range of environmental objectives[4]. Some 100 responses were received, a summary of which will be published shortly. Overwhelmingly, these responses showed strong support for using tax incentives to achieve environmental improvements, while recognising that ECAs are more suitable for dealing with some environmental issues than others. **The Government has evaluated the responses to the Green Technology Challenge consultation and, subject to EU state aids approval, proposes to introduce further ECAs to:**

- **tackle climate change and improve air quality;** and
- **reduce water use and improve water quality.**

7.24 In using the GTC to strengthen its approach to tackling climate change and improving air quality, the Government proposes to focus on two avenues:

- **energy-saving technologies** - this will be taken forward by the Carbon Trust with DEFRA and the Inland Revenue; and
- **cleaner road fuels and vehicles** - proposals for using ECAs will be considered in the context of the Government's consultation on "Powering Future Vehicles" to be launched shortly.

7.25 The Government's plans to take forward the second of these objectives under the GTC are discussed later in this chapter. The Government will consider extending the scope of the GTC over time and in particular to sustainable energy technologies.

Households

7.26 Encouraging greater energy-efficiency in the home is key to tackling fuel poverty and reducing carbon emissions. The Government has introduced a number of measures to ensure that households play their part in meeting the UK's emissions targets while protecting the most vulnerable groups of people.

VAT on energy-saving materials

7.27 The Home Energy Efficiency Scheme provides central heating systems for low-income, older and other vulnerable householders at risk of ill-health from cold homes. By August 2001, more than 175,000 households in England had benefited from improved heating and insulation. In Budget 2000, the Government reduced the rate of VAT on the grant-funded installation of new central heating systems and heating appliances. This has allowed the scheme to assist 19,000 more households than would otherwise have been possible.

Affordable Warmth Programme

7.28 The Government has introduced capital allowances to support the installation of energy-efficient heating systems and insulation in low income households under the Affordable Warmth Programme. By August 2001, more than 15,000 households had benefited from central heating installations carried out under the programme. Additional support for the programme, provided by the European Investment Bank, will enable significantly more households to benefit.

Energy efficiency commitment

7.29 The Energy Efficiency Commitment (EEC) will require gas and electricity suppliers to make significant energy savings between 2002 and 2005 by encouraging and assisting their domestic customers to reduce their household energy consumption. Half of these energy efficiency benefits will be received by low income consumers. The EEC is expected to cut greenhouse gas emissions by around 0.4 million tonnes of carbon a year by 2005.

Transport

7.30 A safe, clean, convenient and efficient transport system is crucial to sustaining economic growth, improving the quality of life and safeguarding the environment. Rising economic activity and increased incomes have generated a higher demand for personal travel and the transport of goods and services over recent decades. Over the last thirty years passenger and freight travel has almost doubled. Road traffic is projected to continue growing over the next decade. The Government's strategy to address these issues includes:

- in the long-term, to assist the switch to a low-carbon economy, including zero emissions transport;
- over the medium-term, to set incentives for greener transport; and
- in the short-term, to encourage use of the most environmentally-friendly widely available fuels and vehicles.

Box 7.4: Promoting cleaner transport

The Government is committed to working with industry and its international partners to improve the environmental performance of road transport using a wide range of policy tools:

- **tax incentives for cleaner transport**: using duty incentives to promote more efficient use of fuel and cleaner forms of petrol and diesel and alternative fuels, reforming vehicle excise duty and company car tax systems to reward less polluting cars, and introducing incentives for greener forms of commuting;
- **targeted grants to promote cleaner technologies**: through PowerShift and CleanUp programmes, supporting the conversion of 8,000 vehicles to road fuel gases or electricity, and the retrofitting of another 2,000 diesel vehicles with advanced after-treatment technologies, such as particulate traps or oxidisation catalysts;
- **voluntary agreements**: playing a leading role in developing voluntary agreements between the European Community and car manufacturers to reduce carbon dioxide emissions from new cars sold across Europe; and
- **regulations**: working closely with European partners to set challenging improvements in vehicle emission and fuel quality standards.

Fuel duties and cleaner fuels

7.31 Differential rates of fuel duty can help to encourage the rapid use of more environmentally-friendly fuels and have stimulated development of new technology to reduce greenhouse gas emissions and reduce the impact of motoring on local air quality. As a result of the Government's policies to encourage more efficient vehicles and cleaner fuels, average carbon dioxide emissions for new cars have fallen by 5 per cent from 1997 to 2000 and are expected to fall by a further 20 per cent by 2008-09.

Low sulphur fuels

7.32 The duty differential in favour of ultra-low sulphur petrol (ULSP) encouraged industry to convert unleaded petrol sales to ULSP by June 2001, making the UK one of the first EU countries to complete this transition. ULSP offers environmental benefits over ordinary unleaded petrol when used in modern cars fitted with three-way catalytic converters. Research suggests that it can reduce emissions of nitrogen oxides by up to 6 per cent, carbon monoxide by around 11 per cent and hydrocarbon emissions by up to 14 per cent.

Chart 7.2: Conversion to ULSP

7.33 Following the successful introduction of a duty incentive from 1997, ultra-low sulphur diesel (ULSD) has accounted for all diesel used by road vehicles in the UK since 1999. ULSD reduces particulate emissions from existing diesel vehicles and allows the use of advanced emission abatement technology, such as particulate traps, which in turn reduce emissions by up to 90 per cent.

Lead replacement petrol

7.34 The higher duty rate for lead replacement petrol (LRP) was abolished in Budget 2001 as it does not create significant environmental impacts over and above ordinary unleaded petrol. Duty on LRP is now based on the fuel's sulphur and aromatics content, providing an incentive to reduce sulphur levels. Low sulphur LRP currently accounts for around 30 per cent of total LRP production and is set to rise during 2001 as further UK refiners switch production.

Green Fuel Challenge

7.35 The Government launched the Green Fuel Challenge (GFC) in November 2000 to promote the development of practical alternative transport fuels with environmental benefits. In response to proposals received under the GFC, a series of duty cuts for alternative fuels were introduced in Budget 2001.

7.36 To maintain the duty differential between road fuel gases associated with lower levels of local air pollution, and petrol and diesel, Budget 2001 cut duty on road fuel gases to 9 pence per kilogramme and froze this duty in real terms until 2004 at the earliest. This is already contributing to positive growth in the road fuel gas market. The number of liquefied petroleum gas (LPG) refuelling sites is expected to exceed 1,000 by the end of 2001, compared with 100 in early 1998. LPG-fuelled cars are expected to rise to nearly 100,000 by 2006 - a four-fold increase from today.

7.37 As announced in Budget 2001, to offset additional production costs of bio-diesel, and permit the UK to benefit from the reduced greenhouse gas emissions that this fuel can offer, the Government will, subject to EU agreement, introduce **a new duty rate for bio-diesel, set at 20 pence per litre below the ULSD rate in Budget 2002.**

7.38 Other proposals made under the GFC offered potential longer-term benefits but still require considerable research and development. The Government invited formal bids for pilot project status in July. **After considering the bids, the Government has now selected three projects which, subject to European agreement, will receive fuel duty reductions or exemptions. These relate to:**

- **hydrogen fuelling infrastructure for fuel cell buses;**
- **the capture, compression and use of landfill gas (biogas) and in a variety of vehicles;** and
- **the testing of methanol in various vehicles, and in the refuelling infrastructure.**

7.39 The Government is also considering promising proposals received in response to this first stage of the Challenge covering ethanol. **It will be inviting a second stage of bids for pilot projects under the Green Fuel Challenge in spring 2002.**

VED for cars

7.40 As announced in Budget 2000, the Government has this year introduced a new vehicle excise duty (VED) system for cars first registered after 1 March 2001. This four-banded graduated system encourages the purchase of cars with better fuel efficiency and lower carbon dioxide emissions and cars using fuels that are better for local air quality. This means that the least polluting vehicles pay up to £70 less VED a year.

7.41 Budget 2001 also extended the incentive to purchase smaller, and typically more efficient, second-hand cars. From 1 July 2001, all cars first registered before 1 March 2001 with an engine size below 1549cc now pay only £105 in VED. This was backdated to new licences purchased from November 2000 through rebates. The DVLA has paid out over £170 million to nearly 4.5 million motorists.

VED for motorcycles

7.42 In recognition of the important role that motorcycles play in the vehicle fleet, the Government is **launching a consultation on options for modernising motorcycle VED** to ensure, in particular, that the VED system reflects the benefits small motorcycles could bring if they substitute for car use.[5]

VED for vans

7.43 Vans make up 8 per cent of the vehicle fleet, but produce a disproportionate amount of local air pollutants. The Government wants to encourage van manufacturers and users to develop and adopt new technologies with environmental benefits, including vans that meet the challenging new Euro-IV emissions standards ahead of the 2007 mandatory date. **The Government will discuss with industry and other stakeholders how best to achieve this objective, for example through VED, in advance of Budget 2002.**

Encouraging new vehicle technology

7.44 As a step towards zero-emissions transport in the long-term, the Government is committed to promoting the development and take up of next-generation low-carbon vehicles. It recognises that early and clear fiscal incentives can have an important role in encouraging this development. **It will consider in Budget 2002 the possible role and scope of such incentives in the context of the Government's draft strategy document, *Powering Future Vehicles*, which will be published shortly.**

Companies

7.45 Companies purchase approximately 50 per cent of new cars in the UK and about 20 per cent of all vehicle miles are made in company cars. Company car taxation therefore plays a crucial role in encouraging the take up of cleaner, more fuel-efficient vehicles. The Government is introducing reforms in three vital areas:

- reforms to company car tax;
- reforms to the allowances employers can pay for business journeys carried out in private cars without incurring a tax liability; and
- incentives to encourage greener forms of commuting.

Company car tax

7.46 As announced in Budget 2000, a major, revenue neutral, reform of company car taxation will be implemented shortly to promote the use of more environmentally-friendly company cars. **From April 2002, the income tax charge on a company car will be based on a percentage of the car's list price graduated according to the level of the car's carbon dioxide 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 of carbon dioxide above a specified level. Diesel cars (except those meeting the Euro-IV emissions standard) will be subject to a supplement of 3 per cent of the car's price, up to a maximum of 35 per cent, due to their higher emissions of particulates and other local air pollutants. Discounts will be available for cars powered by electricity or gas and for hybrid petrol/electric cars. It is estimated that these changes will save around 0.5 to 1.0 MtC per year by 2011-12.

Fuel scale charge

7.47 This tax year is the fourth of a five-year programme of annual increases announced in Budget 1998 to discourage the giving or receiving of free fuel for private use in a company car. **The Government will shortly invite views on proposals to restructure the fuel scale charge for 2003 to relate it to carbon dioxide emissions.**

Authorised mileage rates

7.48 As announced in Budget 2001, building on the reforms to company car taxation, the Government is also **introducing a new statutory system of mileage rates from April 2002** to provide an incentive to drive more efficient vehicles for business trips. Employers will be able to offer compensation of up to 40 pence per mile, free of tax and NICs, for the first 10,000 business miles per year. The tax free rate will be set at 25 pence per mile above this threshold. Both rates apply to all sizes of car, increasing incentives for drivers to use smaller, more efficient cars. As announced in Budget 2001, the Government is also **introducing in April 2002 a new passenger rate of 5 pence per mile per passenger to encourage car-sharing on business trips and an increased income tax and NICs free mileage rate paid by employers for cycle use for business trips of 20 pence per mile.**

Green travel

7.49 The Government is committed to the cost-effective use of the tax system to encourage cleaner, greener forms of commuting. Budget 1999 introduced legislation to allow employers to provide free bus transport for the commute to work without beneficiaries incurring a tax liability. **The Government is currently consulting on proposals to extend the tax exemption for employer subsidised public bus services to give employees free or reduced cost travel to work.**[6]

Haulage industry

7.50 Haulage is important to a successful and sustainable economy. Recent Budgets have introduced a variety of measures to support action by the haulage industry to become more internationally competitive and less environmentally damaging. These include reforms to VED and the introduction of the Haulage Modernisation Fund. The Government's Ten Year Plan for Transport will also increase the efficiency of freight transport and reduce its environmental impact.

VED for lorries

7.51 Budget 2001 set out a **new system of VED for lorries that will come into force on 1 December 2001.** This will encourage hauliers to use lorries that cause less road and environmental damage. It will also give hauliers greater flexibility to vary the type of vehicle they use in their every day operations, by not requiring them to re-license each time they switch vehicle types. It will mean that 80 per cent of lorry VED re-licensing can be done at post offices.

Lorry road-user charging

7.52 The Government is determined to ensure that lorry operators from overseas pay their fair share towards the cost of using

UK roads. It believes that there are good economic, environmental and social reasons to introduce a lorry road-user charge to ensure that lorry operators using UK roads contribute towards the costs that they impose, irrespective of their nationality. **The Government is therefore publishing a consultation document, *Modernising the Taxation of the Haulage Industry*[7], setting out options for introducing a road-user charge for lorries operating in the UK and seeking the views of the haulage industry, business and other stakeholders. The two options outlined in the consultation are for charging either on the basis of time or on the basis of distance.** As the UK haulage industry already contributes towards the costs that it imposes, the Government will ensure that it does not pay more as a result of a new lorry road-user charge, through implementing offsetting reductions in other taxes on lorry operators.

Haulage Modernisation Fund

7.53 The Government announced the creation of a three-year £100 million ring-fenced Haulage Modernisation Fund in the November 2000 Pre-Budget Report. The fund offers support for modernising, improving efficiency and lessening the environmental impact of road freight. Schemes supported by the Fund with important environmental benefits include:

- retrofitting: £30 million is being spent in England to retrofit older lorries with modern technologies to reduce emissions of local air pollutants. Retrofitting will enable some hauliers to qualify for up to £500 lower VED rates; and
- a fuel economy adviser scheme: due to start in England by the end of 2001, the scheme aims to cut overall fuel consumption by at least 5 per cent by providing on-site advice to heavy goods vehicle operators.

VED for tractors

7.54 Budget 2001 abolished VED on tractors and other vehicles that previously qualified for the £40 special concessionary VED rate. This measure took effect from 1 April. As promised in Budget 2001, the Government has consulted with industry representatives and will extend **the exemption to vehicles designed for lifting and loading agricultural, horticultural and forestry materials from January 2002.**

REGENERATING BRITAIN'S TOWNS AND CITIES

Why regeneration matters

7.55 During the last decade many British towns and cities experienced significant changes in their economic base. While some have taken important steps to respond to these changes, physical and economic deprivation and social neglect continue to characterise far too many.

7.56 The Government has an important role to play in supporting sustainable development and regeneration in urban areas, rectifying market failures that deter physical investment in land and buildings and delay economic development. Chapters 3 and 5 describe the measures the Government is introducing to stimulate enterprise in disadvantaged areas and to build stronger and fairer local communities. This section describes how the Government is meeting the challenge of urban regeneration, through:

- fiscal measures, described in the Government's Urban White Paper, that address market failures damaging the urban environment; and
- a range of other measures to improve local quality of life, including work as part of the 2002 Spending Review on how Government policies can improve the safety and attractiveness of public space.

Urban White Paper

7.57 The Urban White Paper responded to Lord Rogers' report, *Towards an Urban Renaissance*, and described how the Government would take action to ensure that:

- the wider benefits of regeneration are reflected in developers' decisions;
- property markets function effectively and derelict land can be sold for re-development; and
- informational asymmetries in the property market are corrected. Extra incentives for developers should encourage them to carry out more detailed assessment of the risks of developing derelict or vacant sites in depressed or unproven locations.

7.58 The Urban White Paper package of fiscal measures, worth £1 billion over five years, will help to make better use of existing housing stock, encourage re-use and re-development of brownfield land and provide assistance to disadvantaged communities. The measures include corporation tax rebates and changes to VAT and stamp duty. Most of these measures have been available since May 2001 and arrangements are being put in place to monitor their impact over time.

Tax relief for cleaning up contaminated land

7.59 A 150 per cent accelerated tax credit for the costs of cleaning up contaminated sites has been available to owners and investors since May 2001. Cleaning up sites will increase the supply of previously developed land available for development, reducing pressure to build on greenfield sites. It can also have significant local environmental, economic and social benefits.

Stamp duty

7.60 To increase investment in deprived areas, an exemption from stamp duty for all property transfers up to £150,000 will be available in the UK's most disadvantaged areas from 30 November 2001. Chapter 3 covers this measure and its impact in driving forward enterprise and economic regeneration in disadvantaged areas in more detail.

Tax relief for creating flats over shops

7.61 Since May 2001, 100 per cent capital allowances have been available for creating flats for letting above shops, encouraging the recycling of redundant space for housing, typically in urban areas, with social and other benefits.

VAT relief for residential conversions

7.62 To make better use of empty properties and the existing housing stock, and to encourage the conversion of houses into flats, the Government has introduced a range of further measures, including:

- a 5 per cent reduced rate of VAT on renovating dwellings that have been empty for three or more years;
- an adjustment to the VAT zero rate to provide relief for the sale of renovated houses that have been empty for 10 years or more;
- a 5 per cent reduced rate of VAT on residential conversions that result in a change in the number of dwellings in a property; and
- a 5 per cent reduced rate of VAT for the cost of converting residential property into residential communal homes, such as care homes and homes with multiple occupation.

Urban Regeneration Companies

7.63 Urban Regeneration Companies (URCs) are a new means of organising and delivering major regeneration projects in key urban locations. URCs are independent companies, established by the local authority, Regional Development Agency and other public and private sector partners. The first URCs, in Liverpool, east Manchester and Sheffield, are already succeeding in coordinating development strategies and increasing business confidence. The Government has recently consulted on the prospect of giving tax relief on company donations to URCs and similar bodies across the UK and will announce the results in Budget 2002.

Public space and the local environment

7.64 In April 2001, the Prime Minister set out a series of measures designed to improve local quality of life. The measures aim to tackle local environmental problems and ensure that all public spaces are safe, clean, well maintained and designed, and serve the needs of all groups, including those with disabilities and minority groups. Local government will have the freedom and control to prioritise and tackle issues of local importance, working within a framework set by central government.

7.65 As described in Chapter 6, the Government is also launching a cross-cutting review, as part of the 2002 Spending Review, to examine how Government policies, funding and targets can produce improvements in the safety and attractiveness of public space. The review, which is open and considering the views of the full range of stakeholders, will produce recommendations by the end of the year.

7.66 As part of the Towns and Cities Initiative, the Government has nominated 24 towns and cities to exchange ideas and experience over the next 12 months to develop strategies for dealing with quality of life problems. Successes and best practice will be showcased at the Urban Summit in autumn 2002.

Abandoned vehicles

7.67 The Government is committed to tackling the problem of abandoned vehicles. It has launched a consultation exercise on proposals to remove them more swiftly in the short-term and to prevent them from being abandoned in the longer-term.[8] **As**

part of these proposals, the Government is determined to challenge motorists who evade VED and is reviewing options for ensuring that there is a sufficient penalty to deter such evasion.

PROTECTING BRITAIN'S COUNTRYSIDE

7.68 The Rural White Paper, published in November 2000, set out the Government's vision of a countryside that is sustainable economically, socially and environmentally. Chapter 5 describes how the Government allocated £1 billion in the 2000 Spending Review to help secure real improvements in health, education, housing and transport for rural communities, and has made available £600 million through the Rural Development Programme. Box 7.5 sets out the range of economic assistance the Government has also provided for rural areas affected by Foot and Mouth disease.

7.70 In addition to this economic support, the Government is taking action to deal with environmental threats that are important in the countryside or that relate to the protection of natural resources, such as biodiversity, visual amenity, water pollution and landfill. These methods include tax measures, like the aggregates levy, the landfill tax and their related spending programmes, plus the voluntary agreement on pesticides. This section describes the action the Government is now taking to:

- reduce the environmental impact of aggregate extraction;
- promote waste minimisation and more efficient waste management;
- minimise the environmental impact of pesticides use; and
- bring about reductions in water use and improvements in water quality.

Box 7.5: Foot and Mouth disease

The impact of the Foot and Mouth outbreak has been severe in many rural areas. Over 2000 farms have been infected in the UK since the first case was confirmed at the end of February 2001, and many other businesses have been affected indirectly. The Government has put in place a range of measures to support badly affected communities and businesses:

- direct payments to farmers who have lost their livestock;
- a scheme to prevent animal welfare problems due to livestock movement restrictions;
- establishing - and replenishing - the Business Recovery Fund operated by Regional Development Agencies;
- a scheme making it easier for rural local authorities to grant hardship rate relief to businesses affected by Foot and Mouth disease (FMD); and
- matched funding for personal charitable donations intended to relieve rural distress.

Following the outbreak of Foot and Mouth disease, the Government also asked HM Customs and Excise and the Inland Revenue to make special arrangements for FMD-affected businesses. Since then the revenue departments have dealt with more than 65,000 calls from businesses and provided direct help to more than 22,000 businesses by allowing them to defer over £191 million in tax and NICs. In recognition of the special circumstances, the Government has also agreed to waive the interest that is normally due on deferred payments. The Government acted decisively to contain and eradicate FMD while assisting those affected, spending an additional £2.7 billion to tackle the disease and its implications for the rural economy.

An assessment of the overall macroeconomic impact of the Foot and Mouth outbreak is provided in Annex A.

Aggregates quarrying

The aggregates levy

7.71 The aggregates levy is set at £1.60 per tonne on virgin aggregate commercially exploited in the UK. **The levy will be implemented in April 2002 and will ensure that the environmental impacts of quarrying aggregate, such as damage to biodiversity and visual intrusion, are more fully reflected in aggregate prices.** It will encourage the use of alternative materials, such as wastes from construction, demolition and clay and coal extraction, that would otherwise be disposed of to landfill. It will also promote greater efficiency in the use of virgin aggregate and the development of new recycling processes, such as using waste tyres and glass.

7.72 The Government has considered in detail the impact of the aggregates levy on Northern Ireland and is minded to phase in the levy for aggregates used in processed products in Northern Ireland. This recognises the potential effects of the levy on this specific sector. Phasing in the levy, including an exemption in 2002-03, will be subject to EU state aids approval.

7.73 Revenues raised from the levy will be recycled to business and communities affected by aggregates extraction through a 0.1 percentage point cut in employers' national insurance contributions (NICs) and a new £35 million a year Sustainability Fund. The reduction in NICs helps to fulfil the Government's commitment to shift taxation away from goods, such as employment, and towards bads, like pollution.

7.74 The Government has considered the case for a differential rate of the levy for quarries with better environmental performance - so-called "green quarries". Following informal discussions with the industry and other stakeholders, the Government has decided not to develop a differential rate scheme at the current time because of the difficulties in assessing environmental performance accurately and the prospect of setting up perverse incentives.

7.75 In consultation with the aggregates industry, the Government is examining proposals to deliver additional environmental benefits through the aggregates levy by encouraging the positive use of aggregates waste.

Sustainability Fund

7.76 The £35 million a year Sustainability Fund will be introduced in April 2002, alongside the aggregates levy, to reduce the need for virgin materials and limit the environmental effects of extraction where this takes place. An initial consultation identified some key priorities for the Fund. The Government has consulted on how to give effect to these objectives in England through existing programmes and will publish the results early next year. Scotland, Wales and Northern Ireland will determine their own spending plans for their shares of the Fund. The National Assembly for Wales plans to issue a consultation document later this year.

Waste

7.77 The Government is committed to the challenging targets set out in Waste Strategy 2000 for recycling and composting, recovery of household and municipal waste and reducing the amount of industrial and commercial waste sent to landfill. A range of instruments are being used to encourage more sustainable waste management, including:

- economic instruments, such as the landfill tax and tradeable permits for biodegradable municipal waste;
- the landfill tax credit scheme;
- statutory recycling targets for local authorities;
- public spending programmes, such as the Waste and Resources Action Programme (WRAP) and the New Opportunities Fund; and
- initiatives to promote best practice.

Landfill tax

7.78 By making waste producers take account of the environmental costs they impose when they discard waste to landfill, the landfill tax encourages efforts to minimise the amount of waste generated and to develop more sustainable waste management techniques, such as recycling, composting and recovery. It makes an important contribution to the Government's waste disposal targets by encouraging diversion of waste away from landfill.

7.79 The tax applies to waste disposed of at licensed landfill sites and is levied at £2 per tonne for inactive waste and £12 per tonne for active waste. **The Government is committed to increasing the rate of tax for active waste by £1 each year until 2004, in line with the landfill tax escalator.**

Landfill tax credit scheme

7.80 To ensure that the funds in the landfill tax credit scheme (LTCS) are used to address its priorities, the Government has set an indicative target of 65 per cent of landfill tax credits to be allocated to sustainable waste management projects and for at least a third of these to be allocated to recycling projects. This significant shift in the use of LTCS funds will help meet the targets for recycling set out in Waste Strategy 2000.

7.81 The Government is attracted to replacing all or part of the LTCS with a public spending programme to direct resources towards Government priorities on sustainable waste management. The Government, together with the devolved administrations, is now developing options for a spending programme for consideration as part of the 2002 Spending Review. As part of this decision, the Government will consider keeping the present scheme in its present form or with minor modifications. **The Government will consult on the future of the scheme, including the transition arrangements.**

Tradeable permits

7.82 As part of its Waste Strategy 2000, the Government announced that it would introduce tradeable permits to ensure that the UK meets its obligations under the Landfill Directive to move away from landfilling biodegradable municipal waste. It has since consulted on how to implement such a system and will publish its conclusions shortly. Introducing such a system will give local authorities and the waste industry a powerful signal about the scale of change required under the Directive and encourage planning and investment in alternatives to landfill.

Statutory recycling targets

7.83 As established by the Waste Strategy, the Government has set local authorities statutory targets, designed to double by 2003-04, and almost triple by 2005-06, the recycling and composting of household waste from 1998-99 levels. The latest survey of performance, for 1999-2000, showed that recycling levels had risen by 1.5 percentage points in a year.

WRAP and the New Opportunities Fund

7.84 The Waste and Resources Action Programme (WRAP) was launched in November 2000 to remove market obstacles to waste minimisation, re-use and recycling and to create more stable and efficient markets for recycled materials and products. £40 million of Government funding is available over the next three years and the programme is expected to attract additional funds from business. WRAP has published its first business plan and is making significant progress in implementation. The New Opportunities Fund will support community recycling with almost £50 million in funding.

Encouraging best practice

7.85 The Government has taken a number of steps to spread examples of best practice. Since Waste Strategy 2000 was published in May last year, it has issued guidance on the management of the municipal waste function under best value and on municipal waste management strategies, identified waste beacon councils and encouraged the establishment of networks to spread best practice.

Pesticides

7.86 Pesticide use is associated with damage to biodiversity and water contamination. The Government is committed to minimising these impacts, consistent with adequate crop protection. The statutory product approval system and the Pesticides Forum make important contributions to achieving this objective. The Government also believes that a tax on pesticides could, in conjunction with other measures, be a useful tool in addressing the environmental impact of pesticides.

7.87 In Budget 2001 the Government welcomed the voluntary proposals from the agrochemical industry and the commitments made by various stakeholders to address these issues, and encouraged their early implementation. The voluntary package was implemented from 1 April 2001 and will run initially for five years, nationwide. It is overseen by a steering group comprising the signatories to the package and representatives of an equivalent number of environmental organisations, under an independent chairman. The Government will review progress on the package in the run up to Budget 2002, to assess whether it is delivering significant environmental benefits over and above those that would result from introducing a pesticides tax.

Water resources

7.88 There have been significant improvements in water quality in recent years, including in coastal and bathing water. The EU Water Framework Directive requires more attention to be paid to the ecological quality of water, taking account of a wider range of influences. The European Commission is expected to propose new or revised EU directives over the coming year on bathing water, groundwater, individual priority hazardous substances and sewage sludge. DEFRA is aiming to produce a strategy for the environmental quality of water by the end of 2002, putting more weight on interactions between water quality and other policies.

7.89 The Green Technology Challenge consultation revealed strong support for using tax incentives to encourage more sustainable water use and improvements in water quality. **As part of the Challenge, the Government is considering the case for introducing enhanced capital allowances for selected technologies that deliver environmental benefits in this area during 2002-03.**

ENVIRONMENTAL APPRAISAL OF POLICY MEASURES

7.90 The Government remains committed to environmental appraisal and evaluation of Budget measures and will continue to make available the methodology underpinning the figures presented in the appraisal table. In line with its sustainable development policy, the Government ensures that policy design, appraisal and evaluation takes account of costs and benefits, the precautionary principle, and the need to make the polluter pay by internalising costs.

Box 7.6: Evaluation in practice: company car tax reform

In Budget 2000 the Government announced a major reform of company cars taxation which will take effect from April 2002 and aims to reduce the level of emissions produced by company cars and unnecessary business mileage.

The Government has put in place a comprehensive evaluation programme to assess the impact of these reforms through the analysis of data from tax returns, information from commissioned surveys, detailed economic modelling, and by utilising a variety of external sources. Some of the policy impacts which will be examined include:

- emissions from company cars;
- provision of alternatively fuelled company cars;
- business mileage;
- revenue from income tax and national insurance contributions; and
- compliance costs for employers.

This extensive evaluation will be on-going over a number of years as the effects of the reform will accumulate over this time.

Table 7.1: The Government's policy objectives and Budget measures

Policy objective	Sustainable development indicator[1]	Data indicating recent trends	Recent Government measures
Tackling climate change and improving air quality	Emissions of greenhouse gases	Between 1998 and 1999 emissions of the basket of six greenhouse gases fell by approximately 6 per cent[1, 2]	*Other Government measures* • Climate Change Programme, DETR November 2000 • Emissions Trading Scheme, DEFRA August 2001 • Air Quality Strategy for England, Scotland, Wales and Northern Ireland, DETR January 2000 • Ten Year Plan for Transport, DETR July 2000 *Budget measures* • Climate change levy package • Reforms to company car tax and authorised mileage rates • Reforms to car and lorry VED • Green travel plans • Reduced rate of VAT on the installation of
	Days when air pollution is moderate or higher	Number of days with moderate or high air pollution has fallen from around 40 per year in both urban and rural sites in 1997, to about 16 in urban sites and 25 in rural sites by 2000[1]	
	Road traffic	Traffic levels in 2000 were 0.3 per cent higher than in 1999[1, 3]	

			energy saving materials • Green Fuel Challenge • Road fuel duty differentials
Regenerating Britain's cities	New homes built on previously developed land	In 2000, 57 per cent of new housing was on previously developed land. This has remained at about the same level since 1995[1]	*Other Government measures* • Urban White Paper, DETR November 2000 *Budget measures* • Capital allowances for flats over shops • Tax relief for cleaning up contaminated land • Stamp duty exemption for disadvantaged areas • Reforms to the VAT treatment of conversion and renovation activity
Protecting Britain's countryside	Waste arisings and management	Proportion of household waste being recycled was over 10 per cent in 2000, an increase of 2 per cent from two years ago[4]	*Other Government measures* • Waste Strategy 2000, DETR May 2000 • Rural White Paper, DETR November 2000 *Budget measures* • Aggregates levy and Sustainability Fund • Landfill tax and landfill tax credit scheme
	Populations of wild birds	From 1970 to 1998 the populations of woodland and farmland birds have declined by 20 per cent and 40 per cent respectively[5]	
	Chemical river quality	In 2000, 94 per cent of rivers in England, Wales and Northern Ireland were classified as being of good or fair chemical quality, compared with 91 per cent in 1995[1]. In Scotland 98 per cent of rivers were of good or fair chemical quality[6]	

[1] *Achieving a Better Quality of Life, DETR January 2001 - latest data from www.sustainable-development.gov.uk*

[2] *The main six greenhouse gases are: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, sulphur hexafluoride*

[3] *After adjustment for the effect of the September 2000 fuel protest, growth is 0.7 per cent.*

[4] *Municipal Waste Management Survey, 1999-2000 DETR. The next update for the waste sustainable development indicator will be in 2002. Currently data is only available for 1997-98.*

[5] *Populations of both bird types have increased over the past year, possibly due to the warm winter of 1998-99*

[6] *A change in measurement process means previous data for Scotland is not directly comparable to 2000 figures*

Table 7.2: The environmental impacts of Budget measures

Budget measure	Environmental impact[1]
• Climate change levy package[2,3]	Levy and exemptions[4] Savings of at least 2.0 MtC[5] per year by 2010
	Negotiated agreements Savings of at least 2.5 MtC per year by 2010
	Energy efficiency measures Savings of at least 0.5 MtC per year by 2010
• Reforms to company car tax	Savings of 0.05 to 0.1 MtC in 2002-03. In the long run savings are estimated at between 0.5 and 1 MtC per year[6]
• Green travel plans	Reductions in carbon dioxide and particulates
• Reforms to authorised mileage rates	Small savings of carbon dioxide in the long run[6]
• Reforms to car and lorry VED	Reductions in emissions of carbon dioxide, nitrogen oxides, and particulates
• Road fuel duty differentials[7, 8]	The ULSP differential is estimated to reduce nitrogen oxide emissions by 1 per cent, carbon monoxide emissions by 4 per cent and emissions of volatile organic compounds by 1 per cent per year between 2001 and 2004, compared to ordinary unleaded
	The ULSD differential is estimated to have resulted in a reduction of 8 per cent of particulates and up to 1 per cent of nitrogen oxides per year, compared to ordinary diesel
	The reductions in duty in Budget 2001 on ULSD and ULSP are estimated to increase emissions by between 0.1 and 0.2 MtC per year by 2010[9]
• Green Fuel Challenge	Identify fuels which could result in reductions in emissions of carbon dioxide, nitrogen oxides, and particulates. Potential waste policy benefits
	The road fuel gas differential will result in a reduction in emissions of particulates and nitrogen oxides
	The biodiesel differential could save up to 0.2 MtC per year by 2010[10]
• Haulage Modernisation Fund[10]	1 per cent reduction in particulate emissions per year by 2004, reductions in carbon emissions of around 0.1 MtC per year by 2004, and reductions in nitrogen oxides
• Reduced rate of	Reduction of 0.1 MtC per year by 2010[11]

• VAT on the installation of energy saving materials	
• Reduced rate of VAT on domestic fuel and power	Estimated to increase emissions by 0.2 MtC per year by 2010[4]
• Capital allowances for flats over shops	Reduced pressure on the countryside due to an increase in the number of empty and derelict properties brought back into use
• Tax relief for cleaning up contaminated land	Increases in clean up of contaminated land
• Stamp duty exemption for disadvantaged areas	Regeneration and improved functioning of property markets in Britain's most disadvantaged areas
• Reforms to the VAT treatment of conversion and renovation activity	
• Aggregates levy and Sustainability Fund	Reductions in noise and vibration, dust and other emissions to air, visual intrusion, loss of amenity and damage to wildlife habitats
• Landfill tax and landfill tax credit scheme	Encourages waste producers and the waste management industry to switch away from landfill towards waste minimisation, re-use and recycling

[1] *These estimates are subject to a wide margin of error*

[2] *There are a number of difficulties involved in estimating the emissions savings from the individual components of the climate change levy, including the need to avoid double counting. The figures are calculated using cautious assumptions and are shown for illustrative purposes only*

[3] *A related measure, the emissions trading scheme, is forecast to save 0.8 MtC per year from 2002 to 2006, rising to 2 MtC per year by 2010*

[4] *Based on the DTI energy model*

[5] *Million tonnes of carbon*

[6] *Based on Inland Revenue modelling*

[7] *Using NETCEN emissions models - further detail on the methodology used is provided in UK Road Transport Emissions Projections, NETCEN, January 2000*

[8] *Between 1996 and 1999, the fuel duty escalator is forecast to have reduced emissions by 1 to 2.5 MtC per year by 2010*

[9] *DTI and DTLR modelling*

[10] *DTLR modelling*

[11] *HM Customs and Excise modelling*

[1]*Climate Change 2001*, Third Assessment Report of the Intergovernmental Panel on Climate Change.[Back]

[2]*The Air Quality Strategy for England, Wales, Scotland and Northern Ireland*, DETR, 2000.[Back]

[3] NETCEN, DETR.[Back]

[4] *Green Technology Challenge: Consultation Document,* HM Treasury, July 2001.[Back]

[5] *Reforming Motorcycle Vehicle Excise Duty*, HM Treasury, November 2001.[Back]

[6]*Consultation on the tax and NICs treatment of employer subsidies of public bus services,* Inland Revenue, October 2001, http://www.inlandrevenue.gov.uk/drafts/busconsult.pdf[Back]

[7]*Modernising the Taxation of the Haulage Industry - A Consultation Document,* HM Treasury, November 2001.[Back]

[8] *Abandoned Cars - a consultation document,* DTLR and DEFRA, October 2001.[Back]

A The Economy

No economy is immune to the impact of the current global slowdown or the events of 11 September. But because the Government has taken tough decisions since 1997 to create a platform of macroeconomic stability, the UK is in a better position than on previous occasions to cope with turbulence in the world economy. The economic challenge is to maintain stable growth through these testing times, while continuing to work to deliver stronger productivity growth and employment opportunity for all. Rising to this challenge is imperative in order to maintain the foundations for meeting the Government's objectives for reducing poverty and delivering high quality public services.

The Pre-Budget Report shows that:

- since Budget 2001, G7 activity and trade have been weaker than expected. For the first time since 1974, there has been a significant and simultaneous slowdown of growth in the US, Europe and Japan. Following the terrorist attacks of 11 September, heightened uncertainty and declining confidence have further weakened demand and delayed the recovery in the major economies. By raising security and insurance costs, the attacks may also have had a negative impact on supply;
- in the UK, economic growth has remained relatively strong during 2001 despite the weaker external environment. Employment is now over 1.2 million higher than in spring 1997 and unemployment has been at its lowest since the 1970s. Inflation has remained lower for longer than at any time since the 1960s, allowing the Monetary Policy Committee to cut interest rates to levels not seen since 1964. Fiscal policy is supporting monetary policy this year and next in smoothing the path of the economy over the cycle;
- the UK economy has been affected by the global slowdown. Growth in the UK's major export markets slowed dramatically during 2001. Business investment has fallen, and business confidence, which was already weakening, has deteriorated further since 11 September. The global slowdown also appears to have had a negative impact on consumer confidence; and
- although UK consumer spending growth is expected to moderate, it should continue to cushion the impact of weaker world demand in the short term. UK GDP is forecast to grow by $2^1/4$ per cent this year, the lower end of the Budget 2001 forecast range, and by between 2 and $2^1/2$ per cent next year. Stronger and more balanced growth is expected to resume from the middle of 2002 as the world economic recovery gathers pace.

INTRODUCTION[1,2]

A1. This annex discusses economic developments since Budget 2001 and provides updated forecasts for the UK and other major economies in the period to 2004. It begins with an outline of world economic developments and prospects, which will have a significant influence on the UK economy over the forecast period. The subsequent discussion sets out the key features of the UK forecast and the associated risks, followed by a more detailed assessment of sector-specific issues.

THE WORLD ECONOMY

Overview

A2. The world economy has slowed significantly since Budget 2001, with sharp declines in world trade growth, investment, industrial production and stock markets. G7 activity has been weaker than anticipated at the time of the Budget, and growth in developing countries has slowed as weaker activity in the industrialised economies, depressed commodity prices and increased risk aversion have taken their toll. The terrorist attacks of 11 September have added to the downward momentum in world activity and are expected to delay the global recovery. However, the decisive response by policy-makers in the US and Europe is expected to support a recovery which gathers pace from mid-2002.

Table A1: The world economy

	Percentage changes on a year earlier				
		Forecast			
	2000	**2001**	**2002**	**2003**	**2004**
Major 7 countries[1]					
Real GDP	$3\frac{1}{2}$	1	$\frac{3}{4}$	3	$2\frac{1}{2}$
Consumer price inflation[2]	$2\frac{1}{2}$	2	$1\frac{1}{2}$	$1\frac{1}{2}$	$1\frac{1}{2}$
World trade in goods and services	$11\frac{3}{4}$	$1\frac{1}{4}$	$1\frac{3}{4}$	$7\frac{3}{4}$	7
UK export markets[3]	$11\frac{1}{4}$	1	$1\frac{3}{4}$	$6\frac{3}{4}$	6

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

[2] *Per cent, Q4. For UK, RPIX.*

[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

G7 activity

A3. The slowdown in G7 activity during 2001 has been sharper than anticipated at Budget time. Falling manufacturing output has been a particular feature of the slowdown across the G7, with the sharpest falls in the US and Japan. Prior to 11 September, most analysts had revised down their growth forecasts for 2001, but were expecting a G7 recovery to begin by the end of the year. Consensus forecasts for G7 growth fell by around 0.5 percentage points between March and August this year. However, the events of 11 September have further weakened demand, with the consensus now expecting recovery to be delayed until the middle of 2002.

Table A2: Consensus forecasts for GDP growth in major economies[1]

	Percentage changes on previous year			
	March 2001		November 2001	
	2001	**2002**	**2001**	**2002**
USA	1.9	3.4	1.1	0.7
Euro-area	2.7	2.9	1.5	1.5
Japan	1.2	1.7	-0.5	-0.6

[1] *'Consensus forecasts', Consensus Economics Inc.*

A4. The Pre-Budget Report forecast for G7 GDP growth this year has been scaled back to 1 per cent from 2 per cent at Budget 2001, reflecting weaker world prospects prior to 11 September and the further effects of the terrorist attacks. Looser policy and lower commodity prices are now expected to support a recovery in the US and the Euro-area from the middle of 2002, with G7 growth forecast to strengthen from $\frac{3}{4}$ per cent in 2002 to 3 per cent in 2003 as the recovery gathers pace.

A5. In the US, falling stock prices and rising unemployment were already beginning to weigh on consumer confidence prior to 11 September, and preliminary estimates show that the economy contracted during the third quarter. Business and consumer confidence deteriorated further after the terrorist attacks. The short-term disruption, increased risk aversion and weak domestic demand are expected to depress activity further in the fourth quarter, and the outlook is now more uncertain. However, monetary and fiscal policy have responded rapidly following the attacks and, together with the cuts in taxes and interest rates implemented earlier in the year, should provide a timely boost to the economy, with the scope remaining for further policy loosening. The policy response is expected to support a recovery which begins in mid-2002 and gathers pace during the second half of the year.

A6. Economic activity in the Euro-area has been much weaker than expected at Budget 2001. The impact of weaker external demand has been only partly offset by recent interest rate cuts. Germany has been particularly affected by the world slowdown and, amongst other factors, continued weakness in the construction sector.

A7. Renewed weakness in Japan is largely attributable to the sharper than anticipated deterioration in the external economic environment. The new Government's commitment to a much needed programme of structural reform is likely to exert further downward pressure on growth and inflation in the short term, but should yield significant long-term benefits.

Box A1: The ICT revolution and US prospects

During the 1990s, the information and communications technology (ICT) sector was one of the most innovative in the US economy. Technological advances and intense competition drove down quality-adjusted prices for computers and peripheral equipment by over 70 per cent between 1995 and 2000. Private investment in ICT goods rose at an average annual rate of 16 per cent[1] during the 1990s, accelerating to an average annual rate of 20 per cent between 1995 and 2000. In 2000, it accounted for 4.7 per cent of US GDP and made up more than one third of all private non-residential fixed investment.

There has been growing support for the view that 'capital deepening' through ICT investment, and the related diffusion of know-how, have contributed to an acceleration in US trend productivity since the mid-1990s. On the other hand, some have argued that recent productivity gains can largely be attributed to cyclical factors. The nature of the US recovery will be determined by which of these views is true. Assuming the trend rate of productivity growth has risen, the US economy should be able to resume stronger output growth relatively quickly. However, if the gains were primarily cyclical, a more prolonged period of lower growth may be required to return the US economy to a sustainable growth path.

First estimates of US labour productivity growth in the third quarter of 2001 showed a slowdown to 1.8 per cent on a year earlier, following growth of 3.0 per cent in 2000 and 2.3 per cent in 1999. However, slower productivity growth is typical during economic downturns, and it will only be possible to assess the full extent of any acceleration in underlying productivity performance once the economic cycle is complete.

Looking ahead, the factors driving high levels of ICT related investment during the 1990s remain in place. Technological progress in semi-conductor production will continue to bring down ICT prices, and can be expected to encourage further ICT related capital deepening. Studies suggest that, since 1971, real ICT investment has increased by more than 1 per cent for every 1 per cent decline in relative prices of ICT goods[2]. Moreover, high rates of depreciation will also provide an incentive for firms to upgrade ICT goods at a faster rate than other forms of capital, while subdued inflationary pressures and low interest rates should continue to support the substitution of capital for labour.

[1] Information processing equipment and software, US national income and product accounts.
[2] *Does the new economy measure up to the great inventions of the past?* Robert Gordon, NBER working paper W7833, August 2000.

Forecast issues and risks

A8. Short-term prospects across the G7 depend heavily on private consumption, which has been the main driver of recent growth. Weakening labour market conditions and the possibility of further equity price falls present downside risks to consumer confidence, while the current weakness of business sentiment could also prove more prolonged than expected, depressing business investment further. Lower short-term growth prospects could also raise concerns about the willingness of investors to continue financing the US current account deficit, prompting an abrupt correction in the US dollar and financial market instability.

A9. On the other hand, if the impact of the terrorist attacks on confidence proves to be more short-lived than anticipated, the policy loosening witnessed this year might stimulate a world recovery which is either stronger, or begins earlier, than expected.

A10. Looking further ahead, evidence from the US suggests that the potential remains for ongoing productivity gains from the use of information and communications technology (ICT) (see Box A1), while the implementation of structural reform in Japan should improve its long-term growth prospects. However, the events of 11 September may prompt a reallocation of resources towards intermediate inputs, such as security and insurance, reducing a little the productive potential of those economies affected by an ongoing threat from terrorist attack.

Chart A1: G7 GDP and world trade

World trade

A11. Following rapid growth of nearly 12 per cent in 2000, world trade contracted in the first half of 2001 as G7 growth slowed and demand for highly traded ICT capital goods collapsed. The slowdown in world trade growth has been much sharper than expected at Budget time, and the forecast for 2001 has been revised down from $6^{3}/_{4}$ per cent to just $1^{1}/_{4}$ per cent. However, this weakness is expected to be short-lived. World trade is projected to grow by $1^{3}/_{4}$ per cent in 2002 and by $7^{3}/_{4}$ per cent in 2003 as the global recovery gathers pace and demand for ICT capital goods recovers. UK export markets are expected to recover broadly in line with the pick-up in world trade, growing by $1^{3}/_{4}$ per cent in 2002 and $6^{3}/_{4}$ per cent in 2003.

Emerging markets and developing countries

A12. Prior to 11 September, weaker external demand, low commodity prices, increasing risk aversion and deteriorating conditions in international financial markets were already affecting the world's developing economies (see Box A2). These pressures are likely to persist as G7 economic activity remains subdued. Many Asian emerging markets have been particularly affected because of the openness of their economies and their heavy dependence on trade in ICT related goods. Excluding the crisis year of 1998, the IMF expects economic activity in emerging Asia during 2001 to be weaker than at any time over the past 20 years. Elsewhere in the world, Latin American economies have been affected by the slowdown in the US and reduced access to international capital markets, while emerging European economies have seen their growth prospects curtailed by weaker economic developments in the Euro-area.

Box A2: The impact of the world slowdown on developing countries

Economic growth is key to tackling the range of problems faced by the world's poorest countries. The global slowdown is likely to have a significant impact on many of these economies. The World Bank estimates that growth in the developing world will slow from 5.5 per cent in 2000 to 2.9 per cent in 2001, and that the events of 11 September will further reduce developing country growth by between $^{1}/_{2}$ and $^{3}/_{4}$ percentage points in 2002 as economic recovery is delayed around the world.

Developing countries have been particularly affected by the fall in commodity prices associated with weaker world demand during 2001. Non-oil commodity prices have fallen by 7 per cent this year, and agricultural commodity prices have fallen by 5 per cent since 11 September. A flight to quality has raised the cost of emerging and developing country borrowing, while foreign direct investment to emerging markets fell by 5 per cent in the first half of this year and is expected to decline further. A slump in tourism has also affected certain regions: in Africa, travel and tourism account for 10 per cent of merchandise exports, and 65 per cent of Caribbean holidays were cancelled in the aftermath of 11 September.

Even before 11 September, the human cost of the world slowdown was high. The World Bank has estimated that, as a result of the attacks, as many as 10 million more people may be forced to survive on less than $1 a day, and between 20,000 and 40,000 more children under five may die as poverty worsens. Africa will be worst affected, with nearly half of the effects expected to be concentrated there.

Oil and commodity prices

A13. Weaker global demand and good harvests have put downward pressure on almost all primary commodity prices in 2001. Non-oil commodity prices have fallen back after a brief rally last year, and oil prices have recently fallen to two-year lows as the world economic slowdown has fed through into oil demand. The outlook for oil prices has become much more uncertain in the aftermath of the terrorist attacks. High stock levels are expected to keep agricultural prices in check during 2002, while metals prices should pick up once growth resumes.

Chart A2: G7 consumer price inflation (CPI) and oil prices

G7 inflation

A14. Despite a sharp increase in the second quarter of the year, largely explained by a rise in oil prices, G7 headline inflation has fallen since the beginning of 2001. Core inflation, which excludes energy and food prices, has been low and stable throughout the year. As world demand has weakened, prices of intermediate inputs and oil have fallen. With inflationary pressures fading, G7 inflation is expected to remain at 2 per cent in the final quarter of 2001 and to decline to $1^1/_2$ per cent thereafter.

UK ECONOMY OVERVIEW

Table A3: Summary of forecast

			Forecast		
	2000	**2001**	**2002**	**2003**	**2004**
GDP growth (per cent)	3	$2^1/_4$	2 to $2^1/_2$	$2^3/_4$ to $3^1/_4$	$2^1/_4$ to $2^3/_4$
RPIX inflation (per cent, Q4)	2	$2^1/_4$	$2^1/_4$	$2^1/_2$	$2^1/_2$

The economy in 2001

A15. No country can fully insulate itself from external developments, and the UK economy has been affected by the deterioration in the world economy during 2001. However, UK growth has remained relatively robust. Inflation has remained slightly below the Government's $2^1/_2$ per cent target for most of the year, allowing the Monetary Policy Committee to take decisive action to sustain domestic demand growth in the face of weaker external conditions. Fiscal policy has supported monetary policy in maintaining stable economic growth. The outbreak of Foot and Mouth Disease (FMD), though clearly affecting certain sectors and regions more than others, appears to have had a minimal effect on aggregate GDP (see Box A3).

A16. With output growth holding up relatively strongly, employment continued to grow in the first half of 2001, and unemployment remained at its lowest rates since the 1970s on both the International Labour Organisation (ILO) and claimant count measures. A pick-up in average earnings growth earlier in the year suggested that the economy was operating slightly above potential, though labour market pressures now appear to be easing. Employment levelled off over the summer, and headline average earnings growth has fallen back to the $4^1/_2$ per cent rate deemed consistent with trend productivity growth and the Government's inflation target. The economy is currently judged to be operating close to potential, with unemployment only slightly below the NAIRU[3], which has itself fallen significantly in recent years.

A17. Underpinned by the strong performance of the labour market, household consumption has grown by over 1 per cent a quarter so far during 2001. The buoyancy of consumption has played an important role in supporting GDP growth in the face of weaker external demand. However, recent growth rates are unlikely to be sustainable. Survey data indicate that consumer confidence has moderated towards its long-run average in recent months, and consumption growth is expected to return to rates more consistent with its longer-term determinants by early 2002.

Box A3: Measuring the macroeconomic impact of Foot and Mouth Disease

Although the final overall macroeconomic impact of the FMD epidemic still cannot be determined, the broad magnitudes involved are now clearer.

The agricultural sector carries a weight of less than 2 per cent in real GDP, of which a third is livestock production. Following internationally established national accounting practice, the contribution of livestock production to GDP is measured by the natural growth in the stock plus births. The lost value of culled animals is scored as a 'catastrophic loss' rather than as a temporary reduction in output, and the effects of movement restrictions are offset by higher work-in-progress within GDP. FMD related livestock slaughter therefore has no immediate effect on agricultural output or GDP: the lost output accrues over time from the foregone growth of the stock and the effects on birth rates arising from a smaller breeding stock. This is likely to have reduced GDP in 2001 only marginally.

Expenditure on tourism, the other sector most likely to have been affected by FMD, is equivalent to around 5 per cent of

UK GDP. While the number of overseas visitors has fallen during 2001, both inbound tourism and business travel to the UK will also have been affected by the world economic slowdown. The scale of the fall in the number of business travellers - whose decision to travel is less likely to have been affected by perceptions surrounding FMD - suggests that, prior to 11 September, around one half of the fall in overseas visitor numbers during 2001 had been the result of FMD.

By contrast, there appears to have been little impact on the UK economy as a whole from lost domestic tourism to directly affected areas. Trips to the countryside foregone because of FMD appear to have been replaced by spending elsewhere in the economy, either in alternative tourist locations or on goods and services unrelated to tourism. UK visitor numbers to overseas destinations have also risen only modestly, providing little evidence that UK holidaymakers have substituted foreign holidays for visits to affected areas.

While the effect on GDP in 2001 is therefore estimated to have been modest relative to normal fluctuations - less than 0.2 per cent of GDP - the impact on severely affected regions has been much more pronounced. To address these difficulties, the Government acted decisively to contain and eradicate the disease and to assist those worst affected by the outbreak. Details of the Government's response are provided in Chapter 7.

A18. The Budget 2001 forecast anticipated subdued business investment growth this year, as firms took steps to reduce indebtedness. Weaker than expected external demand has also led firms to postpone capital spending during the year. Business investment fell between the second half of 2000 and the first half of 2001, and with a further fall in the third quarter of 2001 it was 2.7 per cent lower than a year earlier. Nonetheless, measured at constant 1995 prices, it remains close to a record share of GDP, following a number of years of strong ICT related growth. General government investment has grown very strongly during 2001, increasing by 20 per cent in the year to the second quarter.

A19. UK exports contracted during the second and third quarters of the year as external demand weakened. UK export markets are now forecast to grow by just 1 per cent this year, compared with 6 per cent forecast at the time of Budget 2001. The impact of weak exports on the trade balance has been offset by lower imports, as domestic demand for intermediate and investment goods has fallen. The widening in the trade deficit has therefore been more moderate than anticipated at Budget time, despite strong household consumption. The combination of strong consumer demand and weak export market growth has, however, widened the divergence in performance between exporters and firms producing mainly for domestic markets.

A20. The terrorist attacks on the US have had an impact on the UK economy. Business confidence has fallen since 11 September, and weaker external demand and a more uncertain outlook have encouraged firms to postpone investment. The fall in consumer confidence has been less marked, and the decisions taken by the Monetary Policy Committee to cut interest rates in the aftermath of the attacks appear to have supported households' confidence in their own finances and helped sustain consumer spending. With consumer demand holding up and net trade exerting less of a drag on GDP growth than expected at Budget time, the impact of faltering global growth on the UK economy has shown up mainly in weaker business investment.

The labour market

A21. After a temporary pause during autumn 2000, employment growth picked up into 2001, but employment flattened over the summer as the effects of the world economic slowdown reached the UK. Employment growth appears to have followed the pattern of output growth with roughly a two to three quarter lag. The Labour Force Survey (LFS) employment rate has remained close to its historic high of 75 per cent during 2001, a level last reached in spring 1990 at the peak of the economic cycle. Historically high employment rates are now being achieved with the economy operating very close to potential, highlighting the marked improvement in labour market performance in recent years.

A22. In the third quarter of 2001, LFS employment was up by almost 160,000 on a year earlier, while full-time employment was up by over 240,000. This accounts for growth in total hours worked over this period outpacing growth in total employment, reversing the trend over the previous four years. Full-time employment has continued to rise recently, with the latest modest fall in total employment more than accounted for by a drop in female part-time employment.

A23. Strong growth in the population of working age over the past year, partly reflected in rising inactivity, explains why higher employment has been mirrored less than one-for-one in lower unemployment. Nonetheless, recent ILO unemployment rates have been at their lowest since the 1970s. The ILO unemployment rate fell to 4.9 per cent in the three months to May, somewhat below most estimates of the NAIRU. It has since edged back up above 5 per cent in the three months to September.

A24. The claimant count rate continued to fall through to August, to just 3.1 per cent, its lowest rate since 1975, before ticking up in October. Claimant unemployment over 12 months duration fell by more than 20 per cent in the year to October, and its share of the total has fallen to under 20 per cent, compared with over 36 per cent in early 1997. Moreover, the New

Deal for young people has now virtually eliminated longer-term (over six months) youth unemployment.

A25. Headline average earnings growth has fallen back to 4$^1/_2$ per cent, suggesting that labour market pressures are easing, although annual earnings growth excluding bonuses remains higher at around 5 per cent. Looking ahead, increases in employment within the public sector and among associated private sector subcontractors will provide support to the labour market.

Chart A3: LFS employment, unemployment and participation

A26. The economy's productivity performance strengthened during 2000, with output per job rising by 2.3 per cent across the economy and by 5.8 per cent in the manufacturing sector. However, weaker output growth during 2001 has driven a cyclical slowing in productivity growth, with particularly subdued growth in output per hour reflecting the recent strength of total hours worked. This cyclical effect, and the temporary pick-up in earnings growth earlier in the year, caused year-on-year growth in unit wage costs to rise to 3.5 per cent in the second quarter, but there are now signs of easing. The Government's drive to promote competition, enterprise, innovation and skills should lead to improved UK productivity performance over the longer term, as explained in detail in Chapter 3.

A27. A modest pick-up in the working-age inactivity rate over the past year highlights the ongoing challenge of increasing the economy's labour supply and long-term growth potential. A lower participation rate in the 16-24 age group, probably associated with increased participation in full-time education, can explain a small part of the rise. However, most of the increase in the inactivity rate is attributable to females in the 25-49 age group and males in the 35-49 age group. A more detailed examination of current labour market inactivity and the Government's approach to tackling it can be found in Chapter 4 and in a separate Government paper to be published shortly[4].

A28. The National Minimum Wage (NMW) was increased with effect from October 2001, in line with the recommendations of the Low Pay Commission (LPC). The main rate was raised from £3.70 to £4.10. Earlier in the year, the LPC concluded that the NMW had not had any discernible impact on overall employment, inflation or the wider economy. The new rate is broadly the same level relative to average earnings across the whole economy as when the NMW was first introduced, giving little reason to believe that the recent increase will have any adverse macroeconomic effects. The LPC estimated that the increase in the main rate from £3.70 to £4.10 would raise total wage costs by between 0.1 and 0.3 per cent. The youth rate, which applies to workers aged between 18 and 21, was also increased in October 2001, from £3.20 to £3.50. The NMW, and other elements of the Government's strategy to make work pay, are also discussed in Chapter 4 and the forthcoming paper.

Trend output growth

A29. Table A4 provides a simple decomposition[5] of estimated trend output growth in recent years, and shows the neutral assumptions underlying the GDP forecast ranges presented in this annex. The economy is still judged to have been operating around its potential in the first half of 1997 and mid-1999, and revisions to GDP[6] and workforce jobs data since Budget 2001 have not significantly changed the assessment of trend rates of growth.

Table A4: 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	1.7	0.5	0.5	**2$^1/_2$**
Forecast[7]	2.0	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. Trend output growth is estimated as non-oil Gross Value Added growth between on-trend points for the past, and by projecting components going forward. Estimated trend growth rates for employment and labour productivity allow for employment lagging output. 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, consistent with LFS data on relative entry wages.

[4] *Ratio of workforce jobs to working-age household population.*

[5] *UK household basis.*

[6] *Estimated from 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 2002Q1.*

A30. In line with the approach adopted in Budget 2001, the Pre-Budget Report forecast assumes trend output growth of slightly above $2^1/2$ per cent between the first half of 1997 and the start of the forecast period, consistent with observed GDP growth rates and judgements on the output gap. The Pre-Budget Report forecast ranges are anchored on the neutral assumption of $2^1/2$ per cent annual trend output growth from the start of 2002, with the contribution from trend employment growth expected to be modest in the period ahead. Working-age population growth is assumed to average $^1/2$ per cent per annum over the forecast period, a cautious judgement based on the latest published projections from the Government Actuary's Department[7].

A31. The potential extent of the productivity 'spill-over' from rapid growth in ICT investment, and the associated upside potential to future trend growth in the UK, is subject to a wide range of views. Despite recent downward revisions to US productivity estimates, the data continued to show a marked acceleration in US productivity growth since the mid-1990s. High levels of investment in ICT products, which accounted for over 15 per cent of whole economy fixed investment in the UK in 1999, should ensure that the UK is well placed to benefit from any ICT related productivity gains.

Output and demand

A32. Evidence from the labour market suggests that the economy was operating slightly above potential in the first half of 2001. Latest official labour market data, backed up by recruitment surveys, point to easing pressures in the labour market. Business survey indicators also suggest that capacity constraints have diminished, with demand pressures receding. The economy therefore appears to be operating close to its potential level at present, consistent with trend output growth of just over $2^1/_2$ per cent in recent years. However, any assessment of the present output gap will remain subject to considerable uncertainty until a full range of official and private survey-based data is available for the second half of 2001.

A33. Growth in the UK has remained relatively strong despite the world slowdown. In the second quarter, it eased only modestly below trend, and is estimated to have edged up to 0.5 per cent in the third quarter. The short-term outlook has weakened since 11 September, and a period of below trend growth is expected to lead to a small negative output gap opening up around the turn of the year.

Chart A4: The output gap

A34. The decisions taken by the Monetary Policy Committee to cut interest rates since 11 September appear to have provided support to households' confidence in their own finances, reducing the risk of a sharp slowdown in consumer spending.

Nonetheless, heightened uncertainty is expected to contribute to a moderation of household consumption growth to rates more clearly consistent with its longer-term determinants. Business confidence has deteriorated sharply since 11 September, and surveys indicate weak near-term investment intentions. Weaker external demand, as a result of the delayed global recovery, will also mean that net trade exerts a significant drag on growth in the near term.

A35. Earlier macroeconomic policy action will help to support the pick-up in UK growth as world economic activity recovers during the second half of 2002. Greater certainty surrounding future levels of external demand is expected to prompt a significant improvement in business sentiment. Business investment is projected to accelerate rapidly from the second half of the year, following a period of deferral and balance sheet consolidation. With consumption growth moderating, the UK is expected to return to more balanced growth.

Chart A5: Gross Domestic Product (GDP)

A36. The anticipated pick-up in UK export volume growth through 2002 is likely to be offset by stronger growth of imports as demand for intermediate and investment goods recovers. The resumption of growth in major export markets is expected to support a strong recovery in UK manufacturing output. In particular, a recovery in demand for ICT capital goods, following recent weakness in the UK and overseas, should provide support to the high-technology sector. The forecast showing a decline in manufacturing output in 2002 disguises a marked acceleration in the second half of the year. The annual comparison is also affected by base effects associated with the sharp fall in output during 2001.

A37. GDP is forecast to grow by between 2 and $2^1/2$ per cent in 2002, with net trade continuing to exert a drag. Growth is expected to move temporarily above its trend rate from the middle of 2002 so that the negative output gap closes by the end of the year. With inflation forecast to be slightly below target throughout 2002, there is room for the economy to operate slightly above potential during 2003, before RPIX inflation edges back up to target by the end of the year.

A38. The risks to the Pre-Budget Report forecast are compounded by the more uncertain outlook for the world economy. In the UK, the possibility of a further weakening of business and consumer confidence prompted by continuing uncertainty about the global economic outlook poses the clearest downside risk. A delayed or more gradual global recovery would directly affect UK exports and deter the projected pick-up in business investment. The potential knock-on effects, particularly on the labour market and equity prices, would also impact on the household sector. Conversely, the scale of the policy response already witnessed in the US and Europe raises the possibility of a much stronger than expected global recovery, and a faster than expected pick-up in UK growth during 2002.

A39. There is also a risk that consumption growth will remain stronger than expected as a result of weaker household saving. Recent strong consumer spending has been funded in part by increased borrowing. Low interest rates have ensured that debt-servicing costs have remained affordable. However, with household debt at historically high levels, any further deterioration in households' financial balances would raise the likelihood of a sharper correction in consumption further in the future. These risks underline the importance of the Government's monetary policy framework in ensuring interest rates are set in a forward-looking manner.

A40. In the past, the combination of rising private sector debt and a deteriorating current account position has sometimes been an early indicator of a large positive output gap, and such periods of unsustainable growth have typically preceded sharp adjustments in output and expenditure. On the other hand, widening financial imbalances may equally arise at times of weak external demand, temporarily depressing export volumes relative to imports, and in present circumstances are judged consistent with the economy operating close to potential.

Inflation

A41. The UK economy is continuing to experience its longest period of sustained low inflation since the 1960s, with RPIX inflation picking up during the course of this year but averaging slightly below the Government's $2^1/2$ per cent target. The modest increase in underlying inflation has, to an extent, reflected temporary factors that are expected to unwind next year. Reductions in official interest rates have exerted downward pressure on headline RPI inflation.

Chart A6: RPIX

A42. Upward contributions to inflation have come from a variety of sources, and have more than offset the negative effects from excise duties and lower petrol pump prices. In particular, adverse weather conditions last year led to a sharp pick-up in seasonal food prices earlier this year, and the outbreak of FMD increased retail meat prices. Seasonal food prices have fallen since their June peak, but still remain abnormally high. Price inflation in the utilities sector turned positive in August, as earlier price cuts dropped out of the annual comparison.

A43. Broader upward pressure on inflation has stemmed from goods prices. Core goods price inflation, which excludes food, petrol and oil, turned positive in July for the first time since summer 1999. Buoyant retail sales growth appears to have taken some of the pressure off retailers' margins. In contrast, core service sector inflation, which excludes rent and utilities components, has remained around or just above 5 per cent for much of 2001.

A44. Price pressures further back in the supply chain have eased during the year. Annual producer output price inflation has slowed from over 2 per cent at the end of 2000 to close to zero in recent months. With falling oil and non-oil commodity prices, and weaker world prices for a wide range of goods, annual producer input price inflation has been negative since July. However, given the pick-up in growth of unit wage costs during the first half of 2001, there has been a further slight squeeze on producer margins.

A45. RPIX inflation is projected to be slightly below the Government's $2^1/_2$ per cent target through the turn of the year, partly reflecting recent reductions in petrol pump prices, and to remain below target during 2002 as weaker price pressures in the supply chain feed through into retail prices. Recent trends in commodity prices are likely to persist while global growth remains weak, and domestically generated cost pressures are expected to ease as UK output moves a little below potential during 2002. Food price and housing depreciation components should also exert downward pressure on annual RPIX inflation during 2002, as this year's sharp increases drop out of the annual comparison. The small positive output gap forecast to emerge in 2003, coupled with upward pressure on non-oil import prices from the anticipated pick-up in world growth, should bring RPIX inflation back to target by the end of 2003.

A46. Domestic price pressures could, however, prove stronger than currently assessed. For example, the recent pick-up in unit wage cost growth could prove more persistent than expected, while the scope for consumer spending to remain buoyant might encourage retailers further to rebuild margins. The outlook for UK inflation is also affected by the considerable uncertainties surrounding the external environment. Domestic inflationary pressures could well remain more subdued if the world downturn proves more protracted than expected, while a sharper than expected global recovery would apply upward pressure to imported inflation. A sudden sharp change in the value of sterling against the euro or the dollar could also alter the cost of imported goods. As noted earlier in this annex, uncertainty surrounding the outlook for oil prices has heightened.

A47. GDP deflator inflation has averaged $2^1/_4$ per cent so far in 2001, up from $1^3/_4$ per cent in 2000. Much of this increase can be explained by higher consumers' expenditure deflator inflation, which had been unusually low relative to RPIX inflation in 2000 as a result of coverage differences. The differential between the two inflation rates has subsequently narrowed and is expected to diminish further through 2002, pushing up GDP deflator inflation to $2^1/_2$ per cent.

Independent forecasts

A48. The average independent forecast for GDP growth in 2001 has fallen steadily during the year, from 2.6 per cent at Budget time to 2.2 per cent in November, as world developments have surprised on the downside. Nevertheless, the average growth forecast for 2002 remained at or above $2^1/_2$ per cent for much of the year, but has fallen to 1.9 per cent since the terrorist attacks of 11 September. Independent forecasters expect RPIX inflation to remain close to target, reflecting credibility of the new framework for monetary policy.

A49. The average forecast for the current account balance in 2001 is marginally below the Pre-Budget Report forecast, and most independent forecasters expect the deficit to widen in 2002. As always, there is a wide range of views around the independent average.

Table A5: Pre-Budget Report and independent1 forecasts

Percentage changes on a year earlier unless otherwise stated

	2001			2002		
		Independent			**Independent**	
	Pre-Budget Report	Average	Range	**Pre-Budget Report**	Average	Range
Gross domestic product	$2^1/_4$	2.2	1.9 to 2.7	2 to $2^1/_2$	1.9	0.4 to 2.8
RPIX (Q4)	$2^1/_4$	2.3	1.9 to 2.7	$2^1/_4$	2.3	1.7 to 3.5
Current account (£ billion)	-14	-16.5	-23.3 to -10.0	$-26^3/_4$	-23.6	-35.2 to -16.0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts', November 2001.*

UK FORECAST IN DETAIL

The household sector

A50. Latest official data indicate that consumer spending has grown by more than 1 per cent in each quarter so far this year. Record levels of employment, strong real disposable income growth, low interest rates and housing market gains have all continued to support consumer spending, despite the weakening world outlook.

Table A6: Household sector[1] expenditure and income

Percentage changes on previous year unless otherwise stated

			Forecast		
	2000	**2001**	**2002**	**2003**	**2004**
Household consumption[2]	4	4	$2^3/_4$ to 3	$2^1/_4$ to $2^3/_4$	2 to $2^1/_2$
Real household disposable income	$4^1/_4$	4	$3^1/_4$ to $3^1/_2$	2 to $2^1/_2$	$2^1/_2$ to 3
Saving ratio (level, per cent)	5	5	5	5	$5^1/_2$

[1] *Including non-profit institutions serving households.*

[2] *At constant prices.*

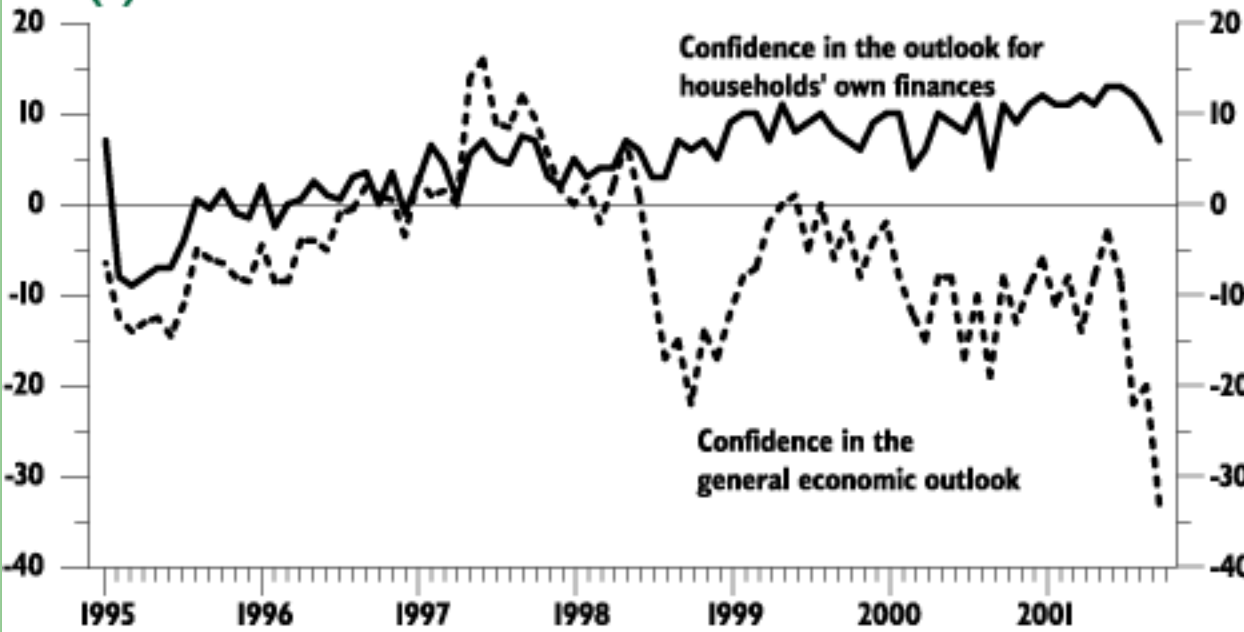
A51. Household consumption has played an important role in supporting GDP growth during 2001 as external demand has weakened. However, the Pre-Budget Report forecast assumes that consumption growth will return to rates consistent with its longer-term determinants by early 2002. Wealth effects are likely to provide less of a boost to consumption following recent declines in equity prices and first signs of lower house price inflation. Confidence in the economic outlook was already falling before 11 September and, combined with the further deterioration since the attacks, should have a moderating influence on consumption growth (see Box A4). Real disposable income growth is also forecast to slow as labour market pressures ease.

Box A4: Consumer confidence and the prospects for consumer spending

Consumer confidence in the UK started the year close to record levels according to the aggregate GfK indicator[1]. Confidence has fallen back in recent months, as world economic prospects have deteriorated, but still exceeds its long-run average. Despite falling consumer confidence, household consumption has continued to grow rapidly during 2001.

Recent movements in the aggregate consumer confidence measure have masked significant divergences between some of its individual components (chart a). In particular, while confidence in the general economic outlook has fallen significantly below its long-run average, households' confidence in their own financial position has held up strongly. A similar pattern emerged during 1998, when global financial instability prompted a sharp downturn in confidence in the general outlook for the UK economy.

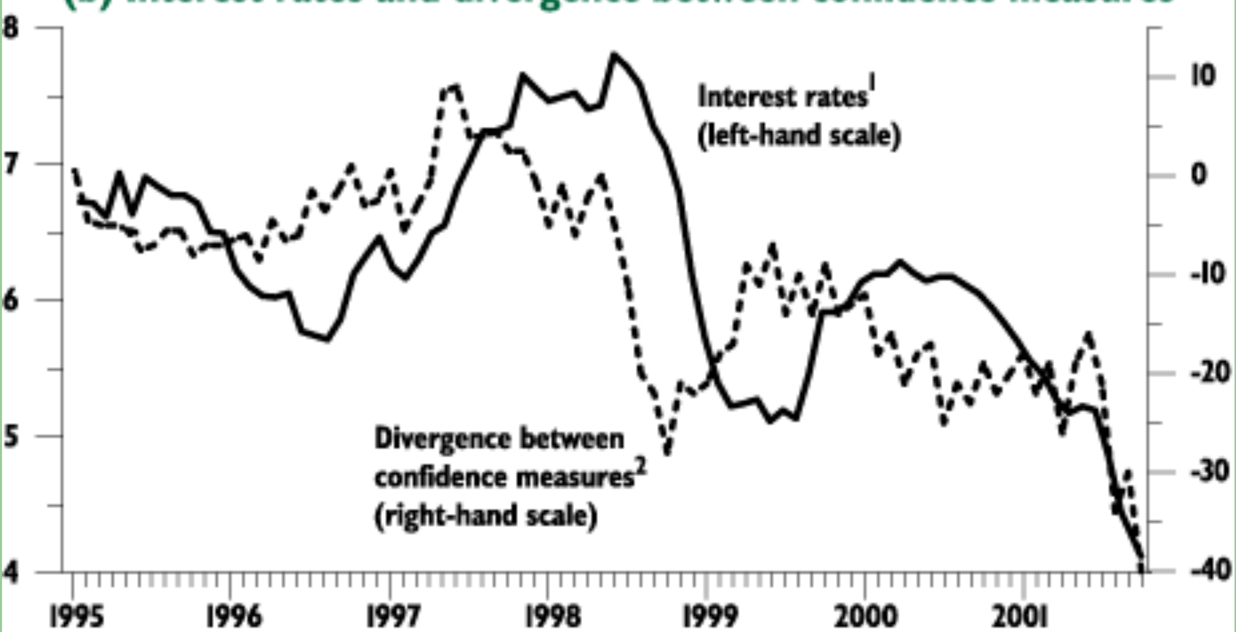
(a) Individual confidence measures[1]



[1] Measures of households' confidence in the outlook for their own finances and for the general economy.

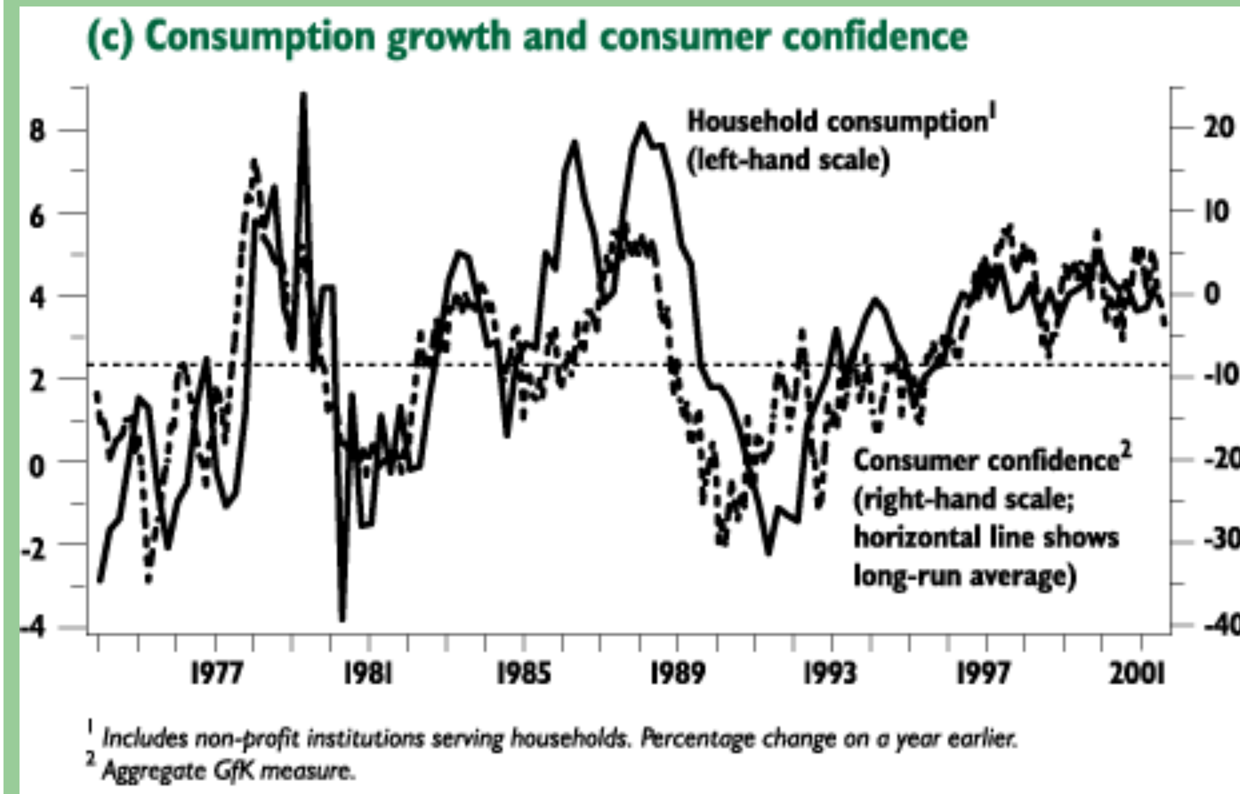
As in 1998, the MPC has responded to the more uncertain outlook by cutting interest rates. The divergence between the two confidence measures during both these periods suggests that pre-emptive monetary policy action can sustain confidence in household finances during temporary periods of heightened economic uncertainty (chart b).

(b) Interest rates and divergence between confidence measures



[1] Sterling interbank offered rate in London (3 months), per cent.
[2] Confidence in general economic outlook minus confidence in outlook for households' own finances.

Over longer periods, consumption growth tends not to be divorced from aggregate consumer confidence (chart c). The recent weakening of confidence is therefore expected to contribute to a moderation of household consumption growth to rates more consistent with its longer-term determinants. On the other hand, further support to household finances should flow from the recent easing of monetary policy, helping to offset the effect of falling confidence on consumption in the short term and reducing the likelihood of a sharper slowdown in consumer spending.



[1] Consumer confidence indicators published by Martin Hamblin GfK (Gesellschaft für Konsumforschung), on behalf of the European Commission.

A52. Household consumption is expected to grow by $2^3/_4$ to 3 per cent in 2002 and by $2^1/_4$ to $2^3/_4$ per cent in 2003. As consumption growth returns to more sustainable levels, the saving ratio is projected to pick up modestly by the end of the forecast period. Greater confidence in economic stability, low inflation and long-term job security may have reduced the desired level of precautionary saving compared with the high levels seen in the mid-1990s.

A53. The clearest risk to consumption is that continued uncertainty or a delayed G7 recovery leads to a further fall in consumer confidence. Conversely, the scale of the recent policy loosening in the UK, and the possibility of a sharper than anticipated global recovery, pose upside risks to consumption. With household debt already at record levels relative to disposable income, further increases in borrowing to fuel continued strong consumption growth would increase the risk of a sharper adjustment in the future. With the economy operating close to potential, financial markets anticipate that interest rates will remain low. Debt-servicing costs are therefore not expected to prompt a sharp retrenchment, in contrast to the early 1990s' experience.

Companies and investment

A54. The UK corporate sector has been affected by the slowdown in the world economy and the slump in global demand for ICT related goods (in 1999 the ICT goods and services sector accounted for 7 per cent of UK output). Externally exposed sectors have been disproportionately affected, with falling output of investment and intermediate goods driving a contraction of manufacturing output in the UK, although to a lesser extent than in some other G7 economies. Output in the electrical and optical equipment sector, which is closely correlated with ICT manufacturing output and accounts for 2.8 per cent of UK GDP, has fallen by almost 20 per cent since the end of 2000. This fall directly accounts for over 50 per cent of the total fall in UK manufacturing output over the period. By contrast, production of consumer goods has increased during 2001, and the service sector has continued to register robust growth, supported by the strength of domestic consumption.

A55. At the time of Budget 2001, business investment growth was expected to be subdued this year as firms attempted to reduce indebtedness. In the event, business confidence has fallen during the year, reflecting weaker external demand and increasing uncertainty surrounding the economic outlook. Weaker corporate profitability and stock market falls have also constrained firms' investment plans, and business investment has slowed more sharply than anticipated this year as firms have deferred investment. In the first half of 2001 it was down almost 2 per cent on the second half of 2000, and it fell further in the third quarter.

A56. Business surveys show a sharp deterioration in confidence among manufacturers and a weakening of service sector optimism since 11 September. Short-term movements in confidence indicators often overstate the longer-term effects of unexpected events, but heightened uncertainty increases the likelihood that firms will postpone investment decisions.

Table A7: Gross fixed capital formation

			Percentage changes on previous year		
			Forecast		
	2000	**2001**	**2002**	**2003**	**2004**
Whole economy[1]	$4\frac{3}{4}$	1	2 to $2\frac{1}{4}$	$4\frac{3}{4}$ to $5\frac{1}{4}$	$2\frac{3}{4}$ to $3\frac{1}{4}$
of which:					
Business[2,3]	5	0	$\frac{1}{4}$ to $\frac{1}{2}$	$4\frac{1}{2}$ to 5	$2\frac{1}{4}$ to 3
Private dwellings[3]	$2\frac{1}{2}$	$-4\frac{3}{4}$	$-\frac{3}{4}$ to $-\frac{1}{2}$	2 to $2\frac{1}{2}$	2 to $2\frac{1}{2}$
General government[3,4]	$8\frac{1}{2}$	$21\frac{1}{2}$	$18\frac{1}{2}$	$10\frac{1}{2}$	$6\frac{1}{2}$

[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.*

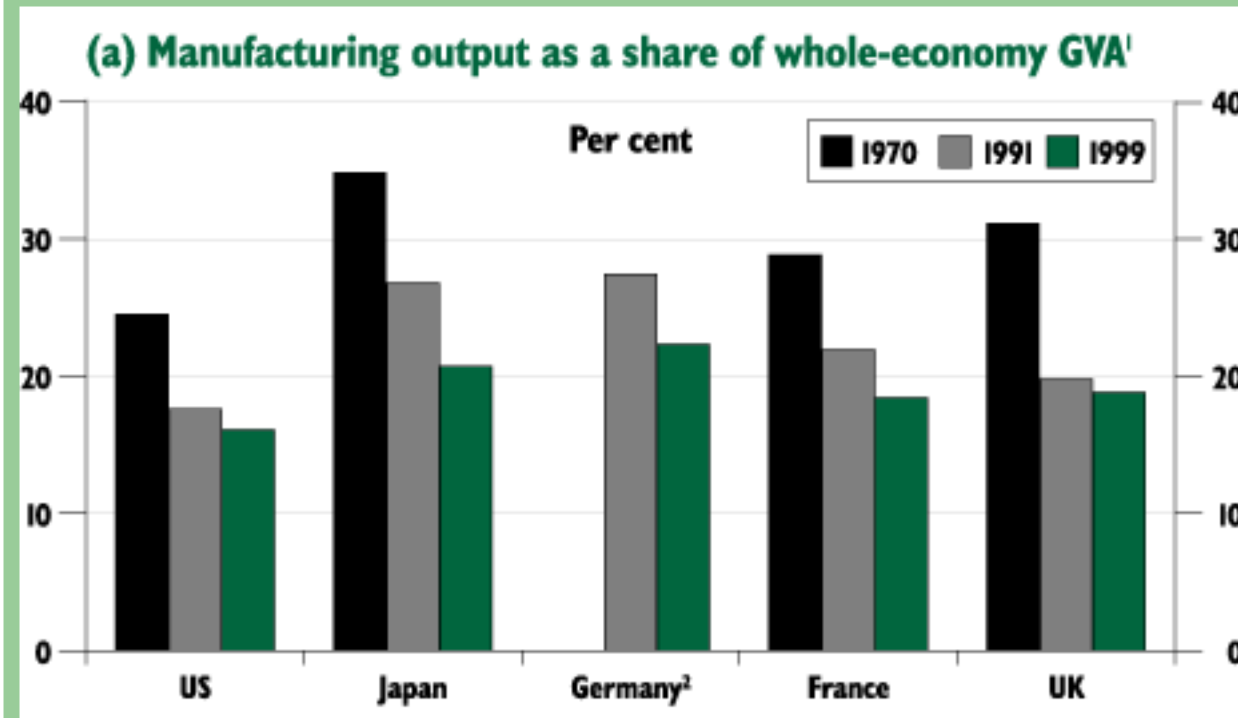
Box A5: Recent manufacturing performance in historical perspective

The UK manufacturing sector includes many of our most innovative businesses and plays a crucial role in generating growth in productivity, exports and R&D. But this has been a difficult year for manufacturing companies. As the world economy has slowed during 2001, UK manufacturing output has declined. At the same time robust household consumption has supported strong growth in service sector output, prompting renewed concerns about the divergent performance of these two sectors.

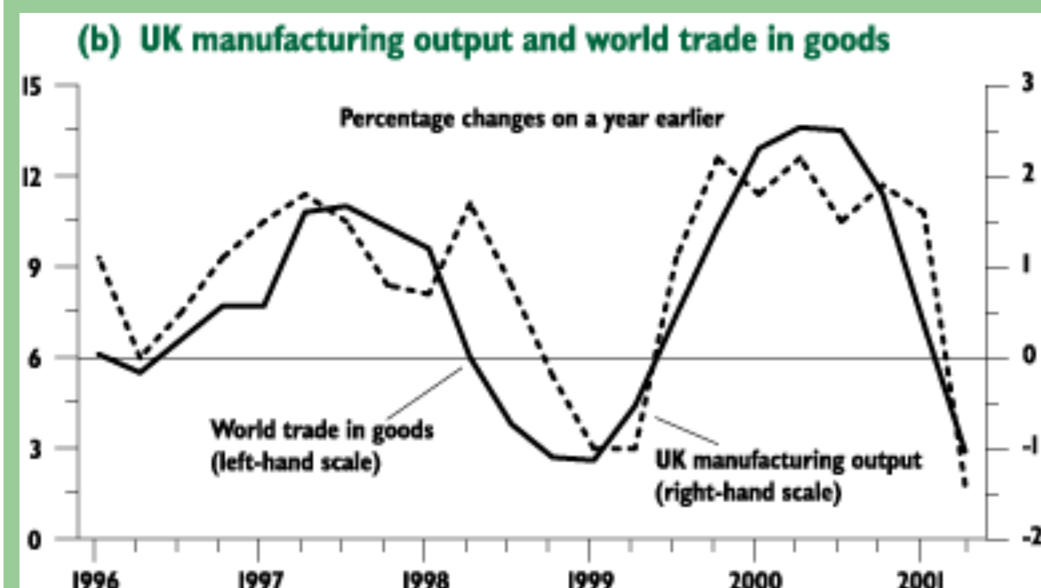
Such divergence has not been confined to the UK, and a decline in the share of manufacturing output in the economy has also been a long-standing feature common to mature industrialised economies. Manufacturing's share in the UK has been moving in line with trends across the industrialised world since the 1970s (chart a). As incomes grow, the shifting composition of consumer demand tends to reduce the relative demand for manufactured goods. In the UK, it is estimated that the declining share of manufactures in domestic demand has accounted for perhaps as much as three quarters of manufacturing's relative decline over the past 30 years. Most of the relative decline cannot therefore be explained by trade competitiveness.

Moreover, the distinction between manufacturing and service sector performance is less clear than the aggregate figures suggest. Within the manufacturing sector, certain industries have grown strongly. Between 1995 and 2000, output of electrical and optical equipment grew by 45 per cent. The chemicals related industries have also grown steadily in recent years. The relatively strong performance of these highly export-intensive sectors again suggests that differing fortunes between manufacturing and services are not solely attributable to exposure of the manufacturing sector to international competition and the exchange rate. Indeed, despite the weakness of the euro in recent years, the UK's trade in goods deficit with EU countries has not widened.

Manufacturers in the UK, and across the industrialised world, have been affected by weaker external demand and the recent sharp fall in world trade growth (chart b). After a number of years of strong growth, the collapse in demand for ICT related goods during 2001 has had a particularly significant impact: over 50 per cent of the downturn in total UK manufacturing output this year can be accounted for by falling output in the electrical and optical equipment sector. In contrast, certain manufacturing sectors have continued to grow: output in the chemicals related industries in the third quarter was 4 per cent higher than a year earlier.



[1] Gross value added. Source: OECD, except US data for 1999 (national source, per cent of GDP).
[2] Pre-unification data omitted.



UK manufacturing output is expected to recover sharply as growth in the major economies picks up from the middle of 2002 and demand for ICT related goods strengthens. In view of the importance of manufacturing to closing the productivity gap between the UK and its competitors, the Government has taken important steps to support manufacturers in their efforts to raise productivity and investment, as described in Chapter 3.

A57. Business investment is forecast to remain subdued in the first half of 2002, but to accelerate sharply as the G7 recovery gathers pace, profitability improves and postponed investment plans come on stream. ICT investment is expected to recover in the UK and elsewhere as ongoing technological improvements increase the incentive to upgrade the existing capital stock, providing renewed impetus to the ICT sector.

A58. Business investment is expected to remain close to a record share of GDP when measured in constant (1995) prices. When measured at current prices the share is lower, reflecting the decline in the relative price of investment goods since 1995, though it has still risen sharply over the period. Whole economy investment will continue to be supported by strong growth in general government investment, which is projected to increase by over 21 per cent in 2001 and over 18 per cent in 2002.

Chart A7: Business and non-residential investment ratios

Trade and the balance of payments

A59. The pattern of UK trade has been heavily affected as world demand, particularly for highly traded ICT goods, has weakened. Lower external demand for intermediate components and investment goods, which together account for around 40 per cent of UK goods exports by volume, contributed to declines in exports in the second and third quarters of 2001. Imports have also fallen, as weaker ICT related manufacturing output and investment have reduced demand for imported intermediate and capital goods.

A60. The deficit on trade in goods and services is forecast to widen to 2 per cent of GDP in 2001, with net trade expected to subtract $^3/_4$ of a percentage point from GDP growth. In recent years, the deficit on trade with EU countries has remained very modest relative to the deficit with non-EU countries. However, margins on exports to the EU have been squeezed further, and the EU balance partly reflects the UK's position as a net exporter of oil to the EU. The non-EU goods deficit has shown signs of levelling off, with a sharp contraction of imports from south-east Asia through 2001 probably reflecting the impact of weakening ICT manufacturing output on demand for imported components.

Chart A8: Balance of payments current account

A61. Official estimates of the current account deficit during the 1990s have been revised upwards, partly reflecting the inclusion of estimates of tobacco and alcohol smuggling in the balance of payments figures for the first time. However, latest figures show that the deficit narrowed slightly in 2000, and it is now forecast to narrow a bit further to around £14 billion in 2001. An unusually strong investment income balance in 2001 more than accounts for the narrowing.

Table A8: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices[1]			
	Exports	**Imports**	**Exports**	**Imports**	**Terms of trade[2]**	**Goods and services balance**
2000	$10^1/_4$	$10^3/_4$	$1^3/_4$	$^1/_2$	$1^1/_4$	$-15^3/_4$
Forecast						
2001	$^3/_4$	$2^1/_2$	$-^1/_4$	$-^1/_4$	0	$-20^3/_4$
2002	$^1/_4$ to $^1/_2$	$2^3/_4$ to 3	$-^1/_4$	$-^1/_4$	0	-28

2003	$6\frac{3}{4}$ to $7\frac{1}{4}$	$6\frac{1}{4}$ to $6\frac{3}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	0	-29
2004	6 to $6\frac{1}{2}$	$5\frac{1}{2}$ to 6	$2\frac{3}{4}$	$2\frac{3}{4}$	0	-30

[1] *Average value indices.*

[2] *Ratio of export to import prices.*

A62. Export volumes are expected to remain subdued during early 2002, but to accelerate sharply as the G7 recovery gathers pace from the middle of the year. Export prices and exporters' share in UK export markets are forecast to remain broadly flat in 2002. However, the economic recovery may encourage exporters to rebuild margins later in the year. Import volumes are expected to pick up more strongly as domestic business investment and manufacturing output recover during the second half of 2002. As a result, with export growth temporarily depressed relative to imports, the deficit on trade in goods and services is expected to widen further, and net trade is forecast to continue to exert a significant drag on GDP growth in 2002.

A63. Thereafter, the current account deficit is projected to level off at around $2\frac{3}{4}$ per cent of GDP, well below past peaks. Import and export volumes are expected to expand at broadly similar rates from 2003, with import growth below the brisk rates seen between 1996 and 2000, reflecting weaker household consumption growth. However, a more prolonged world slowdown or stronger than anticipated household consumption would pose risks to this forecast.

Table A9: Summary of economic prospects[1]

Percentage changes on a year earlier unless otherwise stated

			Forecast[2]			
	2000	**2001**	**2002**	**2003**	**2004**	**Average errors from past forecasts[3]**
Output at constant market prices						
Gross domestic product (GDP)	3	$2\frac{1}{4}$	2 to $2\frac{1}{2}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	1
Manufacturing output	$1\frac{3}{4}$	$-1\frac{3}{4}$	$-\frac{3}{4}$ to $-\frac{1}{2}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$1\frac{3}{4}$ to $2\frac{1}{4}$	$1\frac{3}{4}$
Expenditure components of GDP at constant market prices						
Domestic demand	$3\frac{1}{2}$	3	$2\frac{3}{4}$ to $3\frac{1}{4}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$1\frac{1}{4}$
Household consumption[5]	4	4	$2\frac{3}{4}$ to 3	$2\frac{1}{4}$ to $2\frac{3}{4}$	2 to $2\frac{1}{2}$	$1\frac{1}{4}$

General government consumption	1½	3	4¾	2	2	1¼
Fixed investment	4¾	1	2 to 2¼	4¾ to 5¼	2¾ to 3¼	2½
Change in inventories[6]	-¼	-½	0	¼	0	¼
Exports of goods and services	10¼	¾	¼ to ½	6¾ to 7¼	6 to 6½	2¼
Imports of goods and services	10¾	2½	2¾ to 3	6¼ to 6¾	5½ to 6	2½
Balance of payments current account						
£ billion	-18½	-14	-26¾	-28¾	-30½	5¾
per cent of GDP	-2	-1½	-2½	-2¾	-2¾	½
Inflation						
RPIX (Q4)	2	2¼	2¼	2½	2½	¾
Producer output prices (Q4)[7]	1¾	0	¾	2	2¼	1
GDP deflator at market prices	1¾	2¼	2½	2½	2½	¾
Money GDP at market prices						
£ billion	943	988	1032 to 1036	1086 to 1095	1137 to 1151	13
percentage change	4¾	4¾	4½ to 4¾	5¼ to 5¾	4¾ to 5¼	1¼

[1] *The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2001, released by the Office for National Statistics on 25 September 2001, and output, income and expenditure data for the third quarter, released on 22 November.*

[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 2002.*

[4] *Further detail on the expenditure components of GDP is given in Table A10.*

[5] *Includes households and non-profit institutions serving households.*

6 *Contribution to GDP growth, percentage points.*

7 *Excluding excise duties.*

Table A10: 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**	***Plu* statistica discrepancy**
2000	557.9	151.4	157.8	2.5	870.0	285.4	1155.4	328.9	-0.
2001	580.7	156.0	159.3	-1.0	895.2	287.2	1182.4	337.1	-0.
2002	596.1 to 597.9	163.4	162.5 to 163.0	-1.2 to -1.7	920.7 to 923.6	288.1 to 289.0	1208.8 to 1212.5	346.6 to 347.6	0.
2003	608.9 to 613.8	166.5	170.3 to 171.6	0.3 to 1.6	946.0 to 953.5	307.7 to 310.1	1253.6 to 1263.6	368.3 to 371.2	0.
2004	621.2 to 629.3	170.0	175.0 to 177.2	0.3 to 2.5	966.5 to 979.0	326.3 to 330.5	1292.8 to 1309.5	388.6 to 393.6	0.
2000 1st half	276.5	75.4	77.0	1.5	430.6	140.1	570.7	160.3	-0.
2nd half	281.3	76.0	80.8	1.0	439.4	145.3	584.8	168.6	-0.
2001 1st half	287.1	76.8	80.4	0.8	445.1	147.2	592.3	171.3	-0.
2nd half	293.6	79.2	78.9	-1.9	450.1	140.0	590.1	165.8	0.
2002 1st half	296.5 to 297.1	81.4	80.2 to 80.3	-1.5 to -1.4	456.5 to 457.4	141.8 to 142.0	598.3 to 599.4	170.5 to 170.8	0.
2nd half	299.6 to 300.8	81.9	82.3 to 82.7	0.4 to 0.7	464.2 to 466.2	146.3 to 146.9	610.5 to 613.1	176.1 to 176.9	0.
2003 1st half	302.9 to 305.0	82.6	84.4 to 85.0	0.5 to 1.1	470.5 to 473.7	151.4 to 152.4	621.9 to 626.1	181.6 to 182.9	0.
2nd half	306.0 to 308.8	83.9	85.9 to 86.6	-0.3 to 0.5	475.5 to 479.9	156.2 to 157.7	631.7 to 637.5	186.7 to 188.4	0.

2004 1st half	309.1 to 312.7	84.8	86.9 to 88.0	-0.2 to 0.8	480.6 to 486.2	160.8 to 162.7	641.4 to 648.9	191.7 to 193.9	0.
2nd half	312.2 to 316.6	85.2	88.0 to 89.3	0.4 to 1.7	485.9 to 492.8	165.5 to 167.8	651.4 to 660.6	196.9 to 199.7	0.
					Percentage changes on previous year[4, 5]				
2000	4	$1\frac{1}{2}$	$4\frac{3}{4}$	$-\frac{1}{4}$	$3\frac{1}{2}$	$10\frac{1}{4}$	5	$10\frac{3}{4}$	
2001	4	3	1	$-\frac{1}{2}$	3	$\frac{3}{4}$	$2\frac{1}{4}$	$2\frac{1}{2}$	
2002	$2\frac{3}{4}$ to 3	$4\frac{3}{4}$	2 to $2\frac{1}{4}$	0	$2\frac{3}{4}$ to $3\frac{1}{4}$	$\frac{1}{4}$ to $\frac{1}{2}$	$2\frac{1}{4}$ to $2\frac{1}{2}$	$2\frac{3}{4}$ to 3	
2003	$2\frac{1}{4}$ to $2\frac{3}{4}$	2	$4\frac{3}{4}$ to $5\frac{1}{4}$	$\frac{1}{4}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	$6\frac{3}{4}$ to $7\frac{1}{4}$	$3\frac{3}{4}$ to $4\frac{1}{4}$	$6\frac{1}{4}$ to $6\frac{3}{4}$	
2004	2 to $2\frac{1}{2}$	2	$2\frac{3}{4}$ to $3\frac{1}{4}$	0	$2\frac{1}{4}$ to $2\frac{3}{4}$	6 to $6\frac{1}{2}$	3 to $3\frac{3}{4}$	$5\frac{1}{2}$ to 6	

[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 $\frac{1}{2}$ percentage point ranges for GDP growth because of rou the assumed invariance of the levels of public spending within the forecast ranges.*

[1] The UK forecast is consistent with national accounts and balance of payments statistics to the second quarter of 2001 released by the Office for National Statistics on 25 September, and output, income and expenditure data for the third quarter released on 22 November. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk), and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

[2] The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

[3] Non-accelerating inflation rate of unemployment.

[4] *The Changing Welfare State: Employment Opportunity for All*.

[5] In this framework, the contributions of the capital stock per worker and total factor productivity to trend output are subsumed in estimated labour productivity (output per worker).

[6] Published in the 2001 edition of the *UK National Accounts* (Blue Book).

[7] *2000-based population projections for the United Kingdom and constituent countries*, published on 15 November 2001 and available from www.gad.gov.uk.

B THE PUBLIC FINANCES

The updated projections of the public finances show that the fiscal position is sound. The tough decisions on taxation and spending taken by the Government over the past four years have enabled £51 billion of debt to be repaid and mean that fiscal policy is well placed to play its part in cushioning the effects of the global economic slowdown. Debt levels are stable and low and strong surpluses on the current budget over the past two years provide room for manoeuvre within the fiscal rules over the remainder of the economic cycle.

The interim projections of the public finances show that the Government remains on track to meet both its fiscal rules over the cycle, including in the cautious case:

- **the current budget remains in surplus throughout the projection period, even using cautious assumptions, ensuring that the Government remains on track to meet the golden rule; and**
- **public sector net debt is expected to remain low and stable over the next five years ; comfortably meeting the sustainable investment rule at 31 per cent of GDP, the lowest ratio in the G7.**

In the short term, lower reciepts compared to the Budget mean that fiscal policy is supporting monetary policy this year and next in maintaining economic stability. Over the forecast period, receipts are expected to return to the Budget profile. Public sector net borrowing is projected to be $^1/_4$ per cent of GDP in 2001-02, and 1 per cent of GDP in the following year. Modest deficits are projected to continue, reflecting the rapid growth of public investment, and fully consistent with meeting both fiscal rules.

INTRODUCTION

B1. Chapter 2 describes the Government's fiscal framework and shows how the updated projections of the public finances are consistent with meeting the fiscal rules. This annex explains in more detail the Government's performance against the fiscal rules. It includes:

- five year 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;
- projections of the cyclically-adjusted fiscal balances; and
- detailed analyses of the outlook for government receipts and expenditure.

MEETING THE FISCAL RULES

B2. The Pre-Budget Report provides an update of the projections of the public finances contained in Budget 2001, taking account of developments in both the public finances and the economy since then. 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.

B3. Table B1 compares the Pre-Budget Report projections for the current budget and net borrowing with those made in Budget 2001. These projections inevitably involve a considerable element of uncertainty and are therefore based deliberately on cautious assumptions of key economic variables, including the trend rate of growth of the economy. A cautious asymetric approach to fiscal policy helps ensure that the public finances are well placed to deal with the impact of the world economic slowdown by building in a safety margin against unexpected events.

B4. Reduced economic growth has implications for both public sector receipts and spending. However, the tough decisions on taxation and spending taken by the Government over the past four years to repay debt mean that fiscal policy is able to support monetary policy this year and next in maintaining economic stability, while continuing to meet the two fiscal rules.

The revised fiscal projections show that the current budget will remain in surplus throughout the economic cycle. The outturn for 2000-01 shows a £$2^3/_4$ billion higher surplus on the currrent account and a $3^3/_4$ billion higher net repayment. A current budget surplus of £10 billion is projected for 2001-02, compared with the Budget projection of £16 billion. The current surplus in 2002-03 has also been revised downwards to £3 billion. Similarly, public sector net borrowing of £2.5 billion is now expected in 2001-02, compared with a projected net repayment of £5 billion in the Budget. However, as the economy moves back to trend, the fiscal position moves back towards its Budget 2001 profile.

Table B1: Fiscal balances comparison with Budget 2001[1]

	Outturn[2]	Projections				
	2000-01	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
Fiscal balances						
Surplus on current budget (£ billion)						
Budget 2001	22.3	16	14	8	9	9
PBR 2001	**25.1**	**10.3**	**3**	**4**	**7**	**8**
Net borrowing (£ billion)						
Budget 2001	-15.0	-5	2	10	11	12
PBR 2001	**-18.8**	**2.5**	**12**	**15**	**13**	**13**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2001	2.0	1.2	1.0	0.6	0.7	0.7
PBR 2001	**2.3**	**1.0**	**0.3**	**0.3**	**0.5**	**0.7**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2001	-1.3	-0.1	0.4	1.1	1.1	1.1
PBR 2001	**-1.6**	**0.3**	**1.1**	**1.4**	**1.2**	**1.1**

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

[2] *The 2000-01 figures were estimates in Budget 2001.*

B5. Table B2 shows five year 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. Outturns and projections of other important measures of the public finances, including net borrowing and net worth, are also shown.

B6. The projections show that the Government remains on track to meet the golden rule over the forecast period, with the average surplus on the current budget from 1999-00 projected to be at least 1.1 per cent of GDP throughout the next five years. The current budget balance improved slightly in 2000-01 to a surplus of just over $2^1/_2$ per cent of GDP. The surpluses are projected to fall temporarily over the short term, mainly reflecting the effects of weaker growth, the impact of the audited assumptions, and weaker financial company profits (these are discussed in more detail below). Over the medium term, stronger economic growth and a return in financial company profits to their long term trend will push the current surplus back towards Budget 2001 levels.

B7. Net borrowing is equal to net investment minus the surplus on the current budget. Public sector net investment is projected to be approximately 1.3 per cent of GDP in 2001-02, implying net borrowing of 0.3 per cent of GDP. The ratio of net investment to GDP is projected to increase steadily to 1.8 per cent of GDP in 2004-05 and remain at that level thereafter. The rapid growth of net investment, in conjunction with the effects of slower economic growth, will result in modest levels of net borrowing over the remainder of the period, consistent with meeting the sustainable investment rule.

Table B2: Summary of public sector finances

	Per cent of GDP							
	Outturns		Projections					
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Fairness and prudence								
Surplus on current budget	2.3	2.6	1.0	0.3	0.4	0.6	0.7	0.7
Average surplus since 1999-2000	2.3	2.5	2.0	1.6	1.3	1.2	1.1	1.1
Cyclically-adjusted surplus on current budget	2.0	2.3	1.0	0.3	0.3	0.5	0.7	0.7
Long-term sustainability								
Public sector net debt	36.4	31.2	30.7	30.6	31.0	31.1	31.1	31.1
Net worth	14.7	19.5	21.6	21.2	20.8	20.3	19.8	19.5
Primary balance	4.1	4.1	1.6	0.6	0.5	0.7	0.7	0.6
Economic impact								
Net investment	0.5	0.7	1.3	1.4	1.7	1.8	1.8	1.8
Public sector net borrowing (PSNB)	-1.8	-2.0	0.3	1.1	1.3	1.2	1.1	1.1
Cyclically-adjusted PSNB	-1.5	-1.6	0.3	1.1	1.4	1.2	1.1	1.1
Financing								
Central government net cash requirement	-1.0	-3.7	0.6	1.3	1.7	1.3	1.2	1.3
European commitments								
Treaty deficit[1]	-1.7	-2.0	0.2	1.1	1.3	1.1	1.0	1.0
Cyclically-adjusted Treaty deficit[1]	-1.4	-1.7	0.3	1.0	1.3	1.1	1.0	1.0
Treaty debt ratio[2]	43.1	39.9	38.1	37.2	37.0	36.8	36.6	36.3
Memo: Output gap	0.3	0.6	-0.1	-0.1	0.2	0.0	0.0	0.0

[1] *General government net borrowing on an ESA95 basis.*

[2] *General government gross debt.*

B8. The primary balance is equal to net borrowing excluding net debt interest payments - thus abstracting from the implications of past fiscal deficits. If real interest rates exceed trend GDP growth, a primary surplus is required to stabilise the net debt ratio. The primary balance is projected to be in surplus by $1^1/_2$ per cent of GDP in 2001-02. Surpluses of between $^1/_2$ per cent and $^3/_4$ per cent of GDP are projected over the next five years.

B9. The central government net cash requirement was a repayment of $3^3/_4$ per cent of GDP in 2000-01, higher than expected at Budget 2001. This largely reflects the receipts from the auction of licences to access the electromagnetic spectrum. The net cash requirement is projected to move into deficit from 2001-02 onwards, mirroring the profile of public sector net borrowing. The approximate stock counterpart to the public sector net cash requirement is public sector net debt.

B10. In 1996-97, public sector net debt stood at 44 per cent of GDP. The tough decisions on taxation and spending taken by the Government over the past four years, including the decision to use the proceeds from the auction of spectrum licences to pay off debt, mean that net debt is now projected to be around 31 per cent of GDP in 2001-02, the lowest of all the G7 countries. The net debt-GDP ratio is expected to stabilise at around 31 per cent for the rest of the projected period - well below 40 per cent and comfortably meeting the sustainable investment rule.

B11. The approximate stock counterpart to the current budget balance is public sector net worth. Current budget surpluses of over 2 per cent of GDP a year have begun to raise net worth to an estimated $21^1/_2$ per cent of GDP in 2001-02. At present, net worth is not used as a key indicator of the public finances, due mainly to the difficulties in measuring accurately many government assets and liabilities.

Chart B1: Public sector net debt and net worth

B12. Table B2 also shows the updated estimates of the cyclically-adjusted current budget and net borrowing as a per cent of GDP. These allow underlying or structural trends in the indicators to be seen more clearly, once the estimated effects of the economic cycle are removed.

B13. The cyclically-adjusted current budget balance has moved from a deficit of over 2 per cent of GDP in 1996-97 to a surplus of over 2 per cent of GDP in 2000-01. As with the unadjusted figures, the strong increases in investment and the global economic slowdown result in reduced surpluses in 2001-02 and 2002-03, before the surpluses return towards Budget levels.

B14. Similarly, cyclically adjusted net borrowing of 3 per cent of GDP in 1996-97 has moved to a repayment of around $1^1/_2$ per cent in 2000-01 before returning to a modest deficit over the short and medium term, consistent with the sustainable investment rule.

Forecast errors and risks

B15. The fiscal balances represent the difference between two large aggregates of spending and receipts and are inevitably subject to wide margins of forecast error. Over the past five years, the average absolute error (the average error irrespective of whether the errors have been positive or negative) for one-year ahead forecasts of net borrowing has been around 1 per cent of GDP. The error tends to grow as the forecast horizon lengthens. Much of this error arises from forecast errors of GDP.

B16. 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. Work published by the Treasury[1] suggests that if GDP growth were 1 percentage point higher or lower than assumed over the coming year, net borrowing might be lower or higher by around 0.4 per cent of GDP in the first year and by a further 0.3 per cent in the following year. Allowing for the reduction in the lag between profits and corporation tax receipts resulting from the introduction of the instalment system (discussed in Box B2), these figures are now closer to 0.5 and 0.2 per cent. However, not all cycles will conform exactly to these parameters, notably because the estimates are based on historical data (since which time both the economy and tax regime have changed) and because cycles differ in respects other than their magnitude.

B17. 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.

B18. For this reason, the public finance projections are deliberately based on assumptions for key economic variables, including the trend rate of growth of the economy in the medium term. These are audited by the National Audit Office (NAO) to ensure they remain both reasonable and cautious. Details of these assumptions are given in Box B1.

B19. In addition, the public finance projections are stress-tested against an alternative cautious case, in which the output gap is assumed to be 1 percentage point higher than the central view. This scenario would imply that a greater proportion of the projected surplus on the current budget was due to the cyclical strength of the economy: a 1 per cent larger positive output gap reduces the structural surplus on the current budget by about $^3/_4$ per cent of GDP a year. This is illustrated in chart B2. Even in this more cautious case, the cyclically-adjusted current budget is estimated to remain comfortably in surplus over the past 4 years. The impact of the temporary fall in receipts means that it moves into deficit over the short term, before returning to surplus in 2005-06. However, the average cyclically-adjusted current budget is forecast to be in surplus over the economic cycle.

Chart B2: Cyclically-adjusted surplus on current budget

ASSUMPTIONS

B20. The fiscal projections are based on the following assumptions:

- the economy follows the path described in Annex A. The fiscal projections continue to be based on the deliberately prudent and cautious assumption of trend growth of $2^1/_4$ per cent a year. The main economic assumptions are summarised in Table B3;
- firm Departmental Expenditure Limits (DELs) as set out in the 2000 Spending Review, adjusted for subsequent changes;
- Annually Managed Expenditure (AME) totals as set out in Budget 2001, adjusted to allow for estimated costs of spending measures announced in the Pre-Budget Report (see Table B4);
- prior to firm spending plans being set in the 2002 Spending Review, current expenditure in DEL is projected to grow by $2^1/_2$ per cent a year in real terms over 2004-05 and 2005-06 from a baseline excluding capital to resource switches made by the devolved administrations. This is in line with the neutral view of trend. Current expenditure in AME is projected to grow by $1^3/_4$ per cent a year in real terms, in line with recent trends;
- net investment more than doubles by 2003-04 and is forecast to end the projection period at 1.8 per cent of GDP. This makes a significant contribution toward tackling the historical under-investment while remaining consistent with the sustainable investment rule by ensuring the net debt-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 this Pre-Budget Report (see Table B4) and the indexation of rates and allowances.

Table B3: Economic assumptions for public finance projections

	Percentage changes on previous year						
	2000-01	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**
Output (GDP)	$2^3/_4$	2	$2^1/_4$	$2^1/_2$	$2^1/_4$	$2^1/_4$	$2^1/_4$
Prices							
RPIX	2	$2^1/_4$	$2^1/_4$	$2^1/_2$	$2^1/_2$	$2^1/_2$	$2^1/_2$
GDP deflator	$1^3/_4$	$2^1/_2$	$2^1/_2$	$2^1/_2$	$2^1/_2$	$2^1/_2$	$2^1/_2$
RPI[1] (September)	$3^1/_4$	$1^3/_4$	2	$3^1/_4$	$2^3/_4$	$2^1/_2$	$2^1/_2$
Rossi[2] (September)	$1^1/_2$	$1^3/_4$	2	2	$2^1/_4$	$2^1/_4$	$2^1/_4$
Money GDP[3] (£ billion)	955	998	1046	1099	1150	1205	1263

[1] *Used for revalorising excise duties in current year and uprating income tax allowances and bands and certain social security benefits in the following year.*

[2] *RPI excluding housing costs, used for uprating certain social security benefits.*

[3] *Not seasonally adjusted.*

B21. The key assumptions underlying the fiscal projections are audited by the NAO under the three-year rolling review. The key assumptions and conventions used for the Budget 2001 public finance projections are unchanged. Details of all the audited assumptions are given in Box B1.

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]	Rising slowly to 1.14 million in 2003-04, from recent levels of 0.95 million, consistent with average of independent forecasts.
• Interest rates[1,6,7]	3-month market rates change in line with market expectations (as of 19 November).
• Equity prices[2,7]	FT-All share index rises from 2579 (close 19 November) in line with money GDP.
• VAT[2,7]	Ratio of VAT to consumption falls by 0.05 percentage points a year.
• GDP deflator and RPI[2,7]	Projections of price indices used to plan public expenditure are consistent with RPIX.
• Composition of GDP[3,8]	Shares of labour income and profits in national income are consistent with the public finances forecast and with financing policy.
• Funding[3,8]	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing and with financing policy.
• Oil prices[5]	$22.90 a barrel in 2002, 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).***

8 ***Audit of Assumptions for the March 2001 Budget, 7 March 2001 (HC304).***

PRE-BUDGET REPORT MEASURES

B22. The impact on the fiscal projections of measures announced since Budget 2001 and in this Pre-Budget Report are set out in table B4. In line with the convention adopted in previous Pre-Budget Reports, expenditure measures in AME for future years have been added to total AME, while measures in the current year have been deducted from the AME margin. In 2002-03, lower debt interest payments have enabled £1 billion to be reallocated from AME to resource DEL to fund additional spending on health. Changes to the forecast for individual AME programmes have otherwise been offset in the AME margin.

The interim forecast shows that the AME margin is now expected to be around £0.2 billion in 2001-02, £1.2 billion in 2002-03, and £1.5 billion in 2003-04 (see table B13).

B23. Consistent with the requirements of the *Code for Fiscal Stability*, the forecast does not take account of:

- measures proposed in the Pre-Budget Report for further consultation in the run up to Budget 2002, including the research and development (R&D) tax credit for large companies; and
- other proposals where final decisions on rates have yet to been taken; these include the Working Tax Credit and the Child Tax Credit.

Table B4: Estimated costs for Pre-Budget Report measures and other measures announced since Budget 2001

	(+ve is an Exchequer yield) £ million			
	2001-02	**2002-03**	**2003-04**	**2004-05**
Total	**-345**	**-415**	**-1710**	**-2795**
Measures announced since Budget 2001				
Change CGT business assets taper relief	0	-10	-20	-40
Forex and Corporate Debt - measures introduced in July 2001	90	160	150	150
Remove Crown's preferential right to recover unpaid taxes	0	-35	-70	-70
Removal of automatic VAT fines for small businesses	*	*	*	*
Winter fuel payments increased to £200 for 2001-02	-435	0	0	0
Total measures announced since Budget 2001	**-345**	**115**	**60**	**40**
Measures announced in the Pre-Budget Report				
Increased limit for EMI to £30 million	0	-25	-30	-40
VAT: reform of annual accounting system	0	*	*	*
Implementation of VAT flat rate scheme for small businesses	0	-25	-25	-25
Freeze of Class 2 NICs rates	0	-5	-5	-5
Introduction of Pension Credit	0	0	-975	-2025
Guaranteed increase in basic state pension	0	0	-225	-225
Winter fuel payments increased to £200 for 2002-03 and beyond	0	-435	-440	-445
Disability measures	0	-30	-65	-70
Reform of Pools Betting Duty	0	-5	-5	-5
Green Fuels Challenge - pilot schemes	0	*	*	*
Aggregates levy - special arrangements in Northern Ireland	0	-10	-10	-10
Total Pre-Budget Report measures	**0**	**-535**	**-1780**	**-2850**
Additional PBR policy decisions				
Additional health spending in DEL	0	-1000	0	0
Reallocation from AME	0	1000	0	0

**Negligible.*

FISCAL AGGREGATES

B24. Tables B5 and B6 provide more detail on the projections for the current and capital budgets. The tables show the current surplus and net borrowing, both including and excluding windfall tax and associated spending. Windfall tax and associated spending now has much less impact and, unless otherwise stated, all the projections in this annex now cover all public expenditure. Latest estimates of associated spending are given in Table 4.1.

Table B5: Current and capital budgets

	£ billion						
	Outturn	Projections					
	2000-01	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**
Current budget							
Current receipts	382.2	391.2	406	430	452	474	497
Current expenditure	344.5	367.6	389	411	430	450	471
Depreciation	12.7	13.2	14	15	15	16	17
Surplus on current budget							
(excluding WTAS[1])	25.6	11.1	4	4	7	8	9
Surplus on current budget	**25.1**	**10.3**	**3**	**4**	**7**	**8**	**9**
Capital budget							
Gross investment	23.5	29.8	33	37	39	41	43
less asset sales	-4.5	-3.8	-4	-4	-4	-4	-4
less depreciation	-12.7	-13.2	-14	-15	-15	-16	-17
Net investment	6.3	12.9	15	19	20	22	23
Net borrowing							
(excluding WTAS[1])	-20.1	1.4	11	14	13	13	13
Net borrowing	**-18.8**	**2.5**	**12**	**15**	**13**	**13**	**13**
Public sector net debt - end year	**306.0**	**312.7**	**328**	**348**	**366**	**384**	**402**
Memos:							
Treaty deficit[2]	-19.6	1.9	11	14	12	13	12
Treaty debt[3]	381.0	380.0	390	406	424	441	459

[1] *Windfall tax receipts and associated spending.*

[2] *General government net borrowing on an ESA95 basis.*

[3] *General government gross debt.*

B25. The current budget surplus in 2001-02 is estimated to be £10.3 billion. Net investment is estimated to be £13 billion, resulting in net borrowing of £3 billion. The current budget surplus is projected to fall in 2002-03 to a surplus of £2.5 billion. Net investment rises to £15 billion, which increases net borrowing to £12 billion in 2002-03.

B26. Significant repayments of net borrowing over the last three years have resulted in a declining net debt-GDP ratio. Public sector net debt is projected to fall again in 2001-02 to $30^3/_4$ per cent of GDP from $31^1/_4$ per cent of GDP in 2000-01. The net debt-GDP ratio rises to a sustainable level of around 31 per cent by the end of the projection period, well below the 40 per cent guideline set by the sustainable investment rule.

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

LIST OF ABBREVIATIONS

ACT	Advanced corporation tax
AEI	Average Earnings Index
AESOP	All Employee Share Ownership
AME	Annually Managed Expenditure
AQS	Air Quality Strategy
BoE	Bank of England
BRC	British Retail Consortium
CASC	Community amateur sports club
CBI	Confederation of British Industry
CCL	Climate change levy
CDFI	Community Development Finance Institution
CEML	Council for Excellence in Management and Leadership
CEO	Chief Executive Officer
CG	Central government
CGNCR	Central government net cash requirement
CGT	Capital gains tax
CHP	Combined heat and power
CIS	Construction industry scheme
CITC	Community Investment Tax Credit
CPI	Consumer price inflation
CTC	Child Tax Credit
CTF	Child Trust Fund
DEL	Departmental Expenditure Limits
DEFRA	Department for Environment, Food and Rural Affairs
DfES	Department for Education and Skills
DFID	Department for International Development
DIS	Departmental Investment Strategy
DMO	Debt Management Office
DPTC	Disabled Person's Tax Credit
DTI	Department of Trade and Industry
DTLR	Department for Transport, Local Government and the Regions
DVLA	Driver and Vehicle Licensing Agency
DWP	Department for Work and Pensions
EC	European Commission
ECA	Enhanced capital allowance
EC50+	Employment Credit for the over 50s

EEC	Energy Efficiency Commitment
EER	European Economic Reform
EFSR	Economic and Fiscal Strategy Report
EMA	Educational Maintenance Allowance
EMI	Enterprise Management Incentives
EMU	Economic and Monetary Union
EOF	Employment Opportunities Fund
EU	European Union
EYF	End-year flexibility
EZ	Employment Zone
FDI	Foreign direct investment
FMD	Foot and Mouth disease
FSA	Financial Services Authority
FSBR	Financial Statement and Budget Report
G7	Group of Seven. A group of seven major industrial nations (comprising: Canada, France, Germany, Italy, Japan, UK and US).
GAD	Government Actuary's Department
GCSE	General Certificate of Secondary Education
GDP	Gross domestic product
GFC	Green Fuels Challenge
GNP	Gross National Product
GTC	Green Technology Challenge
GVA	Gross Value Added
g/km	Grams per kilometre
HIPC	Heavily Indebted Poor Countries
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome
IB	Incapacity Benefit
ICT	Information and communications technologies
ILO	International Labour Organisation
IMF	International Monetary Fund
ISA	Individual Savings Account
ISCED	International Standard Classification of Education
JSA	Jobseeker's Allowance
JTS	Job Transition Service
LFS	Labour Force Survey
LLSCs	Local Learning and Skills Councils
LPC	Low Pay Commission
LPG	Liquefied petroleum gas
LRP	Lead replacement petrol
LSC	Learning and Skills Council
LSP	Local Strategic Partnership
LTCS	Landfill tax credit scheme

MDGs	Millennium Development Goals
MIG	Minimum Income Guarantee
MFR	Minimum Funding Requirement
MPC	Monetary Policy Committee
MtC	Million tonnes of carbon
NAIRU	Non-accelerating inflation rate of unemployment
NAO	National Audit Office
NDDP	New Deal for disabled people
NDLP	New Deal for lone parents
NDYP	New Deal for young people
ND25+	New Deal for the over 25s
ND50+	New Deal for the over 50s
NETA	New Electricity Trading Arrangemennts
NETCEN	National Environmental Technology Centre
NICs	National insurance contributions
NIESR	National Institute of Economic and Social Research
NFFO	Non-Fossil Fuel Obligation
NHS	National Health Service
NMW	National Minimum Wage
NVQ	National Vocational Qualification
ONS	Office of National Statistics
OECD	Organisation for Economic Cooperation and Development
OFT	Office of Fair Trading
OPSR	Office of Public Services Reform
PAYE	Pay As You Earn
PBR	Pre-Budget Report
PIU	Performance and Innovation Unit
PSA	Public Service Agreement
PSNB	Public sector net borrowing
PSX	Cabinet Committee on Public Services and Public Expenditure
RAB	Resource Accounting and Budgeting
R&D	Research and development
RDAs	Regional Development Agencies
ROSSI	Retail Price Index excluding housing costs
RPI	Retail Price Index
RPIX	Retail Price Index excluding mortgage interest payments
SBS	Small Business Service
SERPS	State Earnings Related Pension Scheme
SFO	Serious Fraud Office
SIP	Share Incentive Plan
SME	Small and medium-sized enterprise
SMP	Statutory Maternity Pay

TME	Total Managed Expenditure
TUC	Trades Union Congress
ULSD	Ultra-low sulphur diesel
ULSP	Ultra-low sulphur petrol
UN	United Nations
URC	Urban Regeneration Company
VAT	Value Added Tax
VED	Vehicle excise duty
WFTC	Working Families' Tax Credit
WRAP	Waste and Resources Action Programme
WTAS	Windfall Tax and associated spending
WTC	Working Tax Credit

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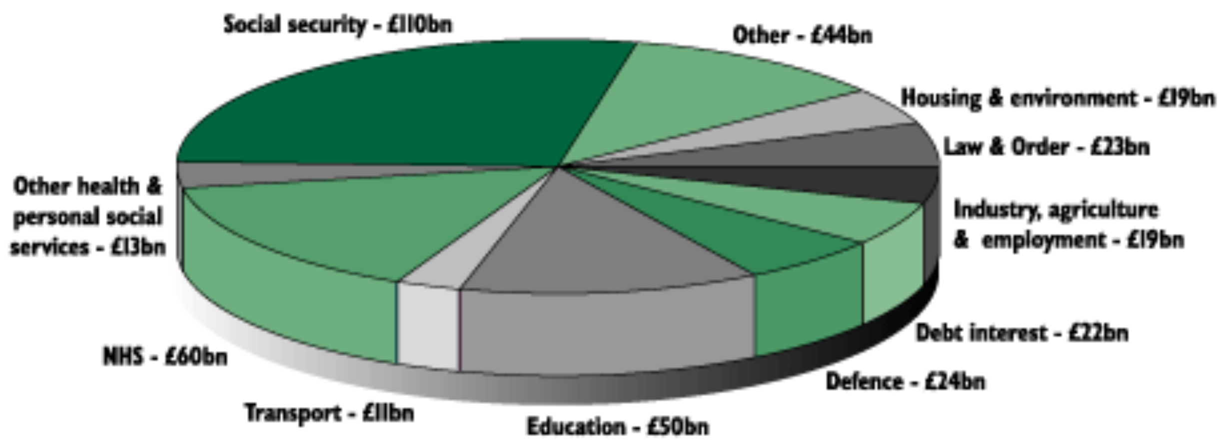
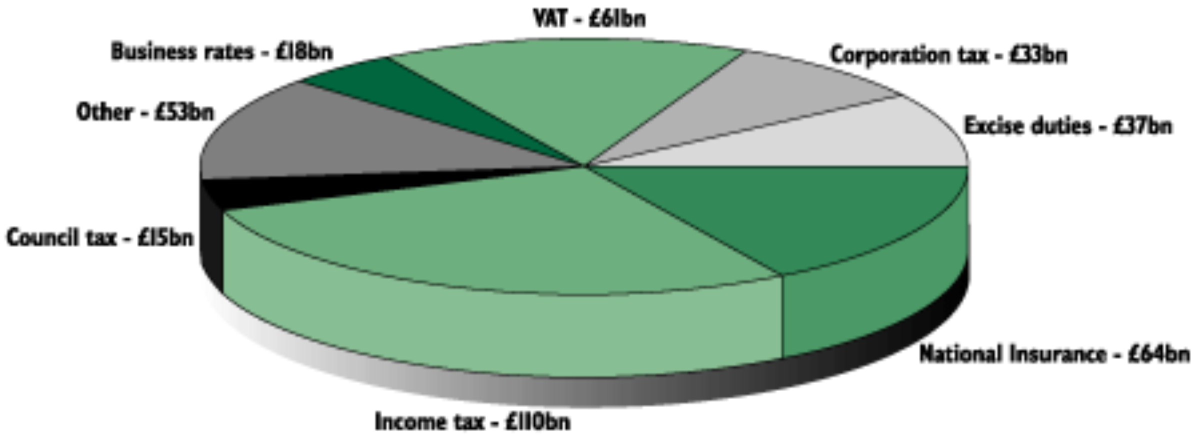
Total managed expenditure: £394 billion



Source: HM Treasury, 2001–02 figures. Other expenditure includes spending on central administration, culture, media and sport, international cooperation and development and public service pensions, plus spending yet to be allocated and some accounting adjustments.

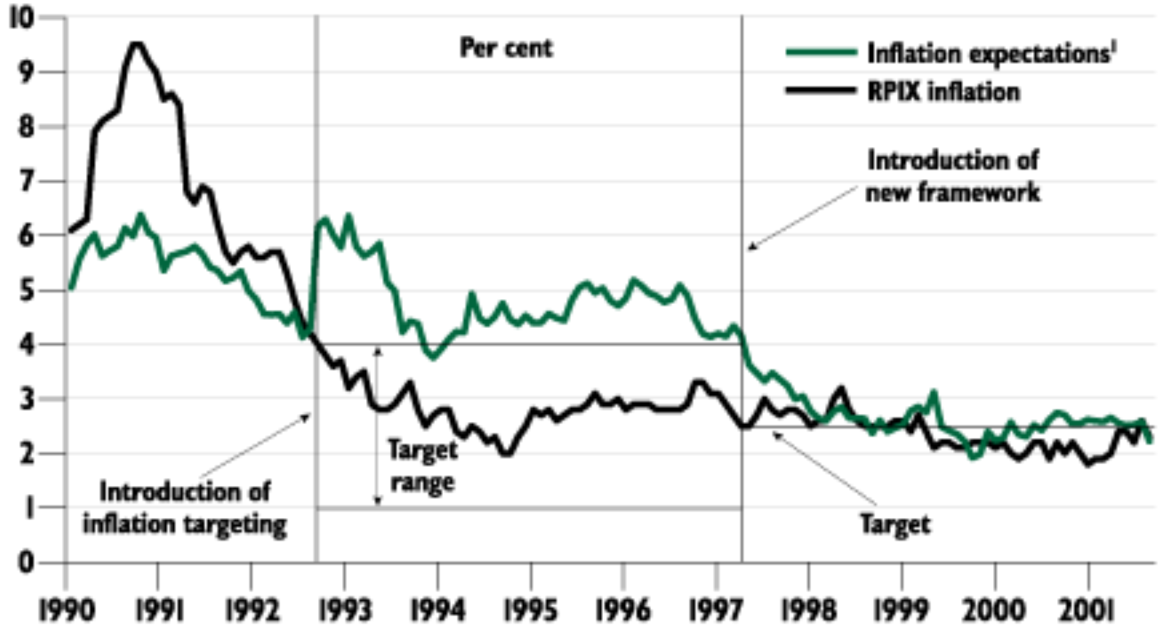
Chart 1.2: Government receipts

Total receipts: £391 billion



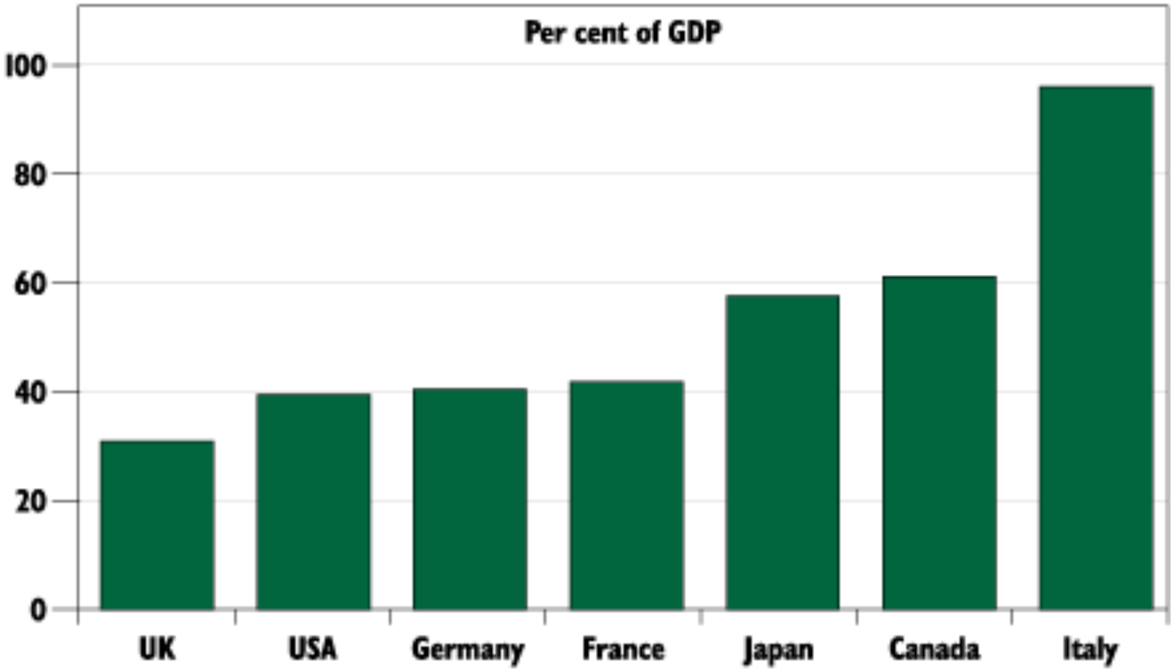
Source: HM Treasury, 2001–02 figures. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts (eg. interest and dividends).

Chart 2.1: Inflation performance and expectations



[1] Ten year ahead market inflation expectations

Chart 2.2: OECD projections of general government net financial liabilities for G7 countries, 2001



Source: OECD Economic Outlook June 2001

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

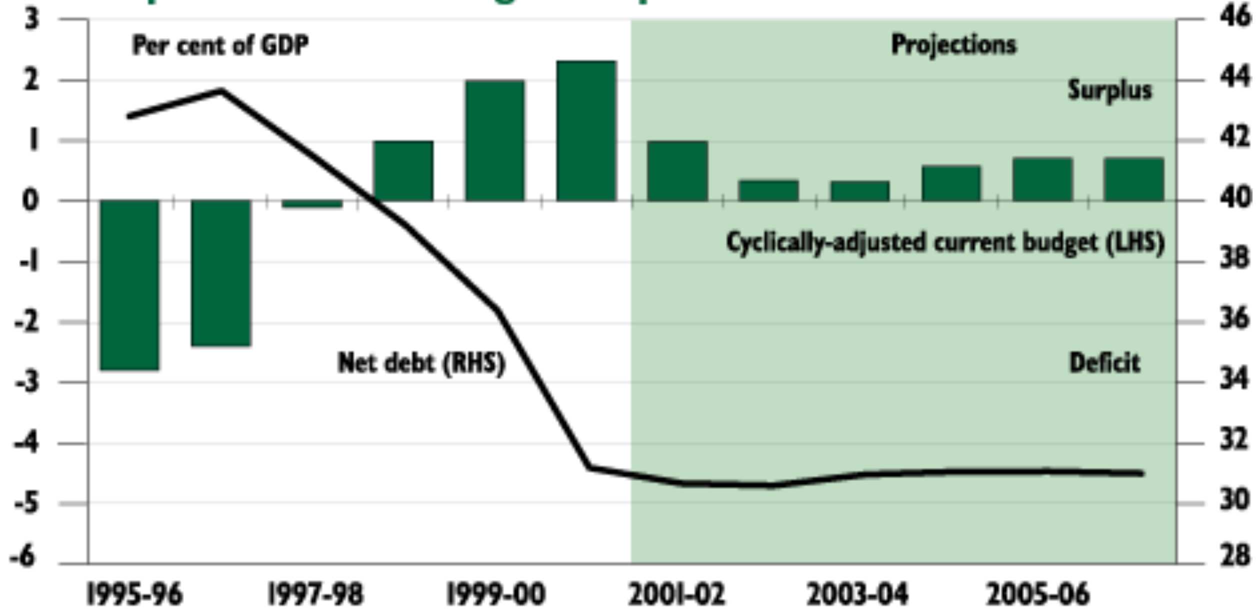


Chart 2.4: Public sector net borrowing – actual and cyclically-adjusted

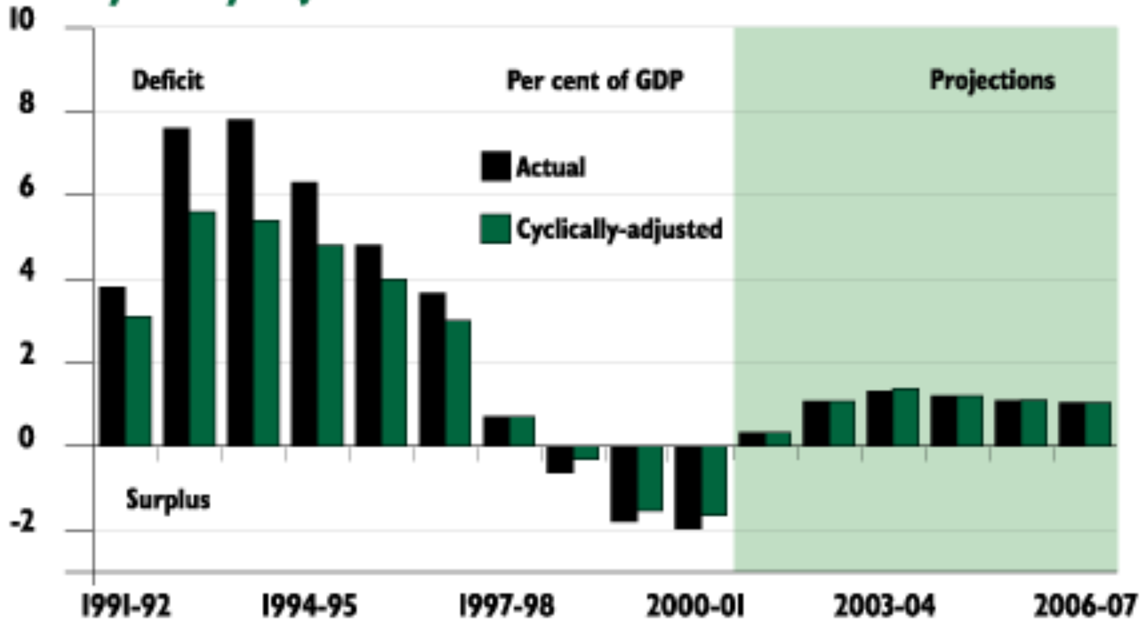
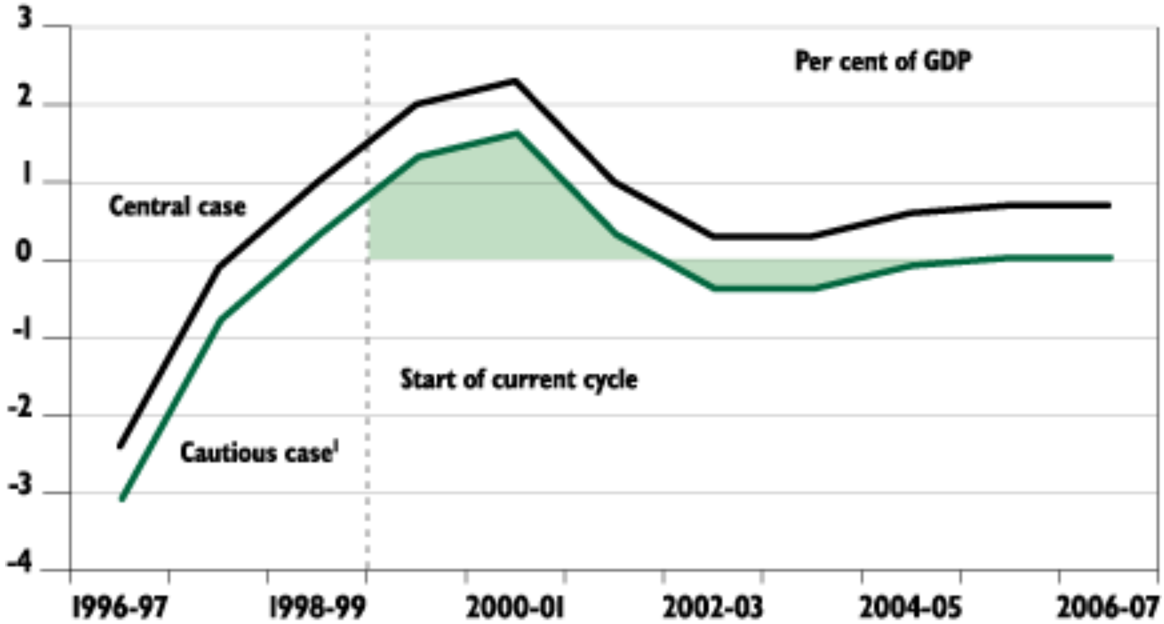
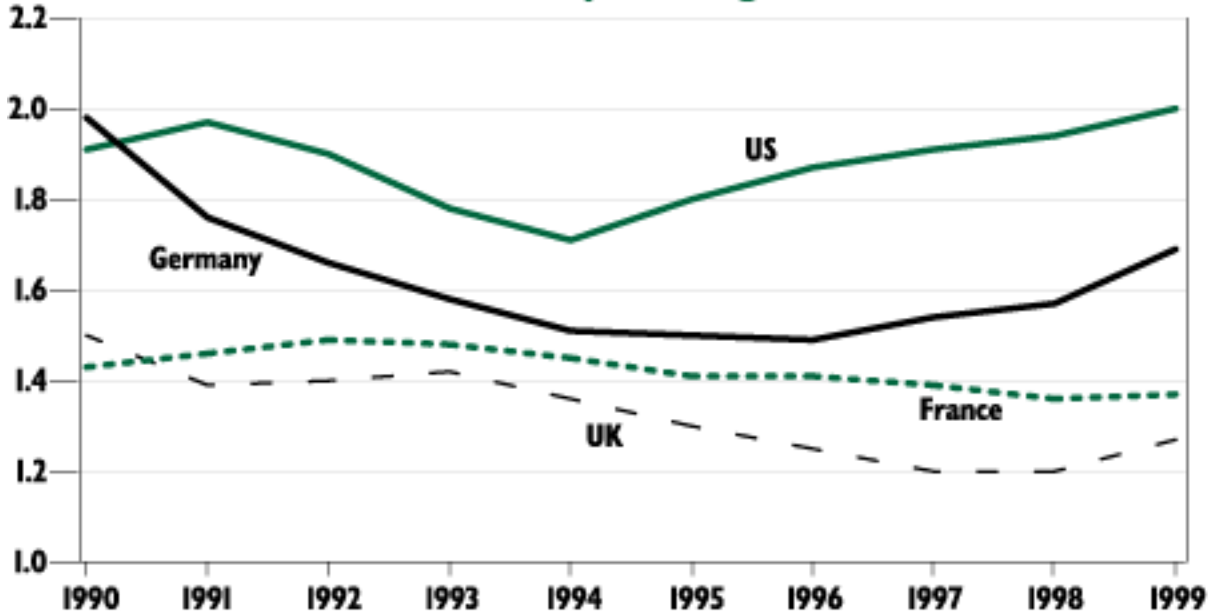


Chart 2.5: Cyclically-adjusted surplus on current budget



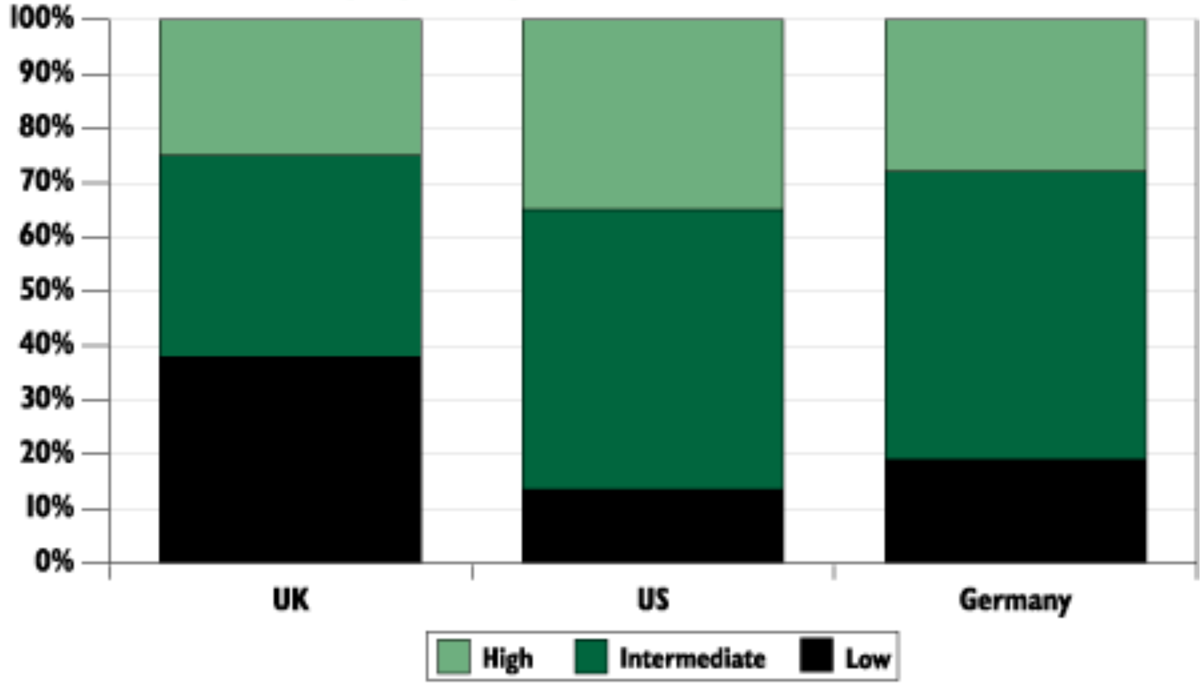
[1] Cautious case assumes trend output 1 percentage point lower in relation to actual output than in the central case

Chart 3.1: Business R&D as a percentage of GDP



Source: OECD

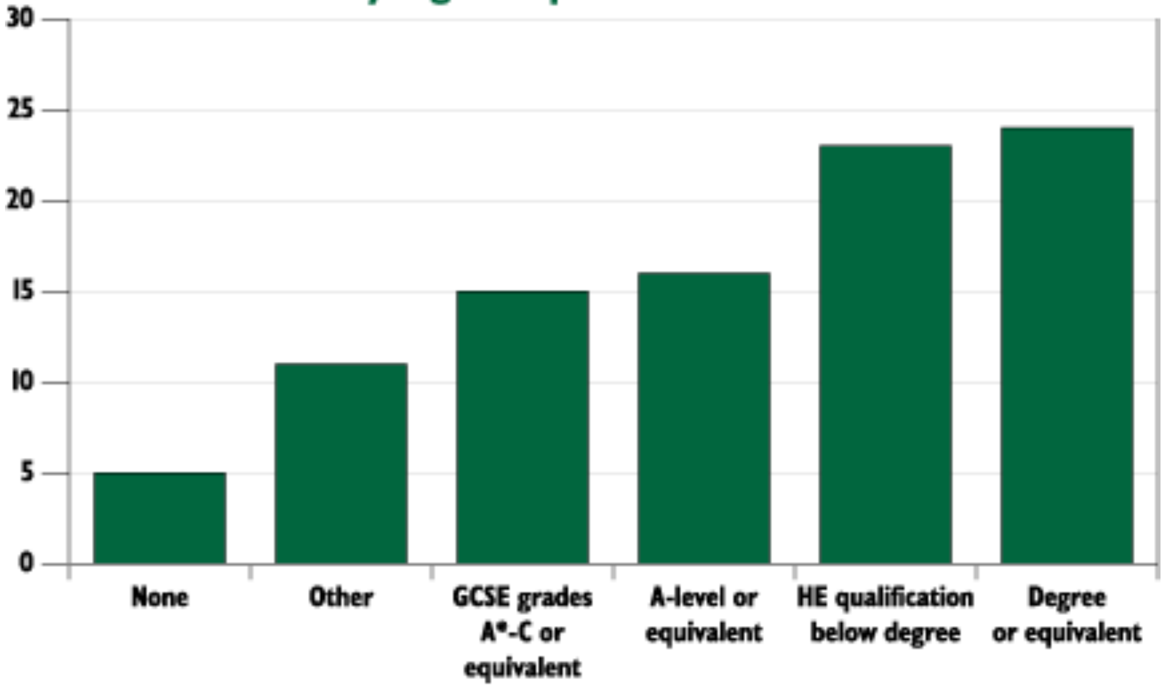
Chart 3.2: Employees by skill level



Source: OECD, 2001

Note: International comparisons of workforce skills are complicated by the difficulty in establishing equivalencies between countries with widely different education systems. The data used here is drawn from OECD (2001) which, unlike previous studies, compares both work-related and academic based qualifications across countries. For this reason, the study shows the UK with a greater human capital deficit compared to the US than the data cited in Productivity in the UK: Enterprise and the Productivity Challenge, HM Treasury, June 2001. Low skills are defined as International Standard Classification of Education (ISCED) levels 0-2, intermediate skills as ISCED level 3 and high skills as ISCED levels 4-6.

Chart 3.3: Percentage of employees receiving training in the last four weeks by highest qualification



Source: Labour Force Survey, Autumn 2000

Chart 4.1: UK employment and ILO unemployment rates

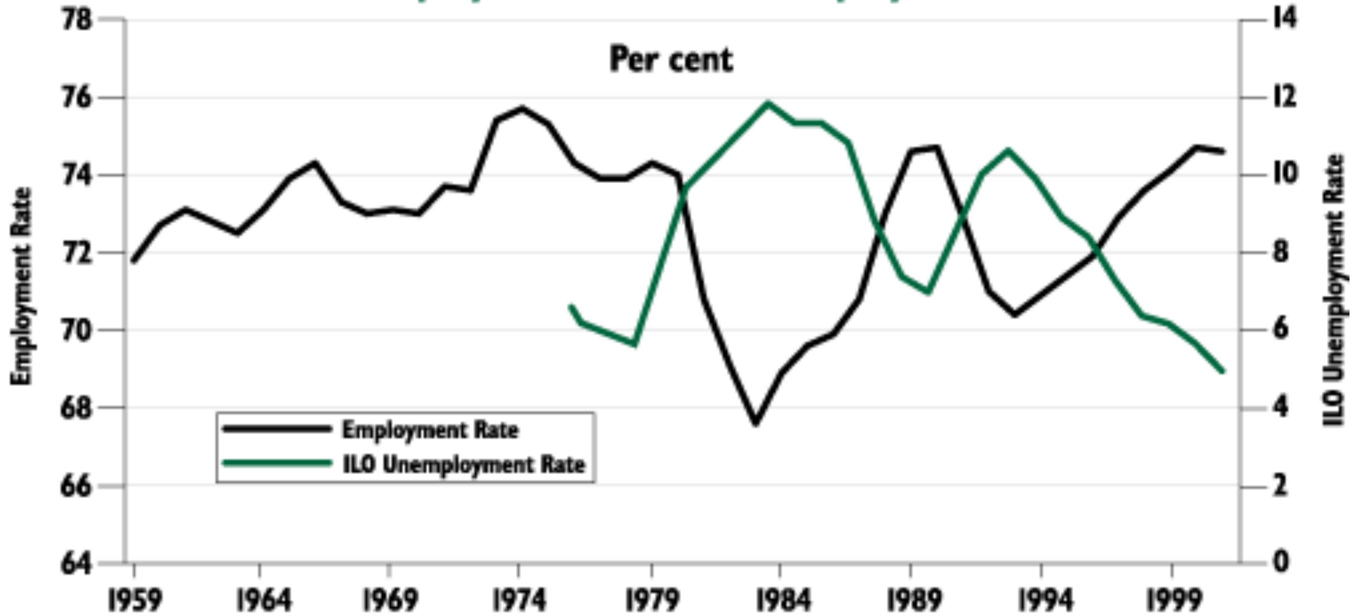


Chart 4.2: Long-Term Unemployment, Youth and 25+

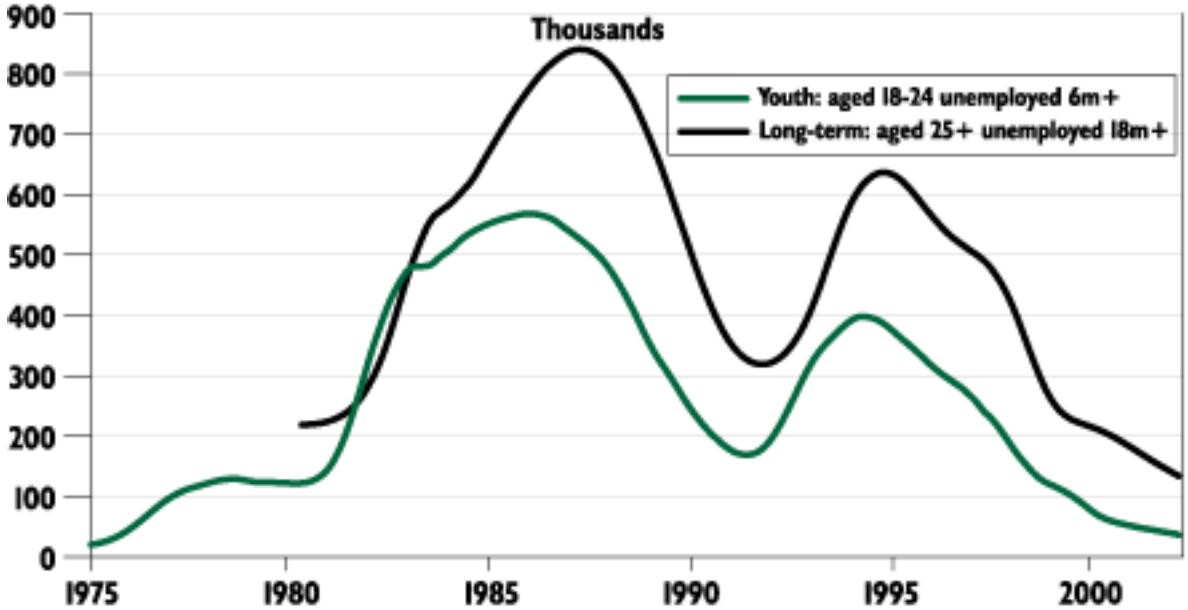


Chart 4.3: Inactivity Rates of Selected Groups in the Population of Working Age (spring 2000)

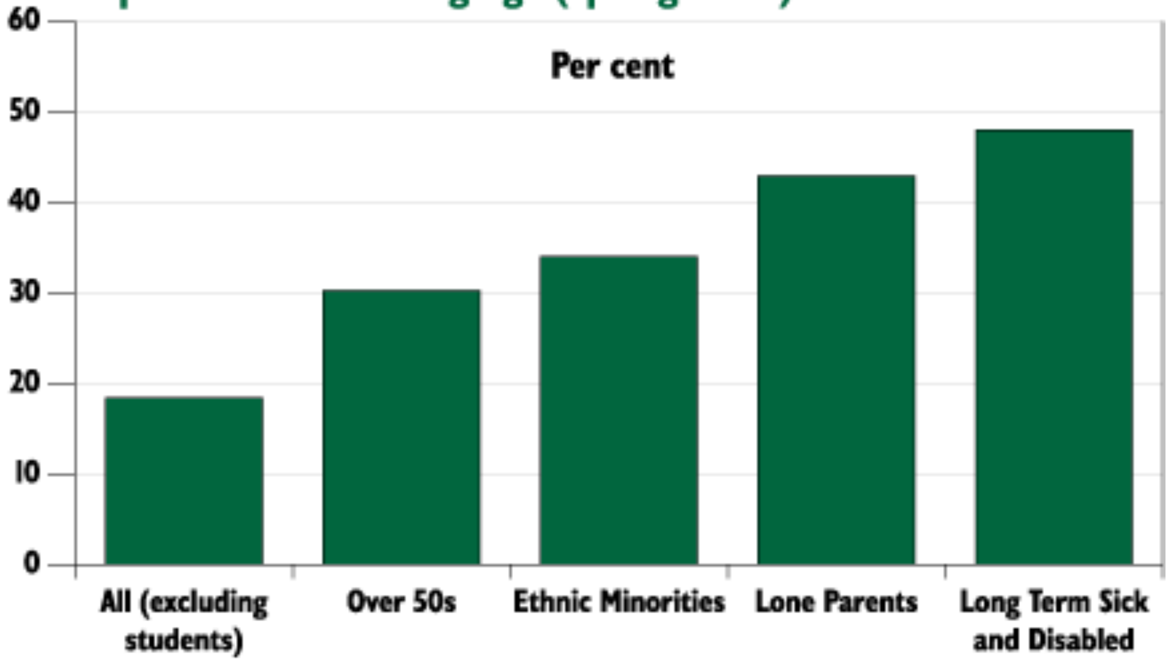


Chart 4.4: Employment rate of lone parents and numbers on Income Support

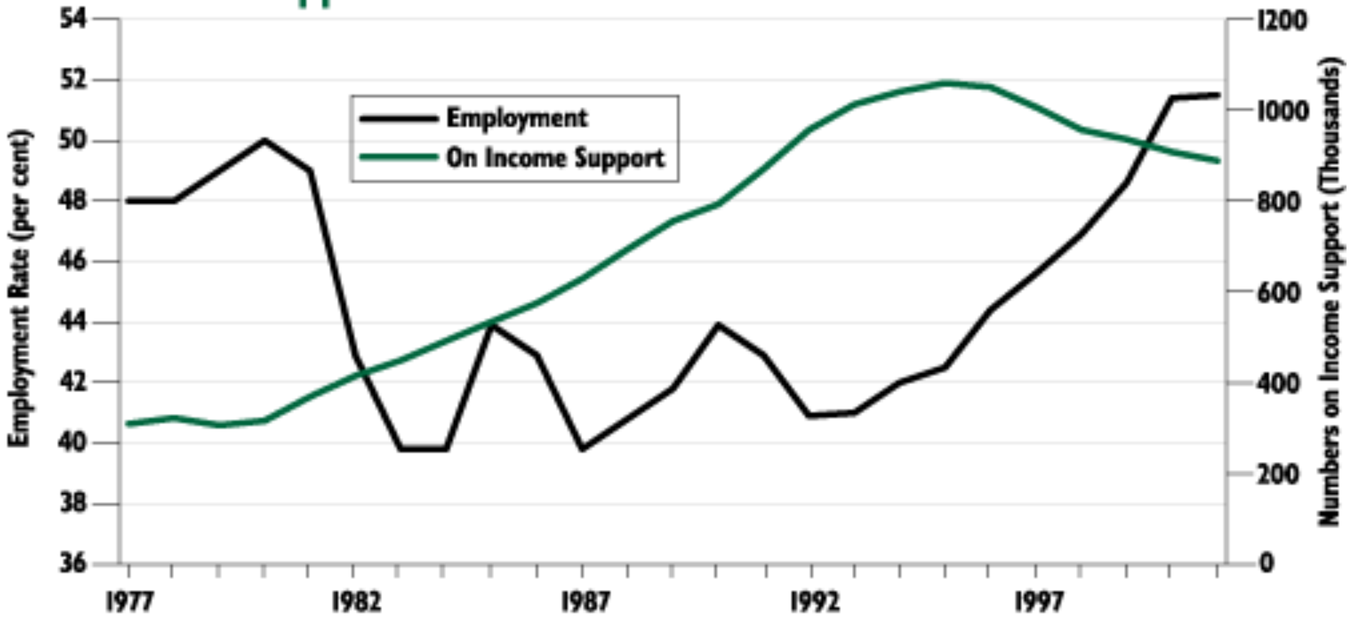


Chart 4.5: Percentage of working age population on an incapacity-related benefit

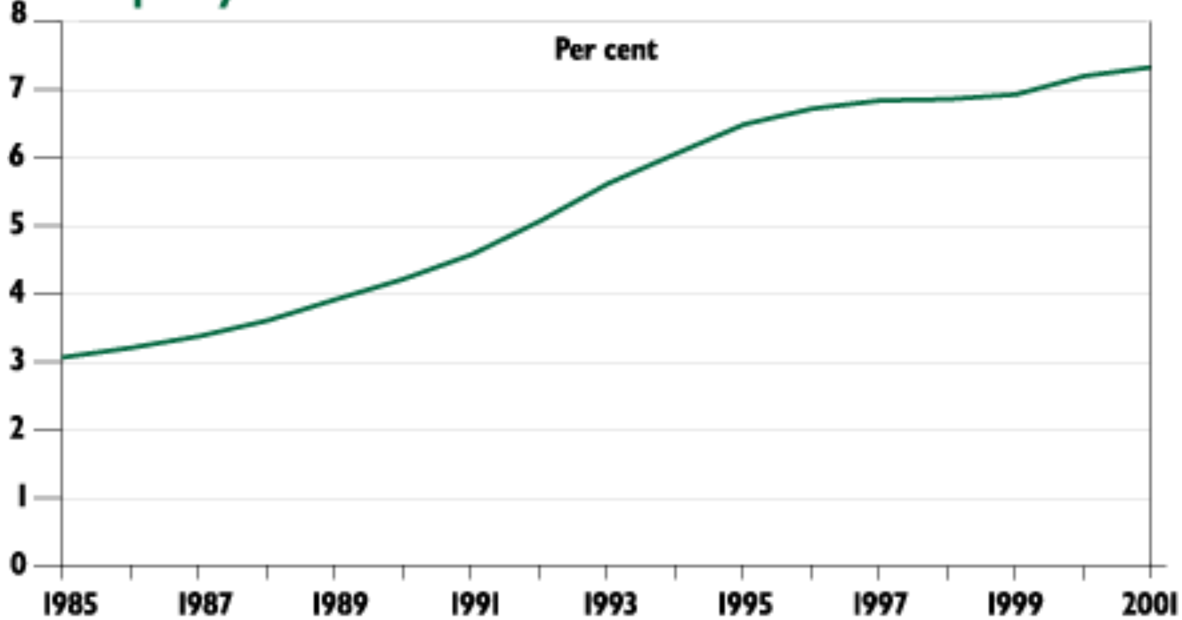


Chart 4.6: Employment rates by local authority district ranked from lowest to highest

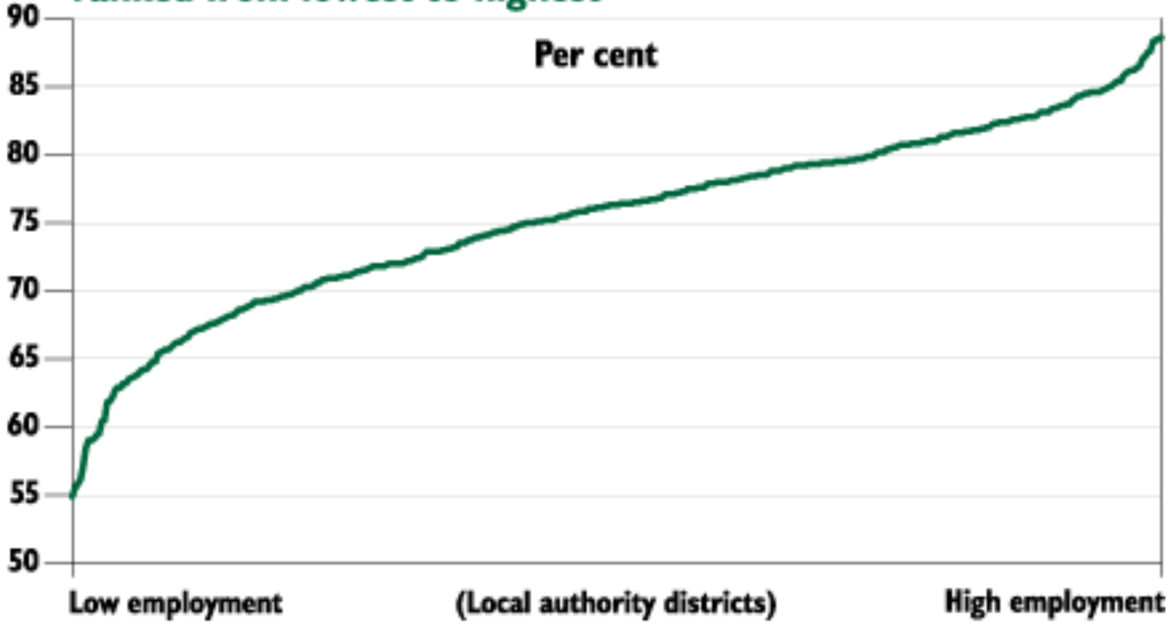


Chart 4.7: The gains to work for different households

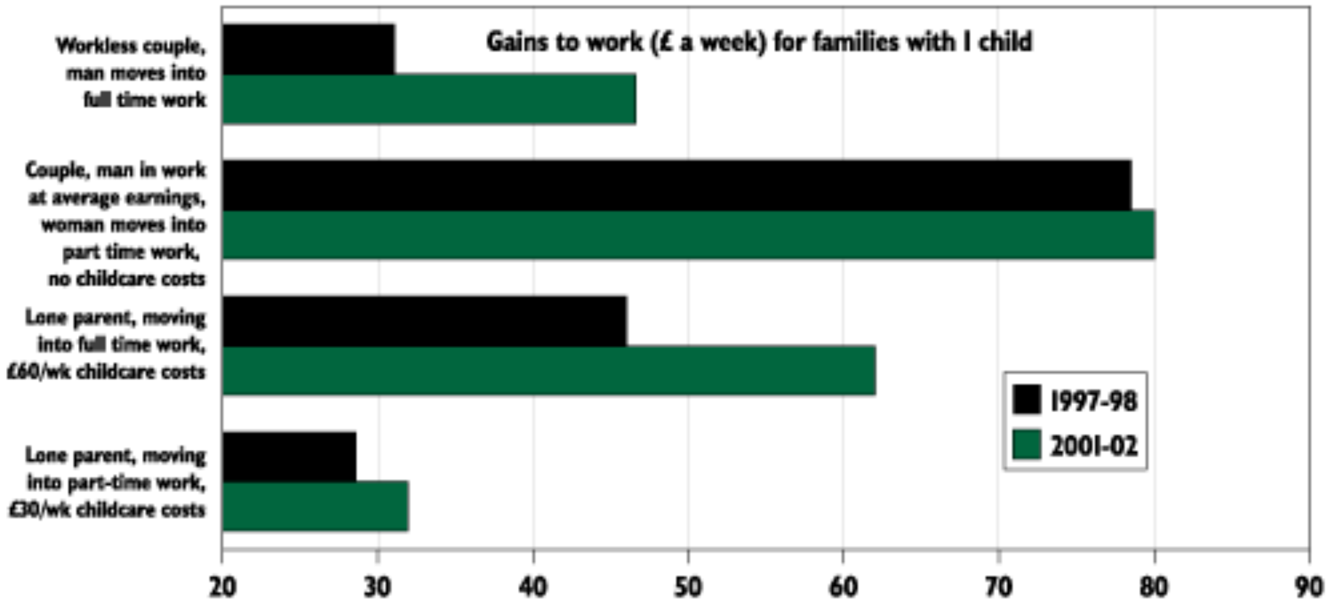
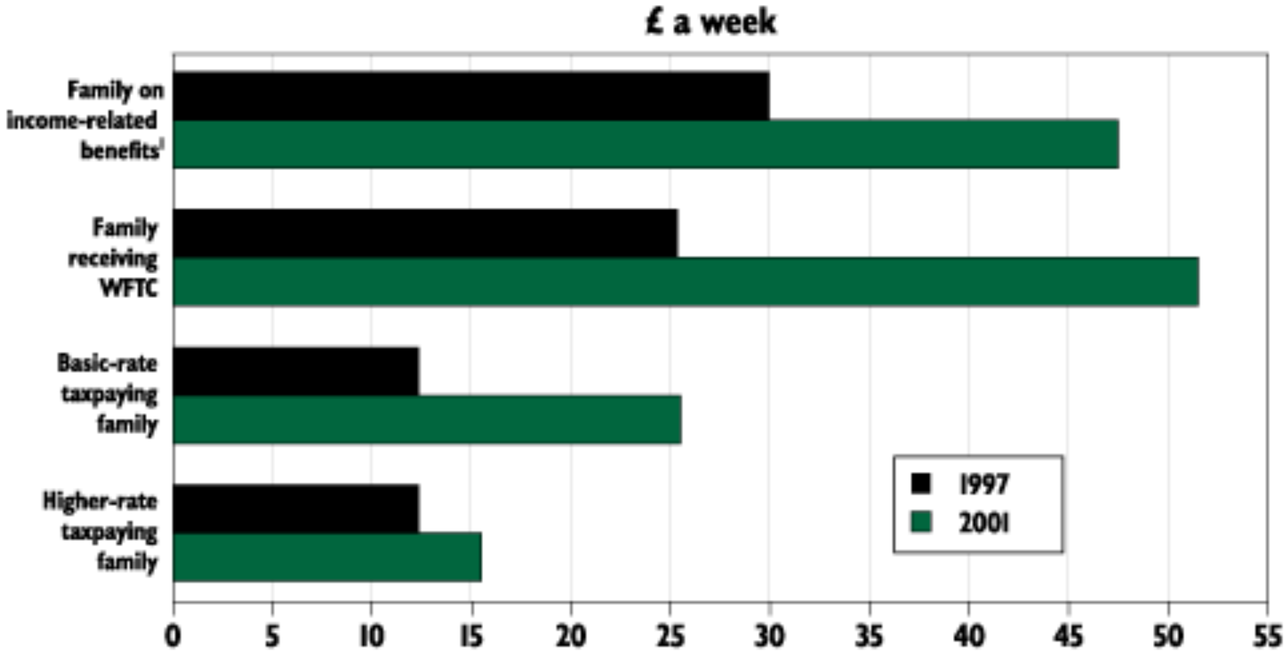


Chart 5.1: Financial support for the first child, in 2001-02 prices



[1]Income Support recipients receive a lower cash payment compared with Working Families' Tax Credit (WFTC). This reflects the fact that families on Income Support receive help with 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

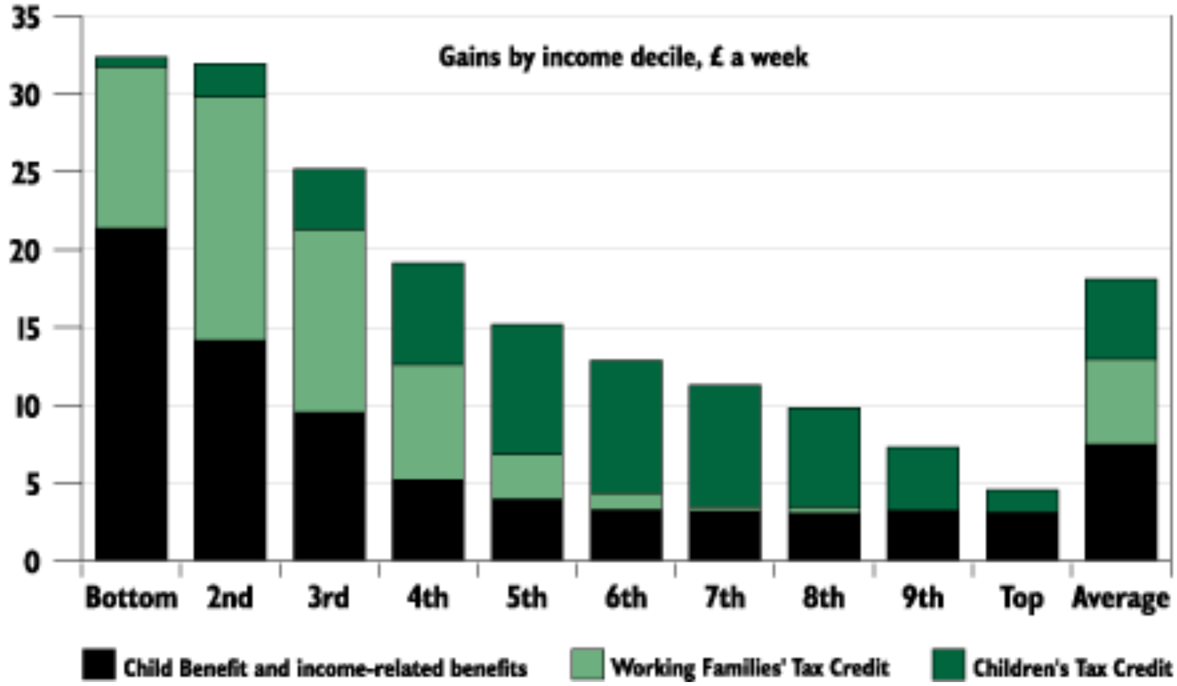


Chart 5.3: New and old systems of support for families with children

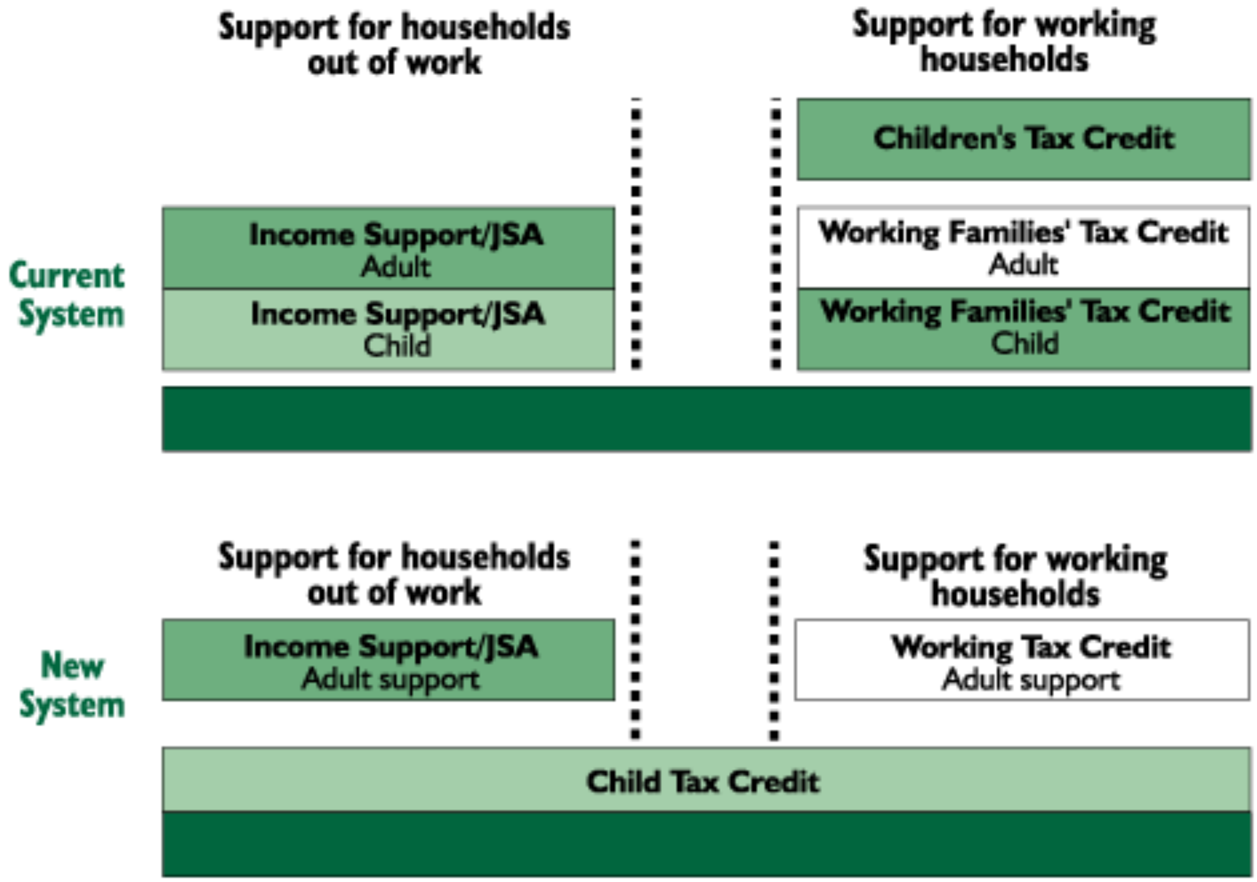


Chart 5.4: Overall gains for pensioner families from pensioner policies including Budget 2002 changes

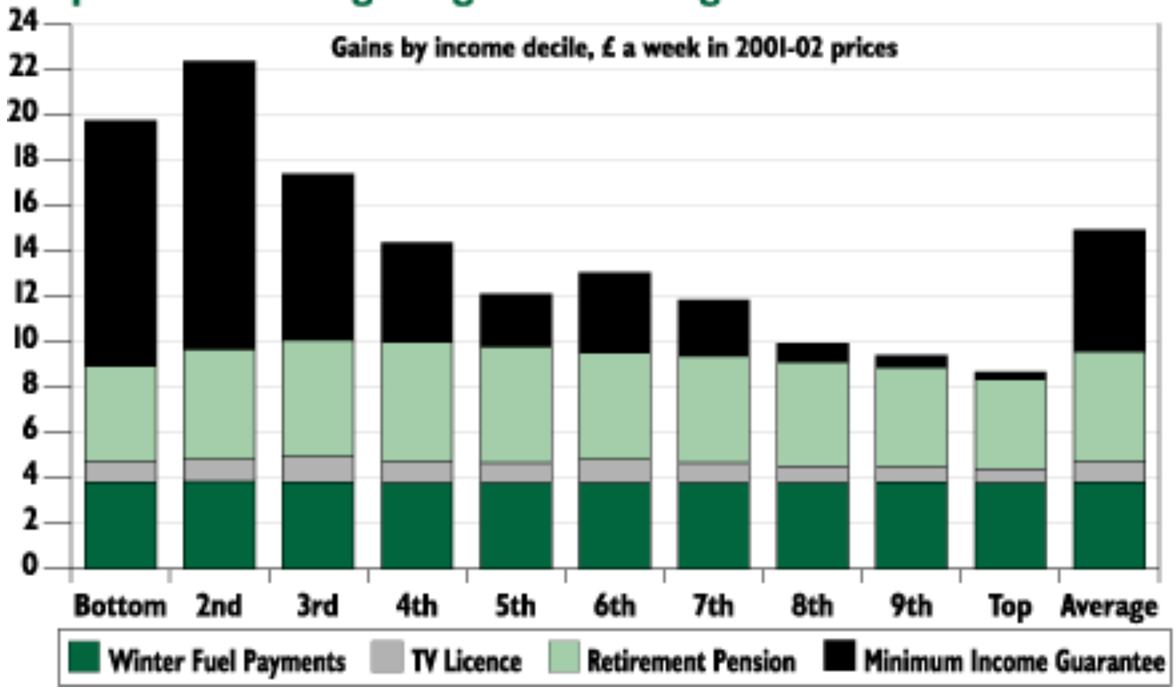
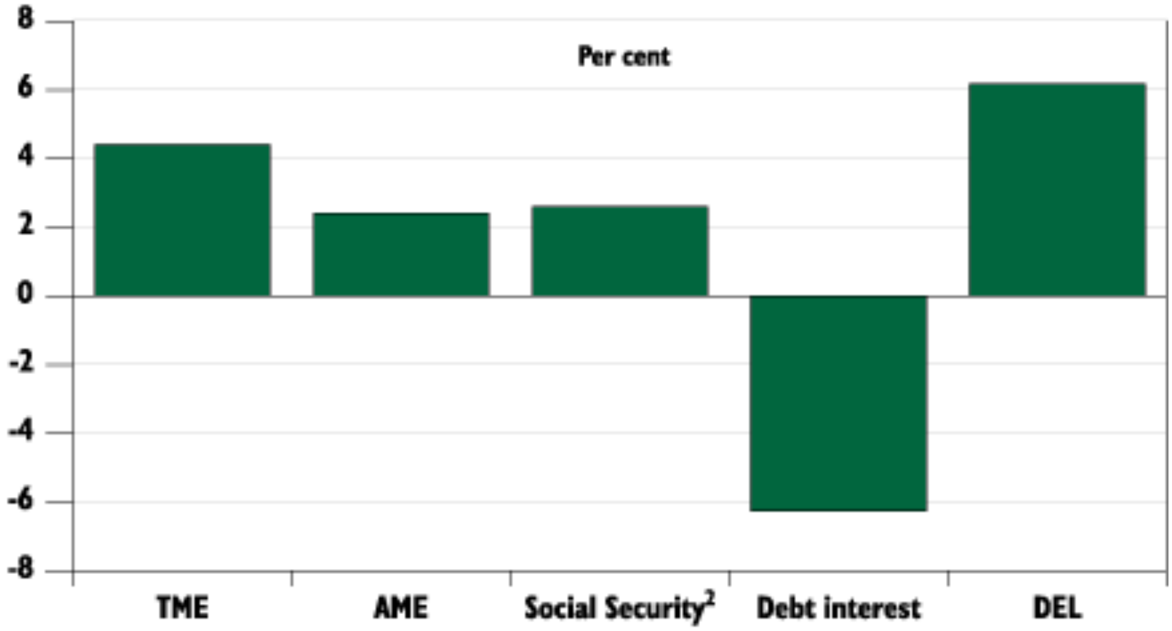


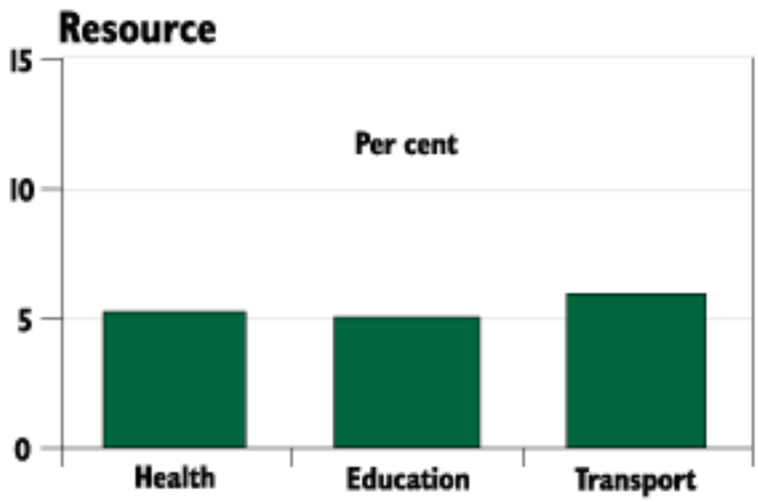
Chart 6.1: Releasing resources for public service priorities over the period covered by the 2000 Spending Review[1]



[1] *Annual average real growth rates in important categories of spending 2000-01 to 2003-04*

[2] *For the purposes of comparison, social security includes the Pension Credit, Working Families' Tax Credit and the Disabled Person's Tax Credit*

Source: HM Treasury.


Resource
15
10
5
0
Per cent
Health
Education
Transport

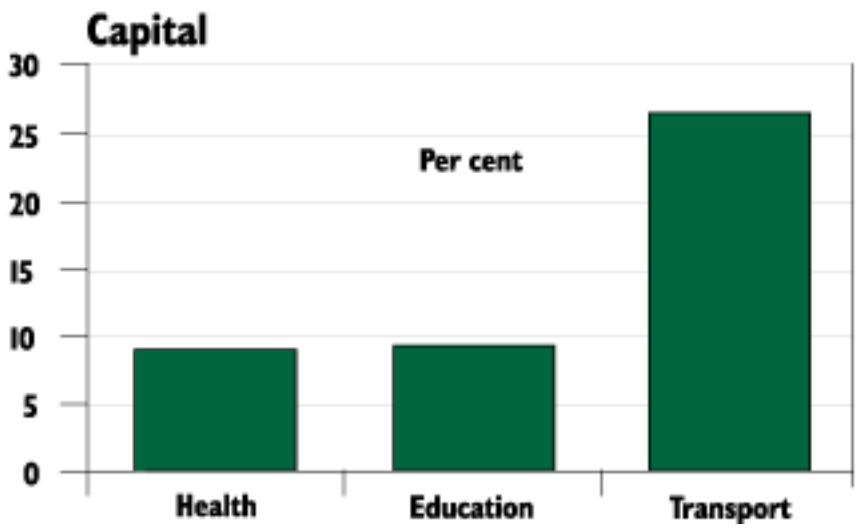
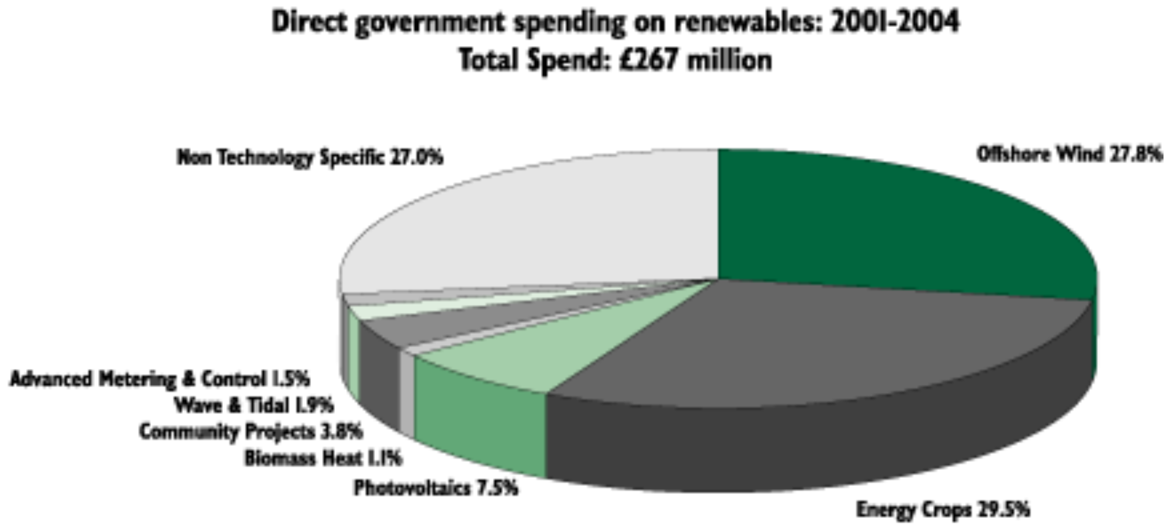
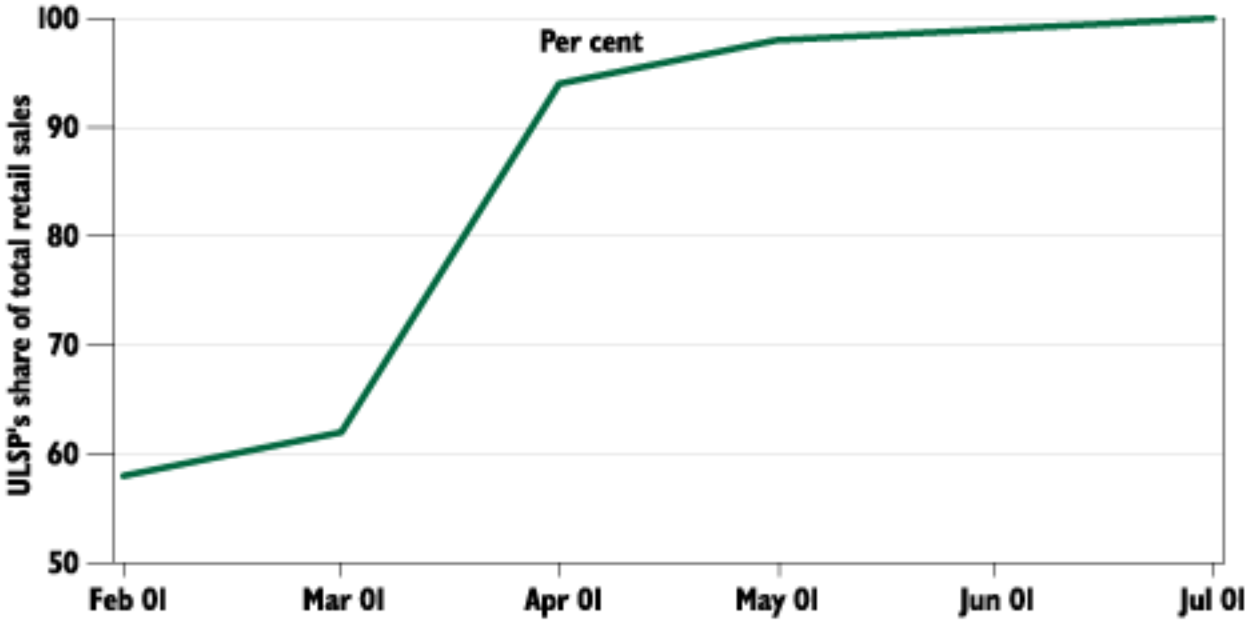

Capital
30
25
20
15
10
5
0
Per cent
Health
Education
Transport

Chart 7.1: Renewable energy



Source: Renewables obligation statutory consultation document, August 2001, Cabinet Office press release, 5th November.

Chart 7.2: Conversion to ULSP



Source: HM Customs & Excise and DTI

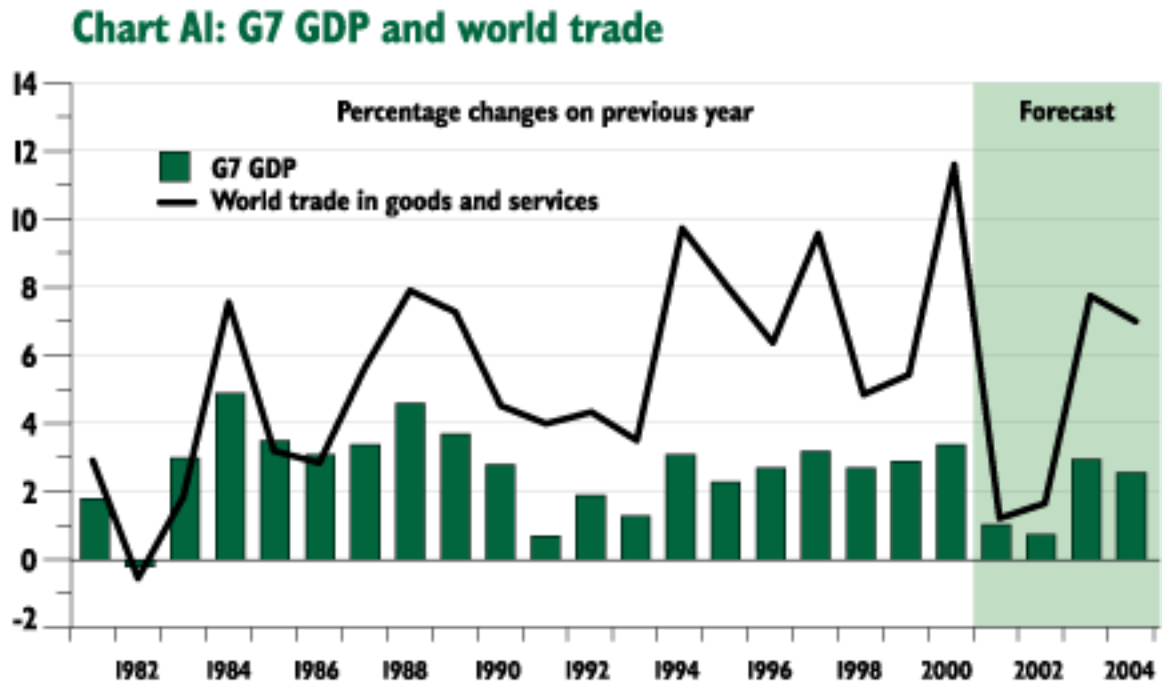


Chart A1: G7 GDP and world trade
Percentage changes on previous year
Forecast
G7 GDP
World trade in goods and services
14
12
10
8
6
4
2
0
-2
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004

Chart A2: G7 consumer price inflation (CPI) and oil prices

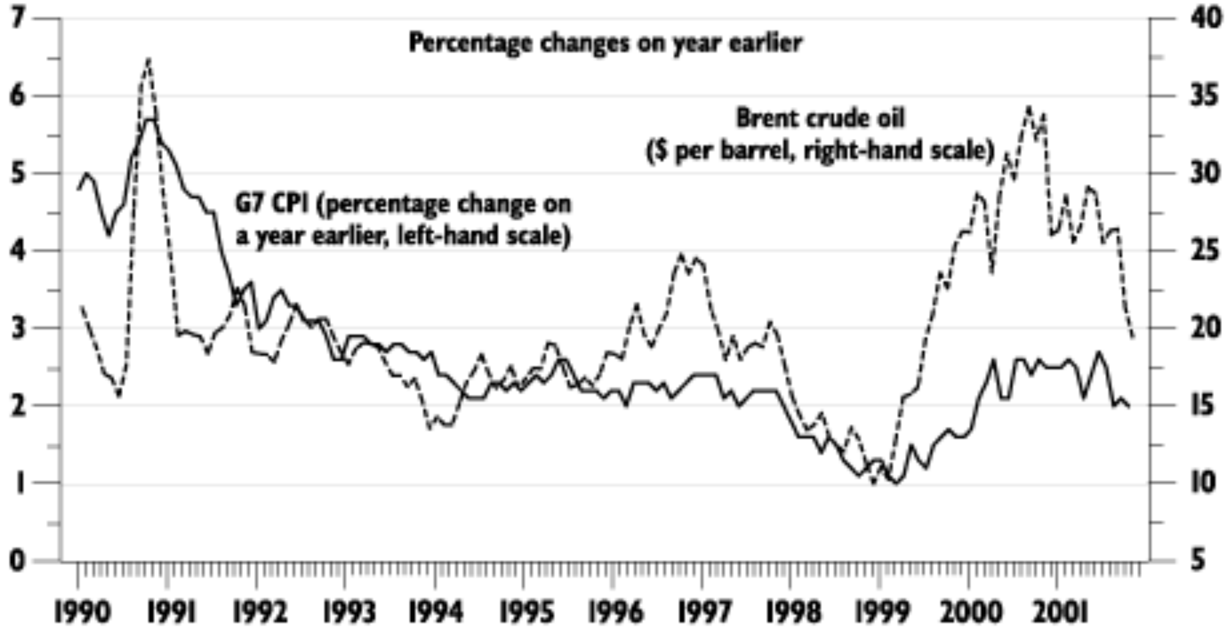
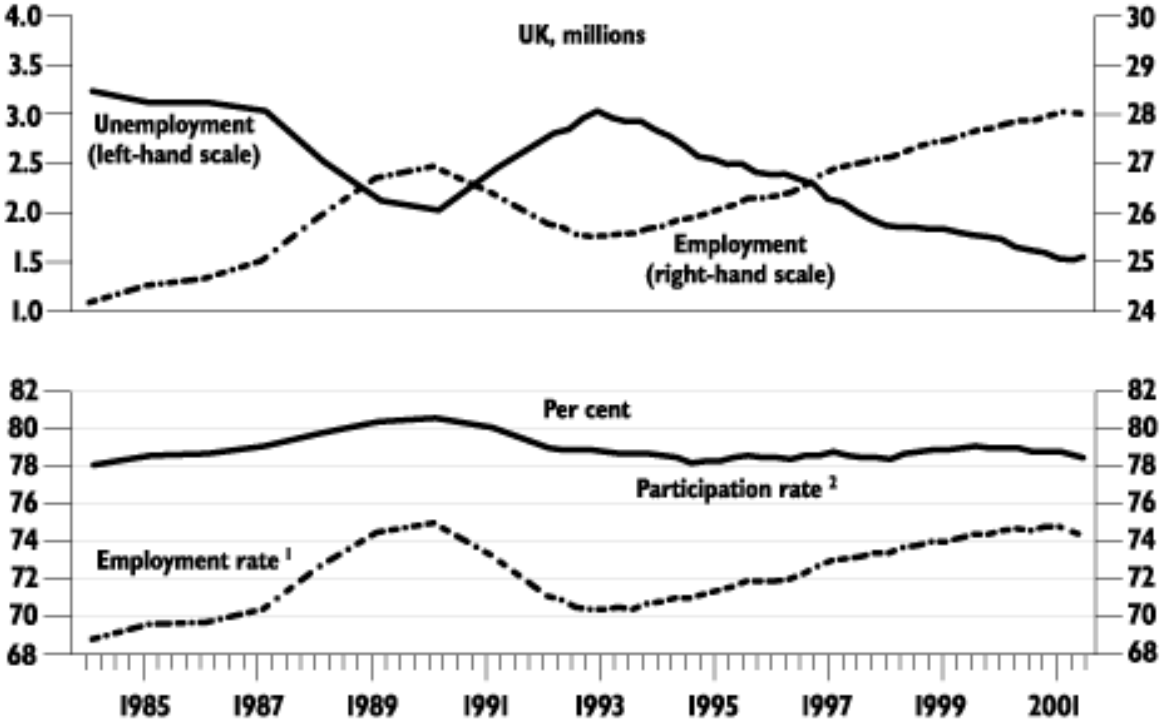


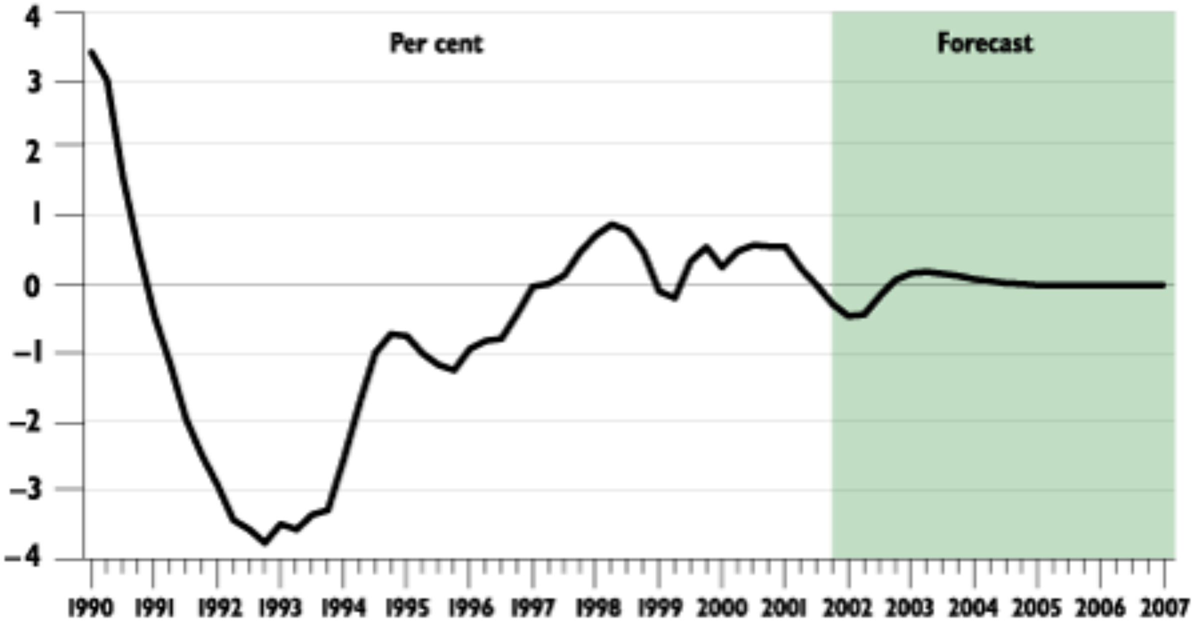
Chart A3: LFS employment, unemployment and participation



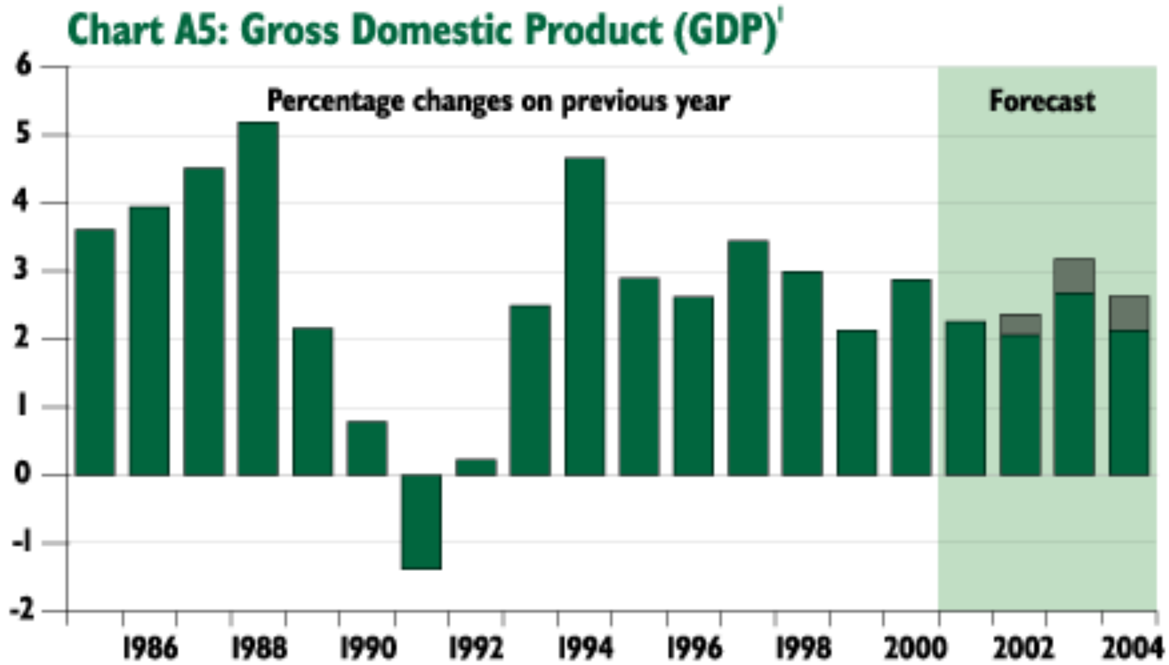
[1] *Employment as a per cent of working-age population.*

[2] *Percentage of the working-age population who are economically active (i.e. employed or unemployed).*

Chart A4: The output gap[1]

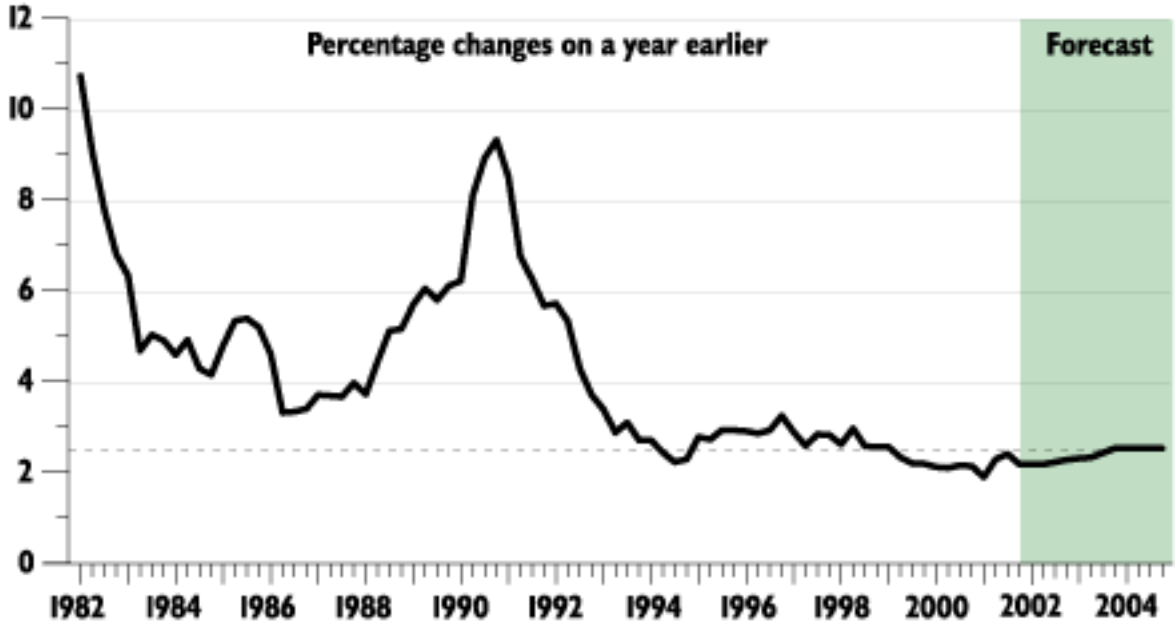


[1] *Actual output less trend output as a percentage of trend output (non-oil basis).*



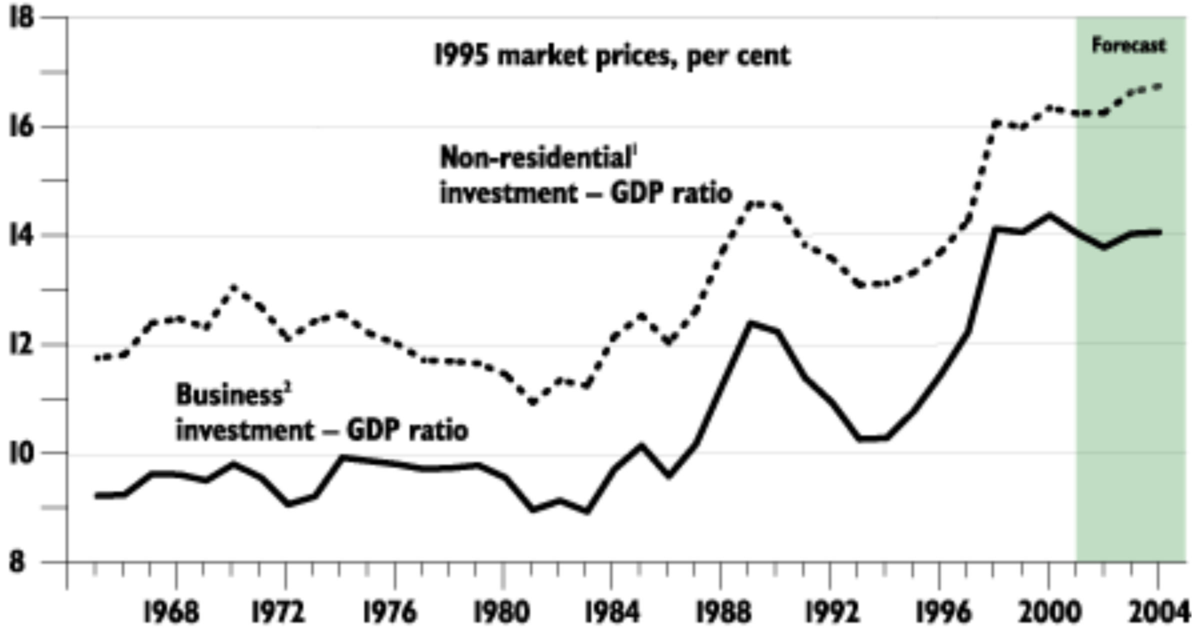
[1] Shaded areas on bars represent forecast ranges.

Chart A6: RPIX[1]



[1] Outturns until 2001Q3; forecasts for every second quarter from 2001Q4 to 2004Q4.

Chart A7: 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.

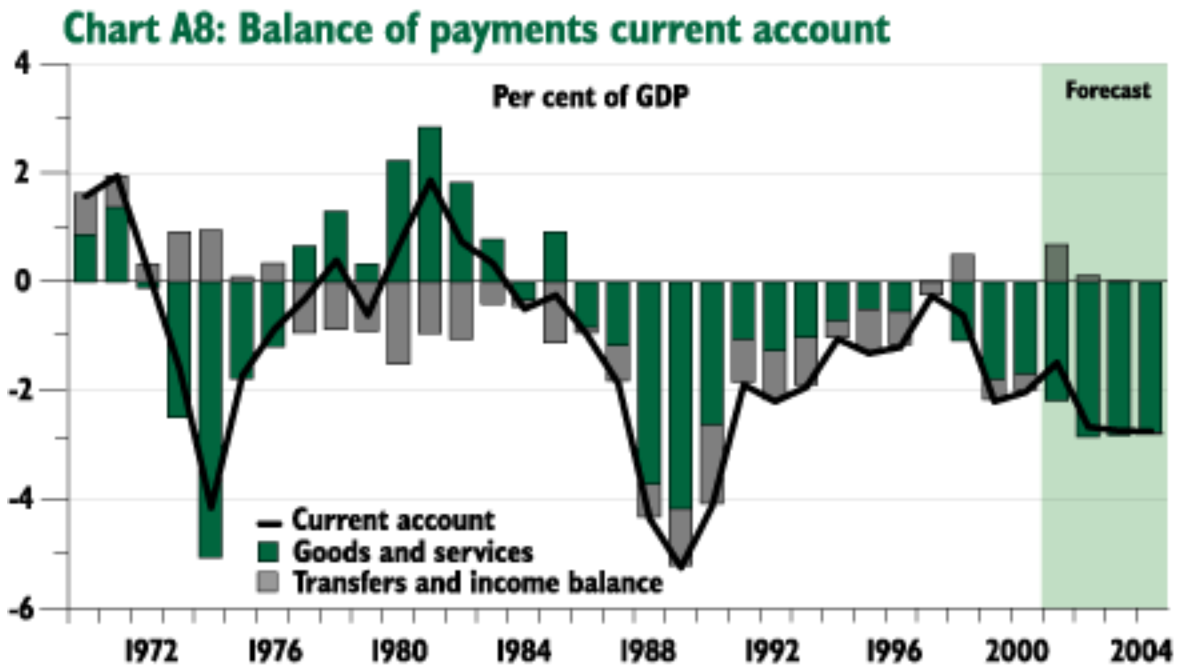


Chart A8: Balance of payments current account
Per cent of GDP
Forecast
4
2
0
-2
-4
-6
1972
1976
1980
1984
1988
1992
1996
2000
2004
Current account
Goods and services
Transfers and income balance

B27. Table B6 shows the Treaty measures of the deficit and debt used in the Excessive Deficits Procedure of the Treaty. The reference levels of 3 per cent of GDP for the deficit and 60 per cent of GDP for debt are achieved comfortably throughout the projection period.

Table B6: Current and capital budgets

	Per cent of GDP						
	Outturn	Projections					
	2000-01	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**
Current budget							
Current receipts	40.0	39.2	38.8	39.1	39.3	39.4	39.3
Current expenditure	36.1	36.8	37.2	37.4	37.4	37.4	37.3
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Surplus on current budget							
(excluding WTAS[1])	2.7	1.1	0.3	0.4	0.6	0.7	0.7
Surplus on current budget	**2.6**	**1.0**	**0.3**	**0.4**	**0.6**	**0.7**	**0.7**
Capital budget							
Gross investment	2.5	3.0	3.1	3.4	3.4	3.4	3.4
less asset sales	-0.5	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3
less depreciation	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	1.3
Net investment	0.7	1.3	1.4	1.7	1.8	1.8	1.8
Net borrowing							
(excluding WTAS[1])	-2.1	0.1	1.1	1.3	1.2	1.1	1.1
Net borrowing	**-2.0**	**0.3**	**1.1**	**1.3**	**1.2**	**1.1**	**1.1**
Public sector net debt							
- end year	**31.2**	**30.7**	**30.6**	**31.0**	**31.1**	**31.1**	**31.1**
Memos:							
Treaty deficit[2]	-2.0	0.2	1.1	1.3	1.1	1.0	1.0
Treaty debt ratio[3]	39.9	38.1	37.2	37.0	36.8	36.6	36.3

[1] *Windfall tax receipts and associated spending.*

[2] *General government net borrowing on an ESA95 basis.*

[3] *General government gross debt.*

B28. Table B7 sets out the effects of forecasting changes, Pre-Budget Report measures and other discretionary changes since the Budget on the main fiscal aggregates. The table gives a further breakdown of the large forecasting changes to receipts.

B29. The latest available outturn information for 2000-01 shows current receipts £1 billion lower than estimated in Budget 2001. However, this was more than offset by lower spending so that the surplus on the current budget was £2 $^3/_4$ billion higher, and net borrowing £3 $^3/_4$ billion lower than the Budget forecast.

Table B7: Fiscal balances compared with Budget 2001

	Outturn[1]	Projections				
	2000-01	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
Fiscal balances (£ billion)						
Surplus on current budget						
Budget 2001	22.3	15.9	14	8	9	9
Effects on receipts of:						
Revisions and forecasting changes	-1.0	-7.3	-10	-3	-1	1
of which:						
changes to GDP	0	-0.8	-2	0	0	1
changes to equity prices	0	-0.7	-2	-2	-2	-2
changes to other audited assumotions	0	-0.8	-2	-2	-1	-1
changes to financial company profits	0	-3.1	-2	0	1	2
other	-1.0	-2.0	-1	1	1	1
Policy measures since Budget 2001	-	0.1	0	0	0	0
Effects on spending of:						
Revisions and forecasting changes	3.7	2.1	-1	0	1	1
Policy measures since Budget 2001	-	-0.4	0	-2	-3	-3
PBR 2001	**25.1**	**10.3**	**3**	**4**	**7**	**8**
Net borrowing						
Budget 2001	-15.0	-4.7	2	10	11	12
Effects on receipts of:						
Revisions and forecasting changes	1.0	7.3	10	3	1	-1
of which:						
changes to GDP	0	0.8	2	0	0	-1
changes to equity prices	0	0.7	2	2	2	2
changes to other audited assumotions	0	0.8	2	2	1	1
changes to financial company profits	0	3.1	2	0	-1	-2
other	1.0	2.0	1	-1	-1	-1
Policy measures since Budget 2001	-	-0.1	0	0	0	0
Effects on spending of:						

Revisions and forecasting changes	-4.8	-0.5	0	0	-1	-1
Policy measures since Budget 2001	-	0.4	0	2	3	3
PBR 2001	**-18.8**	**2.5**	**12**	**15**	**13**	**13**
Cyclically-adjusted budget balances (per cent of GDP)						
Surplus on current budget - Budget 2001	2.0	1.2	1.0	0.6	0.7	0.7
Surplus on current budget - PBR 2001	**2.3**	**1.0**	**0.3**	**0.3**	**0.5**	**0.7**

[1] *The 2000-01 figures were estimates in Budget 2001.*

B30. The current surplus for 2001-02 onwards is much lower than in Budget 2001, mainly because of forecasting changes to receipts. Further details of these changes are given in the next section. Net borrowing is also adversely affected by the forecasting changes to receipts.

B31. There are no forecasting changes to total spending during the 2000 Spending Review period. However, the split between current and capital expenditure changes and as a result of the different assumptions made about current and capital spending after 2003-04 (see paragraph B20) total expenditure then is slightly higher than in the Budget.

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B32. Changes to the projections of the main taxes since the Budget are shown in Table B8. Table B9 gives projections of receipts as a percentage of GDP and Table B10 sets out the Budget and Pre-Budget Report projections of the overall tax-GDP ratio. A more detailed breakdown of receipts is given in Table B11, while Table B12 looks in more detail at the changes for receipts between 2000-01 and 2001-02.

Table B8: Changes in current receipts since Budget 2001

		£ billion	
	2000-01	**2001-02**	**2002-03**
Income tax (gross of tax credits)	-0.8	-1.9	-1.9
Non-North Sea corporation tax[1]	0.3	-4.3	-4.0
Tax credits[2]	-0.3	-0.2	-0.4
North Sea revenues	-0.5	-0.5	-0.7
Capital taxes[3]	0.3	0.5	-0.1
Stamp duty	0.0	-0.6	-0.9
Value added tax	-0.5	0.0	-0.2
Excise duties[4]	-0.2	0.0	-0.1
Social security contributions	0.6	1.6	1.0
Other taxes and royalties[5]	0.5	0.3	0.6
Net taxes and social security contributions	-0.5	-4.9	-6.7
Other receipts and accounting adjustments	-0.5	-2.4	-3.2
Current receipts	**-1.0**	**-7.2**	**-9.9**

[1] *Gross of company tax credits.*

[2] *Includes company tax credits.*

[3] *Capital gains tax and inheritance tax.*

[4] *Fuel, alcohol and tobacco duties.*

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

B33. As shown in Table B8, total receipts in 2001-02 are now expected to be around £7 billion lower than in Budget 2001. This means that current receipts are now expected to grow by
2 per cent, compared with 4 per cent in Budget 2001.

B34. The estimated effect of changes since Budget 2001 to the assumptions for GDP and its components is shown in Table B7. These changes account for around £1 billion of the drop in receipts in 2001-02 and £2 billion in 2002-03. Although economic growth in 2003 is expected to be higher than in Budget 2001, the cumulative effect on levels of the main tax bases (wages and salaries, industrial and commercial company profits and consumers' expenditure) is such that the effect on tax receipts in 2003-04 is still negative. However, the impact of the economic forecast means that receipts are expected to be slightly higher at the end of the projection period, consistent with a higher level of money GDP. The main taxes affected by these changes are income tax, corporation tax and VAT.

B35. Changes to some of the other assumptions have large effects on tax receipts. In particular, equity price levels are important determinants of capital taxes, stamp duty and corporation tax, mainly because of the effect on the capital gains of life insurance companies. The audited assumption that underpins the current projections is that equity prices increase in line with money GDP from the existing level of the FT - All Share Index - in this case 2579. Compared with the Budget 2001 starting point of 2902, this means that equity prices are about 14 per cent lower in the current forecast. This reduces receipts by about £$^1/_2$ billion in 2001-02 and by around £2 billion from 2002-03 onwards, due to the lags in the payments of capital taxes.

B36. Changes in other assumptions audited by the NAO also have a significant impact on receipts, particularly in the early years. Oil prices are $1.7 a barrel lower than at the time of Budget 2001, reducing receipts by about £$^1/_2$ billion a year throughout the period. Much of the change in the "other audited assumptions" line of Table B7 is explained by lower market expectations of 3 month market interest rates than in Budget 2001. This has an impact on income tax deducted at source from bank and building society interest payments and, with a lag, on the extra tax paid on interest income by higher rate taxpayers. It also has a large impact on non-tax receipts of the public sector, such as interest receipts.

B37. As discussed in Box B2, corporation tax receipts in 2001-02 are expected to be £4$^1/_2$ billion lower than in the Budget projections. Some of this reflects changes in the tax paid by industrial and commercial companies, largely due to changes in the economy. This element is included in the GDP line of Table B7. However, much of the fall in receipts is due to a fall in the taxable profits of financial companies. This is not directly reflected in forecasts for GDP. The "financial companies" line in Table B7 shows the impact on the fiscal balances of the reduction in corporation tax receipts due to the lower assumption about financial company profits. This excludes life insurance companies, whose profits forecast is based on equity prices. The "financial companies" line also includes falls in income tax because of changes stemming from lower bonuses paid by financial companies to their employees. These have recently had a substantial impact on PAYE receipts.

Table B9: Current receipts

	Per cent of GDP						
	Outturn	Projections					
	2000-01	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**
Income tax (gross of tax credits)	11.1	11.0	11.1	11.3	11.4	11.5	11.7
Non-North Sea corporation tax[1]	3.2	3.0	3.0	3.2	3.3	3.4	3.4
Tax credits[2]	-0.5	-0.8	-0.9	-0.8	-0.8	-0.8	-0.8
of which:							

Working Families' Tax Credit[3]	-0.5	-0.6	-0.6	-0.6	-0.5	-0.5	-0.5
North Sea revenues[4]	0.4	0.5	0.5	0.5	0.4	0.4	0.3
Value added tax	6.1	6.1	6.1	6.0	6.0	6.0	5.9
Excise duties[5]	3.9	3.7	3.6	3.5	3.5	3.4	3.3
Social security contributions	6.3	6.4	6.3	6.2	6.2	6.2	6.2
Other taxes and royalties[6]	6.8	6.7	6.6	6.6	6.7	6.7	6.7
Net taxes and social security contributions[7]	37.3	36.8	36.4	36.4	36.6	36.7	36.8
Accruals adjustments on taxes	0.2	0.0	0.0	0.1	0.1	0.1	0.1
less EU transfers	-0.7	-0.6	-0.5	-0.4	-0.4	-0.4	-0.4
Tax credits[8]	0.5	0.6	0.6	0.6	0.6	0.5	0.5
Other receipts	2.6	2.4	2.3	2.4	2.4	2.3	2.3
Current receipts[9]	40.0	39.2	38.8	39.1	39.3	39.4	39.3
Memo:							
Current receipts (£bn)	382.2	391.2	406	430	452	474	497

[1] *Gross of company tax credits.*

[2] *Includes company tax credits.*

[3] *The Working Families' Tax Credit will be replaced in 2003 by a new system of tax credits.*

[4] *Includes oil royalities, petroleum revenue tax and North Sea corporation tax.*

[5] *Fuel, alcohol and tobacco duties.*

[6] *Includes Council Tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.*

[7] *Includes VAT and 'own resources' contributions to EU budget. Net of income tax credits. Cash basis.*

[8] *Excludes Children's Tax Credit, and other tax credits which score as a tax repayment in the national accounts.*

[9] *Accruals basis.*

Chart B3: Tax-GDP ratio

Total taxes

B38. The remaining changes to receipts cover a wide variety of different changes to the forecasts for individual taxes. Many reflect the effects of outturn data.

B39. Table B10 and Chart B3 show the tax-GDP ratio, measured as net taxes and social security contributions as a percentage of GDP. The revision to the tax-GDP ratio in 2000-01 largely reflects upward GDP data revisions which also feed through in later years. The lower levels of tax receipts now expected in 2001-02 and 2002-03 lead to larger falls in the ratio than in the Budget 2001 projections.

Table B10: Net taxes and social security contributions[1]

	Per cent of GDP						
	Outturn[2]	Projections					
	2000-01	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**
Budget 2001	37.7	37.5	37.3	37.0	37.0	37.0	
PBR 2001	37.3	36.8	36.4	36.4	36.6	36.7	36.8

[1] *Net of tax credits; cash basis.*

[2] *The 2000-01 figures were estimates in Budget 2001.*

B67. The forecast for the central government net cash requirement for 2001-02 has now been revised by £6 billion to £6.3 billion forecast, the Debt Management Office's target for buy-backs from the secondary market has been scaled back to £0.5 billion. Add that National Savings' net contribution will be some £3 billion higher than originally planned. This means that the revised net fina 2001-02 is now £25.6 billion, an increase of £2.5 billion from the forecast published with the outturn data for 2000-01 on 23 Apr

B68. In order to meet this increased financing requirement, the Debt Management Office's gilt remit for 2001-02 has been revise instructed to:

- increase gross gilts issuance by £0.5 billion to £14 billion;
- increase the planned stock of outstanding Treasury bills by £1.4 billion to £9.7 billion; and
- increase the planned rundown of their net cash position by a further £0.6 billion to £5.2 billion.

B69. Full details of all these measures and a complete financing table for 2001-02 can be found on the Debt Management Office' (www.dmo.gov.uk).

Table B21: Public sector transactions by sub-sector and economic category

				£ billion
				2000-01
		General government		
		Central	**Local**	
	Line	**government**	**authorities**	**Total**
Current Receipts				
Taxes on income and wealth	1	143.8	0.0	143.8
Taxes on production and imports	2	131.6	0.2	131.8
Other current taxes	3	3.3	14.0	17.3
Taxes on capital	4	2.2	0.0	2.2
Social contributions	5	62.2	0.0	62.2
Gross operating surplus	6	4.3	3.4	7.7
Rent and other current transfers	7	1.7	0.0	1.7
Interest and dividends from private sector and abroad	8	4.8	0.8	5.6
Interest and dividends from public sector	9	5.4	1.4	6.7
Total current receipts	**10**	**359.3**	**19.8**	**379.2**
Current Expenditure				

Current expenditure on goods and services	11	107.2	70.1	177.3
Subsidies	12	4.3	1.0	5.3
Net social benefits	13	102.8	11.9	114.8
Net current grants abroad	14	-0.1	0.0	-0.1
Current grants (net) within public sector	15	67.4	-67.4	0.0
Other current grants	16	20.6	0.0	20.6
Interest and dividends paid	17	26.1	0.4	26.5
Apportionment of AME margin	18	0.0	0.0	0.0
Total current expenditure	**19**	**328.3**	**16.1**	**344.3**
Depreciation	20	4.3	3.4	7.7
Surplus on current budget	**21**	**26.8**	**0.3**	**27.1**
Capital expenditure				
Gross domestic fixed capital formation	22	4.5	7.0	11.5
Less depreciation	23	-4.3	-3.4	-7.7
Increase in inventories	24	-0.1	0.0	-0.1
Capital grants (net) within public sector	25	5.0	-4.3	0.7
Capital grants to private sector	26	2.6	1.2	3.8
Capital grants from private sector	27	0.0	-0.7	-0.7
Net capital expenditure	**28**	**7.8**	**-0.3**	**7.5**
Net borrowing	**29**	**-19.0**	**-0.6**	**-19.6**

Table B21: Public sector transactions by sub-sector and economic category

					£ billion
					2001-02
	General government				
	Central	**Local**		**Public**	**Public**
Line	**government**	**authorities**	**Total**	**corporations**	**sector**

1	145.8	0	145.8	-0.1	145.7	Taxes or
2	136.4	0.2	136.6	0.0	136.6	Taxes on pro
3	3.3	14.8	18.1	0.0	18.1	
4	2.4	0.0	2.4	0.0	2.4	
5	63.8	0.0	63.8	0.0	63.8	
6	4.5	3.5	8.0	9.6	17.7	Gro
7	1.9	0.0	1.9	0.7	2.6	Rent and ot
8	3.4	0.7	4.1	0.2	4.3	Interest and dividends from privat
9	5.7	1.8	7.5	-7.5	0.0	Interest and dividend
10	**367.4**	**21.0**	**388.3**	**2.8**	**391.1**	**T**

11	117.8	74.9	192.7	0.0	192.7	Current expenditure on
12	6.5	1.0	7.5	0.0	7.5	
13	110.1	12.4	122.4	0.0	122.4	
14	-2.0	0.0	-2.0	0.0	-2.0	Net cu
15	71.9	-71.9	0.0	0.0	0.0	Current grants (net)
16	24.2	0.0	24.2	0.0	24.2	
17	22.2	0.2	22.4	0.1	22.5	Interes
18	0.2	0.0	0.2	0.0	0.2	Apportionr
19	**350.8**	**16.7**	**367.5**	**0.1**	**367.6**	**Total**
20	4.5	3.5	8.0	5.2	13.2	
21	**12.0**	**0.8**	**12.8**	**-2.4**	**10.3**	**Surpl**

22	6.6	8.6	15.2	4.8	20.1	Gross domestic fix
23	-4.5	-3.5	-8.0	-5.2	-13.2	
24	0.2	0.0	0.2	0.0	0.2	Inc
25	5.7	-4.3	1.5	-1.5	0.0	Capital grants (net)
26	5.3	1.2	6.5	0.0	6.5	Capital gra
27	0.0	-0.7	-0.7	0.0	-0.7	Capital grants
28	**13.3**	**1.4**	**14.7**	**-1.8**	**12.9**	**Ne**
29	**1.3**	**0.6**	**1.9**	**0.6**	**2.5**	

Table B21: Public sector transactions by sub-sector and economic category

				£ billion	
				2002-03	
		General government			
		Central	**Local**		
	Line	**government**	**authorities**	**Total**	**c**
Current Receipts					
Taxes on income and wealth	1	152.5	0.0	152.5	
Taxes on production and imports	2	142.2	0.2	142.3	
Other current taxes	3	3.4	15.8	19.3	
Taxes on capital	4	2.5	0.0	2.5	
Social contributions	5	64.6	0.0	64.6	
Gross operating surplus	6	4.8	3.7	8.5	
Rent and other current transfers	7	1.9	0.0	1.9	
Interest and dividends from private sector and abroad	8	3.1	0.6	3.7	
Interest and dividends from public sector	9	5.8	1.7	7.5	
Total current receipts	**10**	**380.8**	**22.0**	**402.7**	
Current Expenditure					
Current expenditure on goods and services	11	126.0	80.6	206.6	

Subsidies	12	6.4	1.1	7.5
Net social benefits	13	114.0	12.7	126.7
Net current grants abroad	14	-0.9	0.0	-0.9
Current grants (net) within public sector	15	77.0	-77.0	0.0
Other current grants	16	26.6	0.0	26.6
Interest and dividends paid	17	21.4	0.2	21.6
Apportionment of AME margin	18	1.2	0.0	1.2
Total current expenditure	**19**	**371.8**	**17.5**	**389.3**
Depreciation	20	4.8	3.7	8.5
Surplus on current budget	**21**	**4.2**	**0.8**	**5.0**
Capital expenditure				
Gross domestic fixed capital formation	22	8.2	10.2	18.4
Less depreciation	23	-4.8	-3.7	-8.5
Increase in inventories	24	0.2	0.0	0.2
Capital grants (net) within public sector	25	6.1	-5.3	0.8
Capital grants to private sector	26	4.9	1.4	6.3
Capital grants from private sector	27	0.0	-0.7	-0.7
Net capital expenditure	**28**	**14.6**	**1.9**	**16.5**
Net borrowing	**29**	**10.4**	**1.1**	**11.5**

Table B21: Public sector transactions by sub-sector and economic category

			£ billion		
			2003-04		
	General government				
	Central	**Local**	**Public**	**Public**	
Line	**government**	**authorities**	**Total**	**corporations**	**sector**

1	162.9	0.0	162.9	-0.2	162.7	Taxes o
2	148.8	0.2	148.9	0.0	148.9	Taxes on pr
3	3.7	16.9	20.5	0.0	20.5	
4	2.6	0.0	2.6	0.0	2.6	
5	68.0	0.0	68.0	0.0	68.0	
6	5.0	3.9	8.9	10.6	19.5	Gro
7	1.9	0.0	1.9	0.7	2.6	Rent and o
8	3.9	0.7	4.6	0.2	4.8	Interest and dividends from priva
9	6.6	2.0	8.5	-8.5	0.0	Interest and dividen
10	**403.2**	**23.6**	**426.7**	**2.8**	**429.6**	

11	131.7	85.8	217.5	0.0	217.5	Current expenditure or
12	6.4	1.1	7.6	0.0	7.6	
13	120.0	13.1	133.1	0.0	133.1	
14	-1.0	0.0	-1.0	0.0	-1.0	Net c
15	81.5	-81.5	0.0	0.0	0.0	Current grants (net
16	28.9	0.0	28.9	0.0	28.9	
17	23.2	0.2	23.3	0.1	23.5	Interes
18	1.5	0.0	1.5	0.0	1.5	Apportion
19	**392.2**	**18.8**	**411.0**	**0.1**	**411.1**	**Tota**
20	5.0	3.9	8.9	5.7	14.6	
21	**5.9**	**0.9**	**6.9**	**-3.0**	**3.9**	**Surp**

22	9.2	11.6	20.8	4.3	25.1	Gross domestic fixed capital formati
23	-5.0	-3.9	-8.9	-5.7	-14.6	
24	0.1	0.0	0.1	0.0	0.1	In
25	7.0	-6.3	0.7	-0.7	0.0	Capital grants (net
26	7.1	1.5	8.6	0.0	8.6	Capital gra
27	0.0	-0.6	-0.6	0.0	-0.6	Capital grant
28	**18.4**	**2.3**	**20.7**	**-2.1**	**18.6**	**N**
29	**12.5**	**1.3**	**13.8**	**0.9**	**14.7**	

Table B22: Historical series of public sector balances, receipts and debt

	Per cent of GDP							
	Public sector current budget	**Public sector net borrowing**	**Cyclically adjusted public sector net borrowing**	**Public sector net cash requirement**	**General government net borrowing[1]**	**Net taxes and social security contributions**	**Public sector current receipts**	**Public sector net debt[2]**
1970-71	6.7	-0.6	-0.8	1.2	-2.1	43.1		
1971-72	4.2	1.1	0.5	1.4	-0.7	41.2		
1972-73	2.0	2.8	2.7	3.6	2.2	38.9		
1973-74	0.3	4.9	5.8	5.9	4.4	39.4		
1974-75	-1.1	6.6	7.3	9.0	4.1	42.1	52.1	60.4
1975-76	-1.6	7.0	6.6	9.3	4.8	42.7	53.9	58.7
1976-77	-1.2	5.5	4.9	6.4	4.1	43.1	52.4	59.1
1977-78	-1.4	4.3	3.9	3.7	3.6	41.3	49.0	57.1

1978-79	-2.6	5.0	4.9	5.2	4.3	33.2	40.0	47.1
1979-80	-1.9	4.1	4.1	4.7	3.0	33.9	40.6	43.9
1980-81	-3.0	4.9	2.9	5.2	3.8	35.7	42.4	46.1
1981-82	-1.4	2.3	-1.7	3.3	3.3	38.7	45.7	46.1
1982-83	-1.5	3.0	-1.2	3.2	3.1	39.0	45.5	44.8
1983-84	-2.0	3.8	0.4	3.2	3.8	38.2	44.4	45.3
1984-85	-2.2	3.7	0.8	3.1	3.3	38.9	44.4	45.2
1985-86	-1.2	2.4	0.6	1.6	2.6	38.1	43.1	43.4
1986-87	-1.4	2.1	1.6	0.9	2.3	37.8	42.0	41.1
1987-88	-0.3	1.0	1.8	-0.7	1.3	37.6	41.1	36.8
1988-89	1.7	-1.3	0.9	-3.0	-0.9	36.9	40.7	30.6
1989-90	1.4	-0.2	2.3	-1.3	0.3	36.2	39.9	27.7
1990-91	0.4	1.0	2.5	-0.1	1.4	36.3	39.0	26.2
1991-92	-1.9	3.8	3.2	2.3	3.7	35.0	38.6	27.4
1992-93	-5.6	7.6	5.5	5.9	7.4	34.0	36.6	32.0
1993-94	-6.2	7.8	5.6	7.1	7.8	33.0	35.8	37.1
1994-95	-4.8	6.3	5.1	5.3	6.5	34.2	36.9	40.8
1995-96	-3.4	4.8	4.4	4.3	5.0	35.0	37.8	42.8
1996-97	-3.0	3.7	3.5	2.9	3.9	35.0	37.4	43.7

1997-98	-0.1	0.7	0.9	0.1	0.8	36.1	38.5	41.5
1998-99	1.3	-0.6	-0.3	-0.8	-0.6	36.5	39.0	39.2
1999-00	2.3	-1.8	-1.6	-0.9	-1.7	36.5	39.4	36.4
2000-01	2.6	-2.0	-1.7	-3.9	-2.0	37.3	40.0	31.2

[1]*UK national accounts definition.*

[2]*At end-March, GDP centred on end-March.*

[3]*Maastricht measure from 1993.*

[4]*At end-December, GDP centred on end-December.*

Table B23: Historical series of government expenditure

	£ billion (2000-01 prices)				Per cent of GD		
	Public sector current expenditure	Public sector net capital expenditure	Public General government expenditure	Public Total managed expenditure	sector current expenditure	sector net capital expenditure	Ger gover exper
1970-71	152.8	28.9	194.6	201.1	32.4	6.1	
1971-72	159.8	25.4	200.2	205.0	33.1	5.3	
1972-73	167.9	24.5	209.1	212.8	33.0	4.8	
1973-74	183.1	27.4	223.1	233.3	34.9	5.2	
1974-75	191.3	27.3	236.9	241.6	38.7	5.5	
1975-76	204.0	28.0	247.0	256.1	39.7	5.5	
1976-77	209.6	22.9	240.6	257.6	39.7	4.3	
1977-78	207.6	15.6	230.9	248.8	38.2	2.9	
1978-79	214.7	13.6	242.8	254.5	38.2	2.4	
1979-80	214.5	12.3	242.0	252.0	38.2	2.2	
1980-81	226.5	10.1	255.5	262.4	40.8	1.8	
1981-82	239.4	5.2	262.7	271.0	42.5	0.9	
1982-83	246.5	8.7	269.9	280.5	42.6	1.5	

1983-84	258.2	10.9	277.5	295.2	42.2	1.8
1984-85	264.9	9.5	282.1	298.5	42.6	1.5
1985-86	265.9	8.1	281.4	295.6	41.0	1.2
1986-87	266.7	4.8	277.4	293.1	40.1	0.7
1987-88	271.2	4.6	280.0	295.9	38.6	0.7
1988-89	262.4	2.6	270.4	285.6	36.2	0.4
1989-90	265.6	8.9	284.9	295.2	35.7	1.2
1990-91	267.5	10.7	284.7	296.3	36.1	1.4
1991-92	285.2	13.7	301.9	314.3	38.4	1.8
1992-93	301.7	15.0	320.3	331.2	40.3	2.0
1993-94	313.1	12.4	332.4	339.8	40.1	1.6
1994-95	322.2	12.2	339.8	349.0	39.9	1.5
1995-96	326.8	11.7	346.8	353.2	39.4	1.4
1996-97	332.4	5.9	343.5	352.1	38.7	0.7
1997-98	328.7	5.2	342.2	347.2	37.2	0.6
1998-99	328.6	6.1	344.3	348.0	36.2	0.7
1999-00	334.3	4.7	350.3	352.2	35.7	0.5
2000-01	344.5	6.3	363.4	363.5	36.1	0.7

B40. Income tax receipts in 2001-02 are expected to be around £110 billion, almost £2 billion lower than forecast in the Budget. Around half of this shortfall relates to revisions to the data for last year, including a reallocation from income tax to capital gains tax (both of which are collected under self assessment).

B41. The majority of the remaining shortfall in 2001-02 relates to bonuses. At the time of the Budget it was not possible to give a full explanation for the high levels of income tax receipts observed in 1999-00 and 2000-01. It is now apparent that a large proportion of these additional receipts were related to bonus payments made by financial companies, particularly to people at the top of the earnings distribution, increasing the average rate of tax paid on these earnings. In the Budget forecast, PAYE receipts from bonus payments were assumed to continue at 2000-01 levels. However, the decline in financial sector profits, evidenced by lower than expected corporation tax receipts from that sector (see Box B2) suggests that lower bonuses are likely in 2001-02. The PAYE forecast includes an allowance of

Box B2: Corporation tax receipts in 2001-02

The timing of corporation tax receipts in recent years has been heavily influenced by the reforms announced in Budget 1998, which abolished advance corporation tax, introduced a four-year transition to instalment payments for large companies, and cut tax rates.

Small and medium-sized companies should now pay all their tax liability for an accounting period nine months after the end of that period. Large companies now pay most of their tax in four quarterly instalments, based on their own estimates of their tax liability for the period, starting in the seventh month of the accounting period. They pay a fixed percentage of the estimated liability for the year in each instalment. During the transition period, they will also make a balancing payment nine months after the end of their accounting period. The percentages are:

Year 1[1]	**4 instalments of 15 per cent; balancing payment 40 per cent**
Year 2	**4 instalments of 18 per cent; balancing payment 28 per cent**
Year 3	**4 instalments of 22 per cent; balancing payment 12 per cent**
Year 4 +	**4 instalments of 25 per cent**

One result of the new system is that tax payments respond much more quickly to changes in companies' views of their profits and tax liabilities. Large companies with calendar year accounting periods paid their first instalment in respect of their 2001 profits in July 2001, and their second in October. These instalments were expected to show growth of about 30 per cent on the corresponding payments for last year in the Budget 2001 forecast, partly because of the increase in the instalment percentage and partly from profits growth. But actual receipts of instalments this year have shown only modest growth on last year, implying that companies are expecting lower tax liabilities this year than last.

Repayments of corporation tax have also been much higher than expected in the first seven months of the year. By contrast, small company payments have been higher than forecast in the Budget.

As a result of the lower than expected level of net receipts in the first seven months of the year, receipts in 2001-02 as a whole are now expected to be about £4$^1/_2$ billion lower than in the Budget forecast.

1. Year 1 is accounting period ending on or after 1 July 1999.

around £1 billion for the impact of lower bonuses, although this is subject to a high degree of uncertainty. Consistent with the projections for financial company profits, the bonuses are expected to recover later in the forecast period, and to make a small positive contribution to PAYE receipts, relative to the Budget forecast, from 2004-05 onwards.

B42. Self assessment receipts are expected to be slightly weaker than forecast in the Budget until 2004-05, reflecting lower interest rate projections and lower growth in self employment incomes. Other income tax receipts are expected to be somewhat lower in 2002-03 and 2003-04, before returning towards the levels forecast in the Budget. The main factors determining this profile are lower interest rates and recent outturns.

Non-North Sea corporation tax

B43. Non-North Sea corporation tax in 2001-02 is expected to be around £4$^1/_4$ billion below the Budget forecast. Forecast receipts from industrial and commercial companies are driven mainly by their projected profits. Projected profits growth in 2001-02 and 2002-03 is lower than in the Budget, while growth in 2003-04 is higher. Higher levels of tax losses brought forward slow the recovery in corporation tax receipts, but by 2005-06, receipts from both small companies and instalment payers are similar to the levels projected in the Budget.

B44. The Pre-Budget Report forecast assumes that, apart from life insurance companies, the fall in financial company taxable profits implied by their instalment payments this year is temporary, and that profits recover in 2002 and 2003. From 2004 onwards, financial companies taxable profits are assumed to grow slightly faster than money GDP as profits return to a cautious view of their long-term trend. In addition, financial companies' 1999 assessments showed significantly lower levels of deductions against income than assumed in the Budget. Projecting this outturn forward implies higher tax yields for a given level of taxable profits. Hence, receipts from financial companies are forecast to recover to around their Budget levels in 2003-04, and to exceed them slightly in later years.

B45. Life insurance companies' profits are highly dependent on asset prices. The much lower starting point for the audited assumption for equity prices leads to much lower receipts throughout the forecast period.

North Sea revenues

B47. North Sea revenues are expected to be £$^1/_2$-$^3/_4$ billion a year lower than forecast in the Budget projections between 2001-02 and 2003-04. This mainly reflects a reduction in the oil price forecast relative to the Budget of around 6 per cent from 2002-03 onwards.

Capital taxes

B48. As described in paragraph B5, capital taxes receipts are much lower than Budget projections because of the lower equity price assumption. The 2000-01 outturn for capital gains tax was £3.2 billion - around £0.3 billion higher than forecast in the Budget, reflecting the reallocation from income tax referred to in paragraph B40. Receipts are expected to fall slightly in 2001-02 reflecting the taper reforms introduced in Budget 2000. For 2002-03, a larger reduction to £1$^3/_4$ billion is now forecast, arising in part from the maturing of the taper, but also from the sharp fall in equity prices in 2001-02 which impacts on receipts a year later. Inheritance tax receipts for 2000-01 were £2.2 billion, as forecast in the Budget. However, recent outturns have been higher than predicted, resulting in a forecast for 2001-02 of around £2$^1/_2$ billion.

Stamp duty

B49. The outturn for stamp duty receipts in 2000-01 was £8$^1/_4$ billion, the same as the Budget forecast. However, 2001-02 receipts are now expected to be £7$^1/_2$ billion - over £$^1/_2$ billion lower than the Budget forecast - as the reduction in equity prices and volumes more than offsets higher than anticipated house prices. Following this, modest increases in receipts in subsequent years are forecast, though these are much lower than the Budget, mainly because of the lower equity price assumption.

VAT receipts

B50. VAT receipts in 2001-02 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 NAO audited assumption that, after allowing for the effects of VAT measures, the ratio of VAT receipts to consumer spending declines gradually, by 0.05 percentage points a year. This assumption, combined with the Pre-Budget Report forecast of reduced growth in consumers' expenditure from 2002, means that VAT receipts fall from their Budget levels by around £$^1/_4$ billion in 2002-03.

Excise duties

B51. Excise duties in 2001-02 are expected to be slightly lower than forecast in the Budget. Although actual receipts for tobacco and road fuel duties were significantly weaker in the first half of 2001-02 than in 2000-01 (see table B12), they are expected to recover during the remainder of the year. The introduction of anti-forestalling measures in March 2001 means that receipts are much more evenly spread across the year, boosting receipts in the latter half relative to earlier years. Similarly, road fuel receipts in the latter half of 2000-01 were unusually low because of the negative forestalling associated with the Budget 2001 duty cuts. The current forecast assumes that duties will be increased in line with inflation, and that taxable quantities released in March will return to normal levels. However, weaker than expected outturn receipts have resulted in lower full year forecasts for road fuels.

Other indirect taxes

B52. Revised assumptions about the timing of CCL payments have reduced the first year 2001-02 cash forecast by around £$^1/_4$ billion. Forecasts for future years' receipts have been left unchanged and these will be reviewed for the Budget in the light of latest outturns for this new tax. The events of 11 September have also reduced air passenger duty revenues, although there remains considerable uncertainty as to how long receipts will be affected by the current downturn in passenger numbers.

Table B11: Current receipts

	£ billion		
	Outturn	**Projections**	
	2000-01	**2001-02**	**2002-03**
Inland Revenue			
Income tax (gross of tax credits)	105.9	109.7	116.1
Corporation tax[1]	32.4	33.3	35.0
Tax credits	-5.2	-7.6	-9.0
Petroleum revenue tax	1.5	1.4	1.4
Capital gains tax	3.2	2.9	1.8
Inheritance tax	2.2	2.4	2.5
Stamp duties	8.2	7.4	7.7
Social security contributions	60.6	64.3	65.7
Total Inland Revenue (net of tax credits)	**208.9**	**213.8**	**221.1**
Customs and Excise			
Value added tax	58.5	61.3	63.7
Fuel duties	22.6	22.2	23.0
Tobacco duties	7.6	7.8	7.7
Spirits duties	1.8	1.9	2.0
Wine duties	1.8	2.0	2.0
Beer and cider duties	3.0	3.0	3.1
Betting and gaming duties	1.5	1.4	1.3

Air passenger duty	1.0	0.8	0.8
Insurance premium tax	1.7	1.8	1.8
Landfill tax	0.5	0.5	0.5
Climate change levy	0.0	0.6	1.0
Aggregates levy	0.0	0.0	0.2
Customs duties and levies	2.1	2.1	2.3
Total Customs and Excise	**102.2**	**105.4**	**109.6**
Vehicle excise duties	4.5	4.5	4.7
Oil royalties	0.5	0.5	0.5
Business rates[2]	17.3	18.1	18.4
Council tax	14.2	14.8	15.8
Other taxes and royalties[3]	9.0	9.6	10.3
Net taxes and social security contributions[4]	**356.5**	**366.7**	**380.4**
Accrual adjustments on taxes	2.3	0.3	0.2
less own resources contribution to EU budget	-6.3	-5.8	-5.4
less PC corporation tax payments	-0.1	-0.1	-0.2
Tax credits[5]	5.2	6.1	6.5
Interest and dividends	5.8	4.3	4.0
Other receipts	19.0	19.7	20.7
Current receipts	**382.2**	**391.2**	**406.2**
Memo:			
North Sea revenues[6]	4.3	5.4	5.2

[1] *Includes advance corporation tax (net of repayments):*
Also includes North Sea corporation tax after ACT set off, and corporation tax on gains.
Gross of R&D tax credit (zero in 2000-01, £0.1 billion in 2001-02) and tax credit for cleaning contaminated land sites (£50 million in 2001-02) which are scored within the tax credits line.

[2] *Includes district council rates in Northern Ireland paid by business.*

[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, and other tax credits which score as a tax repayment in the national accounts.*

[6] *Consists of North Sea corporation tax (before ACT set-off), petroleum revenue tax and royalties.*

Table B12: Net taxes and social security contributions

	£ billion			Percentage change on 2000-01		
	Outturn[1]	Outturn				
	Apr-Oct	Nov-Mar	2001-02	Apr-Oct	Nov-Mar	Full year
Inland Revenue						
Income tax and capital gains tax[2]	56.9	48.3	105.2	3.9	-1.9	1.2
Corporation tax[3]	23.2	9.9	33.1	6.5	-6.8	2.2
Petroleum revenue tax	0.9	0.5	1.4	0.6	-20.6	-8.4
Inheritance tax	1.4	1.0	2.4	7.1	11.6	8.9
Stamp duties	4.4	3.0	7.4	-11.9	-5.0	-9.2
Social security contributions	36.8	27.4	64.3	7.3	4.3	6.0
Total Inland Revenue (net of tax credits)	**123.7**	**90.1**	**213.8**	**4.7**	**-0.8**	**2.3**
Customs and Excise						
Value added tax	36.0	25.3	61.3	5.1	4.5	4.8
Fuel duties	12.9	9.4	22.2	-3.2	0.4	-1.7
Tobacco duties	4.6	3.2	7.8	-4.3	11.6	1.6
Alcohol duties	3.9	3.0	6.9	3.6	3.4	3.5
Other Customs duties and levies	4.1	3.0	7.1	5.7	6.8	6.2
Total Customs and Excise	**61.5**	**43.8**	**105.4**	**2.4**	**4.1**	**3.1**
Vehicle excise duties	2.7	1.8	4.5	-5.5	14.9	1.9
Oil royalties	0.3	0.3	0.5	7.5	6.3	6.9
Business rates[3]	11.3	6.8	18.1	-1.6	16.2	4.5
Council tax[4]	9.9	4.9	14.8	6.5	1.3	4.7
Other taxes and royalties[4]	5.4	4.2	9.6	3.4	12.3	7.1
Net taxes and social security contributions[5]	**214.8**	**151.9**	**366.7**	**3.6**	**1.8**	**2.9**

[1] *Provisional.*

[2] *Net of income tax credits.*

[3] *Net of company tax credits.*

[4] *Includes money paid into the National Lottery Distribution fund.*

[5] *Includes VAT and 'traditional own resources' contributions to EU budget. Net of income tax credits. Cash*

basis.

PUBLIC EXPENDITURE

B53. Table B13 shows projections for public expenditure for the three years covered by the 2000 Spending Review. The projections cover the whole public sector using the aggregate Total Managed Expenditure (TME). As explained in Chapter 6, TME is split into DEL and AME.

Table B13: Total Managed Expenditure 2000-01 to 2003-04

		£ billion		
	Outturn	**Projections**		
	2000-01	**2001-02**	**2002-03**	**2003-04**
Departmental Expenditure Limits				
Resource Budget	170.8	187.6	201.3	211.9
Capital Budget	20.1	24.9	28.3	33.2
Total Departmental Expenditure Limits	**190.9**	**212.5**	**229.6**	**245.1**
Annually Managed Expenditure				
Departmental AME				
Social Security Benefits	99.2	105.5	109.3	115.1
Housing Revenue Account subsidies	3.2	4.6	4.4	4.2
Common Agricultural Policy	2.7	4.5	2.7	2.8
Export Credits Guarantee Department	1.2	0.9	0.6	0.6
Self-financing public corporations				
capital expenditure	1.4	1.1	1.3	1.1
Net public service pensions	4.9	5.3	5.4	5.8
National Lottery	1.9	2.1	2.2	2.3
Other programme expenditure	0.2	0.2	0.0	-0.1
Non-cash items:				
Depreciation	7.1	8.1	9.l	9.6
Cost of capital charges	13.9	13.6	14.1	14.6
Provisions and other charges	4.9	-0.2	1.8	2.2
Total departmental AME[1]	**140.4**	**145.6**	**151.0**	**158.1**
Other AME:				
Net payments to EC institutions2	3.7	0.7	2.1	2.3

Locally financed expenditure	18.3	19.3	20.2	21.2
Central government gross debt interest[3]	26.1	22.2	21.4	23.2
Accounting and other adjustments	-15.9	-6.9	-7.3	-7.1
Total other AME	**32.2**	**35.4**	**36.4**	**39.6**
AME Margin	0.0	0.2	1.2	1.5
Annually Managed Expenditure	**172.6**	**181.1**	**188.7**	**199.2**
Total Managed Expenditure	**363.5**	**393.7**	**418.2**	**444.3**
of which:				
Public sector current expenditure	344.5	367.6	389.4	411.1
Public sector net investment	6.3	12.9	14.8	18.6
Public sector depreciation	12.7	13.2	14.0	14.6

[1] *Including non-cash items.*

[2] *Net payments to EC institutions exclude the UK's contribution to the cost of EC aid to non-member states (which is attributed to the aid programme).*

Net payments therefore differ from the UK's net contribution to the EC budget, latest estimates for which are (in £ billion):

2000-01	2001-02	2002-03	2003-04
4.3	1.4	3.0	3.2

The trended forecast for 2001-02 is £3.1 billion

[3] *In Budget 2001, and previous documents, central government gross debt interest was defined as payments* gross *of payments to public corporations. In line with changes introduced in the 2001 National Accounts these are now stated* net *of payments to public corporations. Payments from central government to public corporations are now recorded in the adjustments for public corporations line in the accounting adjustments (see Table B15). Debt interest payments on a net basis are around £0.4 billion a year lower than on a gross basis.*

B54. The Pre-Budget Report is an interim report on the public finances. For this purpose, in line with the usual convention, TME has been increased in future years to accommodate the Pension Credit and other AME measures, by £0.5 billion in 2002-03 and £1.7 billion in 2003-04, but otherwise remains unchanged. Within the total for TME in 2002-03 £1 billion has been reallocated from lower debt interest payments in AME to resource DEL to fund additional spending on health. The overall total for DEL is assumed to be fully spent. Within that total, to cover End Year Flexibility drawdown so far, there is an allowance for shortfall. It is assumed that over the year underspends will offset the drawdown of End Year Flexibility. Forecasts of individual AME programmes have been reviewed for this Pre-Budget Report and any changes have been offset in the margin. Again, in line with the convention, the additions to the winter fuel payment in the current year have been deducted from the margin.

Chart B4: Total Managed Expenditure

B55. The main economic assumptions underpinning the AME projections are set out in Table B3. In particular, they assume that UK claimant unemployment will increase slightly from the recent level of 0.95 million (the average of the three months ending in October) to 1.14 million in 2003-04, in line with the average of independent forecasts (see Box B1).

B56. Table B14 shows changes to DEL and AME, and the main national accounts expenditure aggregates, since the Budget. Total DEL spending for 2000-01 was £3.4 billion lower than estimated at the Budget. Total AME expenditure in 2000-01 was £1.4 billion lower than at the Budget, though the outturn figure is provisional and subject to revision. From 2001-02, total DEL remains unchanged since the Budget with the following exceptions: the £1 billion reallocated to health in 2002-03; some relatively small classification changes between DEL and AME which have no effect on overall TME; and some transfers from capital DEL to resource DEL, mainly for the devolved administrations in Scotland and Wales.

B57. Total AME for 2001-02, excluding the AME margin, is £0.8 billion higher than in Budget 2001, reducing the margin to just £0.2 billion. This change is due to a number of factors, of which the main one is the inclusion in AME of estimated costs arising from Foot and Mouth disease of around £2 billion. Estimates of these costs were not available at the time of the Budget and it was expected that they would be met from the AME margin. Offsetting the costs of Foot and Mouth disease, net payments to EC institutions were £2 billion lower than expected, of which £0.2 billion relates to compensation from the EC towards the costs of Foot and Mouth, with the remainder due to a reduction in overall EC contributions. Expenditure on social security benefits is now expected to be £$^1/_2$ billion higher than in the Budget, mainly because of the increase in the winter fuel payment for winter 2001, announced since the Budget. Debt interest payments are about £0.6 billion lower because of lower short-term interest rates.

Table B14: Changes in Total Managed Expenditure since Budget 2001

	£ billion			
	Outturn	**Projections**		
	2000-01	**2001-02**	**2002-03**	**2003-04**
Departmental Expenditure Limits				
Resource Budget	-1.5	0.6	2.1	1.2
Capital Budget	-1.8	-0.4	-1.1	-1.2
Total Departmental Expenditure Limits	**-3.4**	**0.2**	**1.0**	**0.0**
Annually Managed Expenditure				
Departmental AME				
Social Security Benefits	0.1	0.5	0.7	1.6
Housing Revenue Account subsidies	0.0	0.0	0.1	0.1
Common Agricultural Policy	-0.1	1.9	0.1	0.1
Export Credits Guarantee Department	0.0	0.1	0.1	0.2
Self-financing public corporations				
capital expenditure	0.0	0.1	0.1	0.1
Net public service pensions	-0.4	-0.3	-0.1	-0.2
National Lottery	-0.1	-0.2	0.0	0.5
Other programme expenditure	0.3	0.2	0.1	0.2
Non-cash items:				
Depreciation	-0.8	-0.1	0.2	-0.1
Cost of capital charges	0.1	0.1	-0.3	-0.2
Provisions and other charges	3.9	0.4	1.2	1.3
Total departmental AME[1]	**2.9**	**2.6**	**2.2**	**3.5**
Other AME:				

Net payments to EC institutions	0.2	-2.0	-0.5	-0.6
Locally financed expenditure	0.4	0.2	0.1	0.2
Central government gross debt interest[2]	-0.4	-1.0	-2.7	-0.8
Accounting and other adjustments	-4.4	0.7	1.1	0.9
Total other AME	**-4.3**	**-2.1**	**-2.0**	**-0.3**
AME Margin	0.0	-0.8	-0.8	-1.5
Annually Managed Expenditure	**-1.4**	**-0.3**	**-0.6**	**1.7**
Total Managed Expenditure	**-4.8**	**0.0**	**0.5**	**1.7**
of which:				
Public sector current expenditure	-1.5	0.6	3.0	3.8
Public sector net investment	-1.1	1.7	-0.5	-0.1
Public sector depreciation	-2.2	-2.3	-2.0	-2.0

[1] *Including non-cash items*

[2] *In Budget 2001, and previous documents, central government gross debt interest was defined as payments* gross *of payments to public corporations. In line with changes introduced in the 2001 National Accounts these are now stated* net *of payments to public corporations. Payments from central government to public corporations are now recorded in the adjustments for public corporations line in the accounting adjustments (see Table B15). Debt interest payments on a net basis are around £0.4 billion a year lower than on a gross basis.*

B58. Before allowing for the effects of measures, the projections for AME components in 2002-03 are slightly lower than in the Budget. Debt interest payments are £2$^1/_4$ billion lower because of lower short-term interest rates and lower RPI inflation. £1 billion of these lower payments have been reallocated to health spending in DEL. Net payments to EC institutions are again lower, by about £$^1/_2$ million, but social security spending is up

by £$^3/_4$ billion, reflecting the new measures announced in this Pre-Budget Report and because of higher than previously forecast expenditure on benefits to the disabled. There are also a number of small increases in other components. After all these changes the AME margin is £1.2 billion, compared with £2 billion in the Budget projections.

B59. The new measures announced in this Pre-Budget Report add nearly £1$^3/_4$ billion to AME in 2003-04. Spending on other components is up by about £1$^1/_2$ billion since the Budget and as a result the AME margin falls from £3 billion to about £1$^1/_2$ billion. Debt interest payments in 2003-04 are around £0.4 billion lower than Budget projections - a much smaller fall than in 2002-03 because the change in interest rate expectations is smaller and because inflation effects make a positive contribution. Net payments to EC institutions are again lower, by about £$^1/_2$ billion. Social security spending, excluding the effect of the new Pension Credit and other new measures, is almost unchanged as the effects of the higher NAO audited unemployment assumption and lower inflation balance out. National Lottery spending is expected to be about £$^1/_2$ billion higher than in the Budget projections, and there are again small increases in most other components.

B60. Details of the main accounting adjustments, which include those items within TME but outside DEL and AME main programmes, are shown in Table B15. Most of these items have increased since the Budget, partly as a result of revisions made by the Office for National Statistics, this summer, to the National Accounts. Some of the increases, such as the adjustments on VAT refunded on general government expenditure, are offset by changes to receipts.

Table B15: Accounting and other adjustments

		£ billion			
		Outturn	Projections		
		2000-01	2001-02	2002-03	2003-04
1	Non-trading capital consumption	7.7	8.0	8.5	8.9
2	VAT refunded on general government expenditure	6.6	7.4	8.1	8.7
3	EC Contributions	-6.3	-5.8	-5.4	-4.9
4	Income tax credits	5.1	6.1	6.5	6.5
	of which Working Families' Tax Credit and Disabled Person's Tax Credit[1]	*4.6*	*5.6*	*6.0*	*6.1*
5	Adjustments for public corporations	4.3	4.5	4.8	5.1
6	Intra general government debt interest	-3.0	-2.9	-3.0	-3.0
7	Financial transactions in departmental budgets	-2.2	-2.2	-1.9	-2.1
8	Adjustments for expenditure financed by receipts	0.2	0.2	0.1	0.1
9	Other accounting adjustments	-2.2	-0.3	0.3	0.3
	less				
	non-cash items in DEL	0.3	0.2	0.2	0.2
	non-cash items in AME	25.8	21.5	25.0	26.4
Total accounting and other adjustments		**-15.9**	**-6.9**	**-7.3**	**-7.1**

[1] *The Working Families' Tax Credit will, subject to legislative constraints, be replaced in 2003 by a new system of tax credits.*

B61. Table B16 shows the Departmental Expenditure Limits in terms of the resource and capital budgets. It has been updated sin
to reflect the additional £1bn for health reallocated from AME, transfers between departments and programmes, and machinery o
changes.

Table B16: Departmental Expenditure Limits - resource and capital budgets

		£ billion	
	Outturns		**Plans**
	2000-01	**2001-02**	**2002-03**
Resource Budget			
Education and Skills	14.2	17.3	18.8
Health	43.6	47.9	53.3
of which: NHS	*42.8*	*46.9*	*51.4*
Transport and the Regions	3.6	4.7	5.1
Local Government	35.3	36.9	39.0
Home Office	8.4	8.8	9.2
Lord Chancellor's Departments	2.5	2.8	2.7
Attorney General's Departments	0.4	0.4	0.4
Defence	18.1	18.4	18.5
Foreign and Commonwealth Office	1.1	1.2	1.1
International Development	2.4	2.7	3.0
Trade and Industry	3.0	4.1	3.7
Environment, Food and Rural Affairs	1.5	2.1	1.7
Culture, Media and Sport	1.0	1.0	1.1
Work and Pensions (administration)	5.2	5.8	6.1
Scotland[2]	12.7	14.8	15.4
Wales[2]	6.8	7.6	8.2
Northern Ireland Executive[2]	4.6	5.0	5.3
Northern Ireland Office	1.1	1.0	1.1
Chancellor's Departments	3.6	4.0	4.0
Cabinet Office	1.2	1.5	1.4

Employment Opportunities Fund[3]	0.6	0.9	0.9
Invest to Save Budget	0.0	0.0	0.0
Capital Modernisation Fund	0.0	0.0	0.0
Policy Innovation Fund	0.0	0.0	0.0
Reserve	0.0	1.6	1.3
Allowance for shortfall[4]	0.0	-3.1	0.0
Total Resource Budget DEL	**170.8**	**187.6**	**201.3**
Capital budget			
Education and Skills	1.6	2.9	3.0
Health	1.3	2.5	2.4
of which: NHS	*1.3*	*2.3*	*2.3*
Transport and the Regions	5.9	7.3	8.1
Local Government	0.1	0.1	0.3
Home Office	0.5	1.1	0.9
Lord Chancellor's Departments	0.1	0.1	0.1
Attorney General's Departments	0.0	0.0	0.0
Defence	5.2	5.5	5.7
Foreign and Commonwealth Office	0.1	0.1	0.2
International Development	0.2	0.4	0.4
Trade and Industry[1]	0.3	0.8	0.8
Environment, Food and Rural Affairs	0.4	0.5	0.5
Culture, Media and Sport	0.0	0.1	0.1
Work and Pensions (administration)	0.1	0.2	0.1
Scotland[2]	2.0	2.4	2.3
Wales[2]	0.8	0.9	1.1
Northern Ireland Executive[2]	0.7	0.8	0.8
Northern Ireland Office	0.0	0.1	0.1
Chancellor's Departments	-0.2	0.3	0.2
Cabinet Office	0.2	0.3	0.2
Employment Opportunities Fund[3]	0.7	0.0	0.0

Invest to Save Budget	0.0	0.0	0.0
Capital Modernisation Fund	0.0	0.3	0.9
Policy Innovation Fund	0.0	0.0	0.0
Reserve	0.0	0.0	0.3
Allowance for shortfall[4]	0.0	-1.8	0.0
Total Capital Budget DEL	**20.1**	**24.9**	**28.3**
Total Departmental Expenditure Limits	**190.9**	**212.5**	**228.6**
Total education spending[5]	45.9	49.7	53.7

[1] *Includes the capital expenditure of the Export Credits Guarantee Department*

[2] *For Scotland and Wales and Northern Ireland, the split between current and capital budgets is decided by t executives.*

[3] *Formerly Welfare to Work expenditure financed by the Windfall Tax.*

[4] *It is assumed that over the year underspends in total will offset the drawdown of End Year Flexibility.*

[5] *Plans as at Budget 2001*

B62. Table B17 gives a breakdown of public sector capital expenditure.

Table B17: Public sector capital expenditure

			£ billion
	Outturn		**Projections**
	2000-01	**2001-02**	**2002-03**
CG spending and LA support in DEL	10.4	15.6	19.2
Locally-financed spending	1.9	1.9	1.9
National Lottery	1.1	1.1	1.2
Public corporations[1]	4.6	4.8	4.6
Other capital spending in AME	1.0	2.6	1.5
Allocation of reserve and AME margin	0.0	0.0	0.3
Public sector gross investment[2]	**19.0**	**26.0**	**28.8**
Less depreciation	12.7	13.2	14.0
Public sector net investment[2]	**6.3**	**12.9**	**14.8**
Proceeds from the sale of fixed assets[3]	4.5	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 acco arriving at public sector gross and net investment, which are net of sales of fixed assets.*

B63 Table B18 shows estimated receipts from asset and loan sales from 2000-01 to 2003-04. The table shows that, following fix £4 $^1/_2$ billion last year, the Government expects further sales of £4 billion in this year and each of the next two years.

B64. The figures for sales of financial assets include outturn proceeds from the sale of a stake in National Air Traffic Services in 2001 and estimated proceeds from the Public Private Partnership for the Defence Evaluation and Research Agency.

Table B18: Loans and sales of assets

		£ billion	
	Outturn		Projections
	2000-01	2001-02	2002-03
Sales of fixed assets[1]			
Central Government	1.2	1.0	1.0
Local Authorities	3.3	2.8	2.8
Total sales of fixed assets	**4.5**	**3.8**	**3.8**
Total loans and sales of financial assets	**-3.8**	**-2.7**	**-2.8**
Total loans and sales of assets	**0.8**	**1.0**	**1.0**

[1] *National accounts definition of capital. Excludes single-use fighting equipment by Ministry of Defence, whic as capital under resource accounting, and expenditure on and sale of which will be included in the capital bu resource budgeting.*

Financing Requirement

B65. Table B19 presents projections of the net cash requirement by sector, giving details of the various financial transactions tha net borrowing (the change in the sector's net financial indebtedness) but do affect its financing requirement.

Table B19: Public sector net cash requirement

	£ billion						
	2000-01				2001-02		
	General government				General government		
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporati
Net borrowing	**-19.0**	**-0.6**	**0.8**	**-18.8**	**1.3**	**0.6**	
Financial transactions							
Net lending to private sector and abroad	3.7	0.1	0.3	4.1	2.9	-0.1	
Cash expenditure on company securities	0.0	0.1	0.3	0.3	-0.1	0.0	
Accruals adjustments on receipts	-19.7	-0.4	0.2	-19.9	1.3	0.0	
Other accruals adjustments	-2.6	0.0	0.0	-2.6	-0.4	0.0	
Miscellaneous financial transactions	0.5	0.2	-0.7	-0.1	-0.2	0.0	
Own account net cash requirement	-37.1	-0.6	0.8	-36.9	4.9	0.5	
Net lending within the public sector	1.8	-1.1	-0.7	0.0	1.4	-1.0	
Net cash requirement[1]	-35.3	-1.7	0.1	-36.9	6.3	-0.5	

[1] *Market and overseas borrowing for local government and public corporation sectors*.

B65. Table B20 updates the financing arithmetic for 2001-02 to allow for the latest forecast of the central government net cash re Debt and Reserves Management Report 2001-02, published in March, outlined how the Government planned to finance its net ca in 2001-02.

Table B20: Financing requirement forecast

	2001-02		
	Original remit	Revised remit[1]	Pr
£ billion	March 2001	April 2001	
Central government net cash requirement	**0.3**	**0.3**	
Accrued uplift on index linked gilts	1.1	1.1	
Expected net financing of official reserves	1.3	1.3	
Expected gilt redemptions	16.7	16.7	
Debt buy-backs	1.0	1.0	
Financing requirement	**20.4**	**20.4**	
Less assumed net National Savings contribution	-3.0	-3.0	
Less changes in DMO's balance at BoE	-	0.3	
Net financing requirement	**23.4**	**23.1**	
Contingencies			
Less change of Ways and Means facility	na	0.0	
Less increase in planned Treasury Bill stock	na	5.0	
Less further reduction in net short term debt[2]	na	4.6	
Planned gross gilt sales	**13.5**	**13.5**	
Gilt sales to date (April-October 2001)	7.7		
of which			
Short conventionals (3-7 years)	0.0		
Medium conventionals (7-15 years)	2.5		
Long conventionals (>15 years)	2.5		
Index-linked	2.7		
Further planned gilt sales			
Short conventionals (1-7 years)	0.0		
Medium conventionals (7-15 years)	2.3		
Long conventionals (>15 years)	3.0		
Index linked	1.0		

Note: figures may not sum due to rounding.

[1] *An update of 2001-02's financing arithmetic was published when the outturn for 2000-01 was published*

[2] *Excluding DMO cash deposit at the Bank of England*