PRE-BUDGET 98

Pre-Budget Report

November 1997

Securing Britain's long term economic future

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To encourage debate of the important economic issues in this Pre-Budget Report, the Chancellor of the Exchequer will be issuing a range of documents over the coming weeks. Information on these can be obtained from the Treasury's Public Enquiry Unit, Room 89/2, HM Treasury, Parliament Street, London, SW1P 3AG (Tel: 0171 270 4558 or 4860) or from the Treasury's internet site: http://www.hm-treasury.gov.uk

The Treasury will also be arranging a number of regional meetings in the coming months to discuss the issues raised.

The Chancellor of the Exchequer welcomes all contributions to this Pre-Budget debate. Comments can be sent by post to:

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Contents

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Introduction

In the Government's first Budget in July, I set out the economic challenge facing Britain.

As we approach the start of the twenty-first century, Britain faces enormous challenges but has huge new opportunities. If we are to succeed in the global marketplace and have the living standards and public services we expect in a modern society, government, business and individuals must work together with shared economic goals.

The Government's central economic objective is to achieve high and stable levels of growth and employment. In doing so, we want to encourage a fair society in which everyone can share in higher living standards and greater job opportunities. And we want economic development to take place in a way which safeguards the environment for future generations.

In launching this Pre-Budget Report, my aim is to begin a national debate on the major economic issues we face. For too long in the past, Britain has lacked a shared sense of common economic purpose. I want to encourage an open discussion of the economic problems we will all have to address and the possible solutions that are open to us to secure our long-term economic future.

Over the coming months, the Government will listen carefully to all points of view. The debate will inform my decisions for the Spring 1998 Budget.

Rt Hon Gordon Brown MP
Chancellor of the Exchequer
November 1997

1 Overview

Introduction

1.01 The Government's central economic objective is to achieve high and stable levels of growth and employment so that everyone in Britain can share in higher living standards and greater job opportunities.

1.02 In the modern global market place, this challenging objective requires continuous increases in productivity, the breaking down of all barriers to growth and job creation, and a permanent improvement in the employability of the British people.

1.03 The quality of the environment plays an important part in people's standards of living so the Government also attaches importance to economic development taking place in a way which safeguards the environment for present and future generations.

1.04 A strong economy is an essential foundation for the provision of high quality public services. While the Government is determined to ensure that every penny spent on public services is used as effectively as possible, the overall level of provision that will be possible in future is strongly dependent on the overall performance of the economy.

1.05 The achievement of these goals requires a long-term focus. Major improvements are needed both in Britain's product markets and in its labour market. Britain's productivity is significantly behind its major competitors, and in nearly 20 per cent of households with people of working age, no one is currently in work. Economic stability is also essential. In the past, long-term development has often been the victim of short-term cycles of boom and bust which have destroyed good jobs and good businesses and disrupted public services. The box opposite sets out the Government's key economic priorities which were first set out in the July 1997 Budget. This report addresses some of the ways in which they can be taken forward.

1.06 Lasting results will only be achieved if government, business and individuals can work together with common economic purpose. The Government is putting forward its own analysis of the economic challenges facing Britain and possible solutions but it wants to hear other views as well. There is a wealth of experience in Britain and the Government wants to encourage as wide a discussion as possible. The Pre-Budget Report offers a basis for starting a national economic debate.

Economic stability

1.07 Low inflation and low government borrowing are both essential building blocks for long-term growth.

Monetary policy

1.08 The Government's new arrangements for monetary policy have given operational responsibility for setting interest rates to the Bank of England. This has strengthened the prospects for meeting the Government's inflation target (of 2 ½ per cent for RPIX inflation). Since May, market expectations of inflation have fallen by about a full percentage point, lending support to this view.

1.09 The monetary framework is currently being legislated for under the Bank of England Bill. This has now reached Committee stage and is expected to receive Royal Assent by Spring 1998. The Bill will ensure that the Government retains clear responsibility to Parliament for defining the goals of monetary policy, while the Bank is accountable for their achievement. The UK's monetary policy framework is amongst the most transparent and accountable in the world and it means that people and business can now plan ahead with far greater assurance that the inflation target will be met.

Fiscal policy

1.10 The challenge now is to apply a similar approach to fiscal policy: to put in place arrangements to ensure that governments will always set fiscal policy in ways which promote economic stability and which are in Britain's long-term interests. The Government therefore proposes to introduce legislation for a Code for Fiscal Stability.

1.11 The Code would require the Government to:

- adhere to a set of principles of fiscal policy management;
- make available a wider range of information on fiscal policy than before, with the same emphasis on reporting and

accountability that has been made in the monetary policy framework; and
- ensure that the information is produced on the basis of high quality accounting standards.

A discussion paper on the Code is being published alongside this Pre-Budget Report.

1.12 The July 1997 Budget set out two rules which will guide fiscal policy:

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

and it also set out the Government's deficit reduction plan. The public finances section of this report (Appendix B) shows that the deficit reduction plan remains well on course to meet these rules. This section also shows that the UK government deficit and debt ratios are expected to be significantly below the Maastricht reference values in 1997 and thereafter.

1.13 Chapter 2 gives additional information about how the fiscal rules will be applied, taking into account the lessons from recent experience, and sets out the five key principles which will guide fiscal policy and which will be enshrined in the Code for Fiscal Stability. It also draws together other developments that will help to strengthen the implementation of the fiscal framework over time, including the introduction of resource accounting and budgeting and use of balance sheet information. A discussion paper will be published shortly on making more use of public sector balance sheet information in fiscal policy.

EMU

1.14 The Government's monetary and fiscal policies will play a critical role in developing the period of stability that is necessary before the UK is ready to join EMU, should the Government, Parliament and the people so decide. The Government plans to monitor the inflation target in the light of the practices of the European Central Bank (ECB) and will ensure that the effect of the fiscal rules, and the deficit reduction plan, continue to be consistent with the terms of the Stability and Growth Pact.

Comprehensive Spending Review

1.15 The Government is at present conducting the Comprehensive Spending Review promised in its Election Manifesto. This is looking at each department's objectives and every aspect of spending, within departments and across traditional departmental boundaries. It will ensure that spending contributes to the Government's overall objectives as effectively and efficiently as possible.

Removing barriers to growth and employment

1.16 A recent report on competitiveness from the Department of Trade and Industry ("Competitiveness: a benchmark for business") showed that many UK companies lag well behind the standards of the best. Bringing the rest of British business up to world class standards will involve tackling a number of deep-seated problems.

1.17 Government can play an important role in improving business performance by helping to remove barriers to growth:

- promoting fair competition and efficient regulation;
- fostering a culture of entrepreneurship and innovation;
- improving Britain's record on research and development;
- providing, in partnership with the private sector, the infrastructure and high quality public services that are essential to the British economy; and
- ensuring that the tax system promotes high quality investment.

1.18 Chapter 3 explores the barriers to growth and employment within the business world and summarises some of the measures the Government is taking to address the problems and meet the Government's objective of raising the trend rate of growth of the British economy. In particular, it describes changes to the tax system which the Government intends to introduce in the Spring 1998 Budget to improve the environment for high-quality investment.

Employment opportunity

1.19 There have been enormous changes in the labour market in recent years. With developments in new technology and global competition, modern workers need to be able to adapt to rapid change.

1.20 In this new environment, there are new challenges both for government and for individuals. Government has responsibilities to:

- promote a flexible and adaptable labour market;
- encourage investment in skills;
- help people from welfare to work; and
- make work pay.

Individuals have responsibilities to take advantage of the new opportunities that are available.

1.21 Chapter 4 explores these issues in more detail and puts forward some initial thoughts on how the tax and benefit systems might be reformed. It also sets out new ways in which the Government is developing the Welfare to Work initiative: for disabled people, for lone parents, to help with childcare, and to address the problem of skills shortages.

Fair taxes

1.22 The Government announced in the summer a range of reviews across the tax system to ensure that it reflects the following principles:

- the encouragement of employment opportunities and work incentives for all;
- the promotion of savings and long-term investment;
- fairness so that everyone bears their fair share of taxation and pays the correct amount; and
- transparency, so that the system is seen to be fair.

1.23 In this report, tax issues fall across Chapters 3, 4 and 5. Those which are principally motivated by the need to promote productive investment are discussed in Chapter 3; those which are of primary significance to improving work incentives are covered in Chapter 4; and those which are primarily driven by the wish to see a fairer tax system are in Chapter 5.

1.24 Chapter 5 contains a progress report on the various tax reviews which are taking place, and describes the principles which have motivated the Government's development of the new individual savings account (ISA) which will replace PEPs and TESSAs from 1999. The details of the new ISA will be announced in an Inland Revenue consultation paper on 2 December.

1.25 Chapter 5 also contains details of additional payments which will be made to pensioners, this year and next, to help with their winter fuel bills ahead of the conclusion of the Government's pensions review.

The economic outlook

1.26 Success in developing the long-term policies outlined in this report depends in part on not being diverted by short-term economic factors.

Latest forecast

1.27 The Treasury's latest economic forecast, set out in Appendix A, shows that after growing at close to its trend rate for much of 1995 and 1996, GDP accelerated sharply in the second half of last year, and has grown at an annualised rate of around 4 per cent over the past four quarters. This is well above its sustainable rate. Evidence suggests that there is now little or no spare capacity and signs of skills shortages are emerging in certain areas, in part reflecting past under investment in education and training.

1.28 The decisive actions taken by the Government at the start of its term of office will help deliver the economic stability that is required for lasting growth and high levels of employment. The new monetary framework, which takes decisions on interest rates out of the political arena, gives people and business far greater confidence to plan ahead on the basis that the inflation target will be met. Further, the significant tightening of the fiscal stance in July, acknowledged by the International Monetary Fund (IMF), and being delivered as shown in Appendix B, has supported these aims. As a result, the Government is now more optimistic that the economy is on course to get back on track next year. GDP growth is thus expected to slow to more sustainable rates from the beginning of 1998 with domestic demand growth slowing through the year and net trade exerting a negative influence. The overall stance of policy will be reviewed ahead of the Spring Budget.

Future risks

1.29 But there can be no complacency about the short-term prospects. Interest rates were increased by a quarter per cent on 6 May under the old arrangements and since its creation in May the Monetary Policy Committee (MPC) of the Bank of England has raised base rates by a further one percentage point in four equal steps in order to ensure the inflation target is hit.

1.30 As explained in this report, the Government is pursuing a range of policies which, in the long term, will increase the rate of growth the economy can sustain without putting upward pressure on inflation. It is also taking action to accelerate the impact of the New Deal on skills shortages. But it will take time for these policies to work through fully. One of the key choices facing the British economy in the coming months is whether wage increases remain at sustainable levels, so allowing interest rates to remain as low as possible and growth to continue while the Government's policies have time to begin to work; or whether wage increases accelerate, requiring interest rates to be correspondingly higher in order to hit the inflation target, with an inevitable short-term impact on growth and on employment.

Conclusion

1.31 The pursuit of sound and transparent macroeconomic policies is essential to provide a strong foundation for future economic development, giving people and business the certainty they need to plan ahead, and ensuring a stable and competitive exchange rate in the medium term. Comprehensive action to tackle product market and labour market barriers will help business strengthen its competitiveness and deliver sustainable growth and good job prospects over the coming years. Taken together, the Government believes this framework and these measures will help achieve its economic aims.

2 Economic stability

Introduction

2.01 The Government's key economic and social goals are high and stable levels of growth and employment, a fairer society and higher standards of living for everyone. These goals are attainable because of the creativity, flexibility and inventiveness of the British people. However, the Government can also make an important contribution by creating a stable economic environment in which people and businesses can plan and invest with confidence.

2.02 In recognition of the need for a stable economy, in its fifth day in office the Government announced a new framework for monetary policy - one that ranks amongst the most open and transparent in the world. The Bank of England is now free to set interest rates so as to achieve the Government's target of low inflation, giving everyone greater assurance that the inflation target will be met and helping to reduce the likelihood of a repeat of the boom and bust cycles that have undermined the UK's economic performance in the past.

2.03 The task now is to apply a similar approach to fiscal policy - to build a framework that will promote economic stability and help Britain to achieve its key economic and social goals. The Government is making a start by setting out the principles that will guide fiscal policy in the future and by signalling its intention to legislate for a Code for Fiscal Stability. This chapter also looks in more detail at the implementation of the fiscal rules and the development of the wider fiscal framework.

2.04 In the July Budget, the Government announced new fiscal rules together with a deficit reduction plan to ensure that those rules will be met. The new forecast of the public finances set out in Appendix B shows that the deficit reduction plan remains well on course.

2.05 The July Budget also tightened fiscal policy, helping to reduce the PSBR to close to balance next year and to support monetary policy in reducing inflationary pressure. The International Monetary Fund (IMF), after its annual mission to review the UK economy, recognised that firm implementation of the deficit reduction plan "should boost credibility, slow the upswing, and set the public finances on a sound medium-term track".

Principles that will guide fiscal policy

2.06 Five important principles lie at the heart of the Government's fiscal policy framework:

- **transparency** in the setting of fiscal policy objectives, the implementation of policy, and in the presentation of the public accounts;
- **stability** in the policy-making process and in the way fiscal policy impacts on the economy;
- **responsibility** in the management of the public finances;
- **fairness**, not least between generations; and
- **efficiency** in the design and implementation of fiscal policy, and in managing both sides of the public sector balance sheet.

2.07 By applying these principles consistently in practice, the Government is confident that it can make a vital contribution to the achievement of its economic and social objectives. The box below explains the significance of the principles.

Why are the Government's fiscal principles important?

Transparency encourages the sound, long-term policies that are essential for achieving high and stable levels of growth and employment. It leads to increased certainty about government policy-making and its impact on the economy, so that people and businesses can plan for the future with greater confidence. Greater transparency and accountability encourage long-term policies that benefit the many, rather than short-term policies that benefit the few.

Stability is vital for good economic performance. Stability of fiscal policy means having a predictable approach to guide policy over the whole of the economic cycle. Fiscal policy must also help to promote a stable economic environment. Too often in the past, the British economy has been subject to excessive swings in economic performance - so-called boom and bust cycles.

Responsibility is fundamental for a sound and prudent approach to managing the public finances, and a key element of any framework designed to achieve long-term goals. The Government will conduct fiscal policy in the best long-term interests of Britain, rather than chasing short-term goals.

The Government is committed to **fairness**, both between and within generations. Future generations should not be unfairly burdened with meeting the cost of policies that primarily benefit the current generation. Similarly, the current generation should not be expected to pay unduly for policies which will benefit only future generations.

Efficiency and value for money in use of scarce resources are of prime importance if we wish to meet our economic and social goals. The Government will ensure that both sides of the public sector balance sheet - assets and liabilities - are managed in an efficient way.

2.08 The Government does not intend to stop at merely setting out these principles. In proposing a Code for Fiscal Stability, it is seeking to take action to ensure that fiscal policy decisions are consistent with the principles and promote long-term economic stability.

A Code for Fiscal Stability

2.09 To build on the many steps already taken to enhance the transparency and credibility of policy-making, the Government intends to implement a Code for Fiscal Stability. The Code will draw together and make clear the framework in which fiscal policy will operate, with the same emphasis on reporting and accountability that characterises the monetary policy framework. It will be enshrined in legislation to demonstrate further the strength of the Government's commitment to achieving long-term economic success.

2.10 The Code will underpin fiscal discipline and reaffirm the Government's intention to pursue fiscal policy that promotes Britain's long-term interests. The Government believes the Code is a valuable addition to the policy framework and can help to rebuild trust in fiscal policy. This is one of the reasons why the Chancellor proposed, in his statement to the Interim Committee in September, that the IMF, in conjunction with the World Bank and the Organisation for Economic Cooperation and Development, develop a code of good practice for promoting openness and transparency in fiscal and monetary policy.

2.11 As a minimum, the Code for Fiscal Stability will require the Government to state how it intends to operate fiscal policy, both in the short term and in the long term, so as to ensure that the principles of fiscal policy are respected.

2.12 The Government is publishing alongside this Pre-Budget Report a discussion paper on the proposed Code for Fiscal Stability(1), giving more details and inviting comments. The discussion paper suggests that the Code should require the Government to:

- give due regard to the principles of fiscal management when setting fiscal policy;
- publish a wider range of reports and information on the economic and fiscal outlook and the Government's fiscal strategy;
- adopt best practice accounting standards for the public finances, including resource accounting and budgeting and the development of better measures of public assets and liabilities.

The fiscal rules

2.13 A key element of the new fiscal framework is the adoption of two strict fiscal rules:

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

2.14 These rules, the deficit reduction plan and the proposed Code for Fiscal Stability establish a sound long-term basis for fiscal policy. By applying the fiscal rules over the economic cycle, the automatic stabilisers are allowed to operate, which can contribute to economic stability. However, it is important to take a cautious approach so that the automatic stabilisers do not disguise a worsening in the underlying fiscal position.

2.15 On some occasions, discretionary changes in fiscal policy may provide a useful support to monetary policy - for instance, the fiscal tightening in the July Budget is helping to offset some of the pressures on monetary policy. However, such action must always be based on adherence to clear fiscal rules, transparency and a continuing bias towards caution. Discretionary fiscal changes should only be made if they are demonstrably consistent with achievement of the Government's fiscal rules over the economic cycle.

2.16 The fiscal rules focus on the whole of the public sector, because the debts of any part of the public sector could ultimately fall on the taxpayer. Looking at the whole public sector also removes incentives to reclassify activities simply to evade prudent constraints on borrowing.

The golden rule

2.17 The golden rule distinguishes between current spending and investment, since worthwhile capital spending by government provides benefits for both current and future generations. By aiming to match over time the costs and benefits of public expenditure, the golden rule is consistent with the principle of fairness between generations. Moreover, the golden rule is also consistent with the principle of efficiency because it means that growth-enhancing public investment will not be sacrificed for current spending or lower taxation.

2.18 The Government currently monitors progress against the golden rule using the public sector current balance, based on national accounts data produced by the Office for National Statistics (ONS) apart from two differences. Firstly, the cost of capital consumption, i.e. depreciation, is treated as current spending so that it is met through taxation rather than borrowing, just like any other consumption. Secondly, capital taxes are counted as current receipts because they are not strictly speaking capital transactions.

2.19 Meeting the golden rule means the avoidance of a current account deficit on average over the economic cycle. The UK failed to meet this benchmark over the last economic cycle (from 1985-86 to 1996-97) when the public sector current balance was on average in deficit by over 1 ½ per cent of GDP. In 1996-97, the public sector current deficit was 2 ½ per cent of GDP.

2.20 Using national accounts data for the purposes of the golden rule ensures that its implementation is transparent. Over the course of this Parliament, there will be two significant changes to the way that public expenditure is recorded. First, next year's national accounts data produced by the ONS will be based on the new European System of Accounts (ESA95). More significantly, the first set of departmental resource accounts will be published for 1999-2000.

2.21 Resource accounting and budgeting (RAB) offers substantial benefits in its own right (see paragraphs 2.35 to 2.39 below). It also offers improved information for the purposes of fiscal planning. In particular, resource accounting will provide better information on a basis consistent with the golden rule for aggregate capital spending and capital consumption. Adopting information on this basis would mean that the system of public expenditure accounting, budgeting and control corresponds more closely with the fiscal framework.

CHART 2.1: Current balance (excluding windfall tax and associated spending)

Stable and prudent public debt ratio

2.22 The rule for the public debt ratio complements the golden rule by ensuring that any borrowing for public investment is conducted in a responsible way. It promotes fairness between generations by preventing the current generation from running-up an excessive stock of public debt. That is why, on average over the economic cycle, the ratio of public debt will be held at a stable and prudent level.

2.23 Progress against the rule for public debt can be judged by looking at the ratio of net public sector debt to GDP, which nets off most financial assets from liabilities; and by looking at the ratio of general government gross debt to GDP, which is the measure used in the European Union (EU) excessive deficits procedure.

2.24 The deficit reduction plan introduced in July sets the debt ratio on a downward path, see Chart 2.2, which is sensible at this stage of the economic cycle.

CHART 2.2: Public debt

Taking account of the economic cycle

2.25 The fiscal rules are set as an average over the economic cycle to recognise the significant effect of cyclical fluctuations on the public finances. This approach aims to enhance stability by allowing borrowing to fluctuate due to cyclical changes in output (i.e. by allowing the automatic stabilisers to operate). On present estimates, the economy is currently not far from its sustainable trend so, for the purposes of evaluating the fiscal policy against the rules, outturns for 1997-98 will represent the starting point of the economic cycle.

2.26 Fiscal policy will be guided by cyclically-adjusted estimates of the fiscal indicators, also making an allowance for uncertainty. However, in deciding what effect Budget changes should have on public borrowing, attention must also be paid both to previous progress against the fiscal rules as well as to future prospects. This is because a policy of targeting a zero cyclically-adjusted current balance might not guarantee meeting the golden rule on average over the economic cycle if the upswing and downturn phases of the cycle were of different length or strength.

2.27 This transparent approach will help to avoid repeating the mistakes of the past. The fiscal surpluses of the late 1980s were taken largely at face value. However, these surpluses arose only because output was significantly above its trend level. Fiscal policy was relaxed, and the public finances deteriorated rapidly (see Chart 2.3) until the cyclically-adjusted PSBR reached nearly 4 per cent of GDP in 1993-94, with the actual PSBR reaching 7 per cent of GDP. The ratios of public debt to national income have risen every year in the 1990s to date, because of high levels of government borrowing.

CHART 2.3: PSBR illustrative projections 1989-92

2.28 Five years of stringent fiscal control have been required to retrieve the situation. The deficit reduction plan introduced in the July Budget took a major step forward towards securing sound public finances. However, the UK is still paying for these earlier mistakes in terms of higher debt interest payments. If policy then had made some allowance for uncertainty and had taken greater account of the economic cycle, the severity of the deterioration might have been avoided. A discussion paper has been published, looking in more detail at lessons from the last economic cycle(2).

Performance against the fiscal rules

2.29 The outlook for the UK economy and the public finances is set out in detail in Appendix B. In brief, the fiscal outlook has changed very little since the July Budget and the deficit reduction plan set out then remains well on course.

Uncertainty and the fiscal projections

In assessing the state of the public finances, it is helpful to adjust figures for the effect of the economic cycle. The adjustment is based on the Treasury's estimate that a 1 per cent increase in output relative to trend would reduce the PSBR by around ¾ per cent of GDP by the following year. The chart below shows the cyclically-adjusted PSBR (excluding windfall tax and associated spending). The deficit reduction plan outlined in the July Budget sees a significant reduction in the cyclically-adjusted deficit over time.

CHART: Cyclically-adjusted PSBR - central case

The cyclical position of the economy is subject to considerable uncertainty. The Treasury's assessment is that the economy is currently not far from its trend level. However, if this proved to be wrong, then so would the estimate of the cyclically-adjusted deficit. As the costs of being optimistic are likely to be greater than those of being pessimistic, the chart below shows an alternative, more cautious, estimate of the cyclically-adjusted PSBR based on a level of trend output 1 ½ per cent lower (i.e. that there is a significant positive output gap) than our central view. This cautious case highlights the need to keep borrowing under control to ensure that the fiscal rules are met.

CHART: Cyclically-adjusted PSBR - cautious case

2.30 The forecast figures, summarised in Table 2.1, show that, over the economic cycle, the Government is well on track to meet the fiscal rules it set out in July:

- even on the highest spending case, the public sector current account looks to be heading for a reasonable surplus on average between 1997-98 and 2001-02;
- both measures of the debt ratio are projected to fall significantly after this year.

Table 2.1: The public finances

	per cent of GDP						
	Outturn	Forecast		Projections(1)			
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Current balance(2)	-2 ½	- ¾	¼	¾ to 1 ¼	1 ½ to 2 ½	2 to 3 ½	2 ¼ to 4 ¼
GGFD(2)	3 ¾	1 ¾	¾	- ¼ to ¼	-1 ½ to - ½	-2 ½ to - ¾	-3 ¼ to -1 ¼
PSBR(2)	3	1 ½	¾	- ¼ to ¼	-1 ¼ to - ¼	-2 ¼ to - ½	-3 ¼ to -1
Net public sector debt(3)	45	44	43	41 to 42	39 to 40	35 to 38	30 to 35
General government gross debt(3),4	54 ¼	52 ¼	51	49 to 50	46 to 48	42 to 46	38 to 43

1 Based on three illustrative assumptions for spending growth (see paragraph B.22).

2 Excluding windfall tax receipts and associated spending.

3 Figures from 1999-2000 rounded to nearest per cent.

4 Definition on a Maastricht basis.

2.31 However, there are still large uncertainties and there is no room for complacency. It is still possible that the forecast could turn out to be optimistic: for instance, if the cyclical position of the economy was worse than expected (see the above box on uncertainty); or if the medium-term fiscal prospect was worsened by lower tax revenues or higher public spending. If so, it would be more difficult to meet the fiscal rules.

2.32 The decision whether to make any change to the overall stance of policy will therefore be taken nearer the time of the Spring Budget. The decision will be based on the latest information on economic and fiscal prospects, taking into account both the overall stance of macroeconomic policy and the balance between monetary and fiscal policy.

Fiscal policy and Europe

2.33 In addition, the deficit reduction plan also demonstrates the Government's commitment to avoiding an excessive deficit under Article 104c of the Maastricht Treaty. The effect of the fiscal rules and the deficit reduction plan, which explicitly errs on the side of caution to ensure that the Government's goals are achieved, continues to be consistent with the terms of the EU Stability and Growth Pact. The Maastricht measure of the deficit is expected to be 1 ¾ per cent of GDP in 1997, comfortably below the 3 per cent reference value. Moreover, in 1998, the UK is expected to have lower government borrowing than any other major EU country. The box below summarises the Chancellor's statement on UK membership of EMU.

The UK and the single currency

The Chancellor set out the Government's approach to EMU on 27 October, in a statement to the House of Commons. He said that in principle membership of a successful single currency would be of benefit to Britain, and that the determining factor for joining was whether it was in Britain's national economic interest. On the basis of an assessment of five economic tests, and the fact that the necessary preparations had only just begun, the Chancellor concluded that, barring some fundamental and unforeseen change in economic circumstances, making a decision during this Parliament to join was unrealistic. The tests covered:

Convergence: It is not yet possible to be confident that the British economy can have stability and prosperity with a common European monetary policy. Britain's business cycle is out of line with our European partners, as is evident with British official short interest rates above 7 per cent compared with just over 3 per cent in Germany and France, and this divergence is expected to continue for some time.

Flexibility: Britain will need flexible labour and product markets to deal with problems if they emerge in EMU. Persistent long-term unemployment, lack of skills and, in some areas, insufficient competition indicate that there is not yet enough flexibility in the UK to meet the challenges of a single currency.

Investment: Membership of EMU could help create conditions for higher and more productive investment, through reduced exchange rate uncertainty, lower transactions costs and greater price transparency. But entry without proper preparations and sufficient convergence would be costly.

Financial Services: The Treasury assessment concluded that the financial services industry has the potential to thrive in or out of EMU, though the benefits would be easier to capture from within the euro area.

Employment and Growth: Employment-creating measures and welfare state reform will be important before any move to EMU. Whether membership of the single currency would be good for jobs comes back to sustainable convergence. At present, in vital areas the economy is not yet ready.

In order to have a genuine choice in the future, Britain needs to prepare now so that there is a real option of joining early in the next Parliament, should we wish to. Britain also needs a settled period of sustainable convergence, as well as a period for preparation. Both require stability. The measures outlined in this Chapter, together with the labour and product market reforms discussed elsewhere in this Report, will contribute to making Britain better able to pass the economic tests in due course.

To assist preparations the Government has commenced work on the detailed transitional arrangements for the possible introduction of the euro in Britain and stepped up work on what business should do to prepare for EMU. The Chancellor has established a standing committee to oversee preparatory work and longer term arrangements.

The wider fiscal framework

2.34 The Government is committed to meeting its fiscal rules. A wider fiscal framework is needed to support this goal, and at the same time take forward the Government's five principles of fiscal policy. The Government has already taken a series of actions to put the elements of this framework in place, and is committed to developing it further - for example, through the proposed Code for Fiscal Stability. Many of these elements aim to ensure that progress can be assessed with maximum transparency, consistent with the Government's long-term aims.

Resource accounting and budgeting

2.35 Resource accounting and budgeting (RAB) applies to central government the financial reporting practices of both the private sector and much of the rest of the public sector. The move to RAB is an integral part of the Government's new fiscal framework. Based on accruals accounting, RAB captures the full costs of resources consumed in the production of outputs during the reporting period. RAB will underpin the golden rule by making a clear structural distinction between current and capital spending, which will no longer be treated as if they are equivalent economic categories.

2.36 RAB is being developed in such a way as both to fit within and to increase the transparency of the new fiscal framework and efficiency of public spending. RAB aims to improve the efficiency of public spending and yield greater value for money for the taxpayer. It also underpins the drive towards better stewardship of public assets, so that they are used as productively as possible and to the best effect.

2.37 Departments are on course to produce the first full set of published resource accounts for the financial year 1999-2000. These will be accruals-based accounts similar to those prepared for private sector companies but with two additional features: a statement showing use of resources approved by Parliament, and a statement analysing spending by objective.

2.38 Resource accounts will provide the basis for a new system of public expenditure planning ("resource budgeting"). This should be fully implemented in 2001-02, making use of information that becomes available before then.

2.39 The shape of the overall control framework under RAB has not yet been finalised. Work is currently underway on a pilot exercise to test how decisions on the allocation of resources would be made in practice. In broad terms and on current plans, there will be two key aggregates:

- the **Resource Control Total** (RCT): based on departmental current spending including the current cost of capital use (depreciation and interest) plus relevant items not allocated to departmental programmes;
- the **Total Financing Requirement** (TFR): based on the cash and finance (e.g. borrowing permissions) required by departments to finance their current spending and new capital spending, plus relevant items not allocated to departmental programmes.

The Comprehensive Spending Review

In place of a normal annual Public Spending Survey, the Government has set up a Comprehensive Spending Review (CSR) to reorder spending programmes to meet its priorities. There are 24 departmental reviews led by the relevant Secretary of State, while also involving the Treasury, the Prime Minister's Policy Unit and the Efficiency Unit. There are also 6 cross-departmental reviews on Criminal Justice, Local Government Finance System, Illegal Drugs, Provisions for Young Children, Countryside and Rural and Housing. These cross-departmental reviews have been set up, to ensure that the CSR is not constrained by the existing structure of government, and that different parts of government are working together in the most efficient way. The terms of reference for the reviews were published on 24 July and 30October 1997.

The CSR is also examining the allocation of resources between departments, overseen by a Ministerial committee chaired by the Chancellor.

These reviews are zero based and are examining each spending programme, considering whether it meets the public interest; whether it contributes to the achievement of the Government's objectives; whether it is the most effective way of achieving those objectives; and whether there is scope for improving efficiency and effectiveness.

The review process is due to finish in the summer of 1998. A new set of spending plans building on the results of the CSR will be announced following its conclusion, providing the foundation for sound public finances and high quality public services into the next century.

Whole of government accounts

2.40 The Government announced in July 1997 that it was to undertake joint research with the National Audit Office (NAO) on the merits and feasibility of whole of government accounts. This study would look at what might be needed to produce a consolidated set of financial statements initially for central government, but beyond that to look at the scope for extending this to the whole public sector, including local authorities and public corporations.

2.41 The initial study will be carried out jointly with the NAO in the case of the accounts of central government bodies, as recommended by the Public Accounts Committee; and in the case of other public sector bodies, in consultation with other relevant auditing bodies, relevant sponsor departments and, through them, with the bodies themselves. The aim is for preliminary conclusions of the initial scoping study to be published by the summer of 1998.

2.42 It is thought that whole of government accounts might provide more robust underpinning for a wide range of fiscal policy decisions. The scoping study will consider the possible benefits in more detail and also set out what further action would be necessary for their production.

Role of the NAO

2.43 Before the July Budget, the NAO was invited to review a proposed more cautious approach in setting a number of key forecasting assumptions and conventions used in the Budget arithmetic. The involvement of the NAO, which enhances the transparency and responsibility of fiscal policy, has been further extended by the invitation to comment on a further four key assumptions used in drawing up the forecast of the public finances detailed in Appendix B. That forecast also maintains the assumptions reviewed by the NAO in advance of the July Budget. The NAO confirmed that the new assumptions to be reasonable and "broadly consistent with past relationships and with each other". The NAO will have a continuing involvement in auditing the public finances in future Budgets.

Publishing details of foreign exchange transactions

2.44 The Chancellor announced in September that he would publish a new quarterly report on foreign exchange operations, a further measure aimed at increasing transparency. This will include the UK's forward foreign exchange position and a full set of annual accounts for the Exchange Equalisation Account which holds the UK's official gold and currency reserves. The new quarterly report will be published around two months after the end of each quarter and will include a commentary on market developments, and a breakdown of reserve assets and liabilities on a consistent basis, including forward positions.

National Asset Register

2.45 The National Asset Register was published by the Treasury on 24 November giving the clearest indication that any government has ever had of the extent and coverage of the assets it owns. Government departments and other bodies will now have a clear statement of their assets, so that they can consider what changes are necessary - disposal or entering a partnership arrangement, for example - in respect of any of those assets which are not contributing to meeting the Government's objectives. It also gives private sector parties and local authorities the basis for proposing how assets could be used more productively to mutual advantage. As such, it is consistent with the Government's principles of transparent and efficient policy.

2.46 In addition, the Government has announced two measures to complement the National Asset Register. From April 1998 until the new resource budgeting arrangements are in place in April 2001, the Treasury will allow departments to reinvest all receipts from the disposal of assets, subject only to certain limits necessary to ensure that these sales do not distort the Government's overall spending allocation.

2.47 Departments are not simply being asked to dispose of surplus assets. The second change is that they are also being encouraged to make better use of those they retain (see paragraph 3.50). This may include increasing commercial activity: for instance to make use of spare capacity, such as Ministry of Defence medical stores; or intellectual property generated by Government research establishments. There is already a good deal of such activity in trading funds and elsewhere similar bodies, but the new measures are designed to encourage efficient use of assets across the whole public sector.

Looking to the future

2.48 As well as proposing the Code for Fiscal Stability, the earlier part of this chapter outlined action that the Government has already taken, or will shortly be taking, to safeguard economic stability and to foster confidence in economic policymaking. Another way in which the fiscal framework can be developed further over time is by making more use of the information in public sector balance sheets.

Monitoring the public sector balance sheet

2.49 The July 1997 Financial Statement and Budget Report included for the first time information on public sector net wealth, which takes account of both sides of the public sector balance sheet: tangible assets as well as net financial liabilities. The inclusion of public sector assets means that the balance sheet offers a richer indication of the health of the public finances over time than public debt alone.

2.50 The public sector current balance, which shows progress against the golden rule, is closely linked to net wealth. If the Government borrows only to invest, any new liabilities will be matched by new assets. Therefore, subject to the measurement difficulties mentioned below, meeting the golden rule should prevent further large falls in the level of public sector net wealth, such as experienced in the first half of the 1990s.

2.51 To date, balance sheets have not played a large part in the fiscal policy framework. There are unresolved questions about how to measure the assets and liabilities in the balance sheet; which items should be included; and how to interpret the data. Some people have argued for a very wide measure of net worth, that takes account of all future cash flows into and out of government, rather than just the balance between existing assets and liabilities.

2.52 Over the next few years, the introduction of resource accounting should greatly increase the quality of available information on assets held by central government, and on the depreciation of those assets. Work on the development of resource accounting has already made possible production of the National Asset Register. Other developments which may provide useful information include the scoping study for producing whole of government accounts and a joint project in which the Treasury is working with the National Institute of Economic and Social Research and the Bank of England to construct generational accounts for the UK.

CHART 2.4: Public sector net wealth

2.53 The Government believes balance sheet data provide useful information on the conduct of fiscal policy and the state of the public sector. A discussion paper looking more closely at these issues will be published shortly. The Government would welcome comments on the issues raised in that paper and on the role which balance sheets should play in setting fiscal policy.

The public sector balance sheet

The ONS publishes balance sheet data, including that for the public sector, in the Blue Book. The last published data were for the end of 1996, when the public sector was estimated to hold tangible assets of £405 billion and net financial liabilities of £340 billion. The balance between these - public sector net wealth - was £65 billion. The public sector balance sheet also provides useful information on the disposition of the public sector's assets and liabilities.

The main tangible assets held by the public sector are: civil engineering works (including roads); commercial industrial and other buildings; and residential buildings. The main financial liabilities are government securities and National Savings.

Changes to public sector net wealth reflect new net acquisitions of, and also changes in the value of, existing assets and liabilities. A large part of the fall in net wealth in the 1990s reflects the high levels of governmental borrowing, much of which was to finance current spending rather than investment. However, falls in the prices of land and buildings in the early 1990s will also have reduced the value of tangible asset holdings, and hence net wealth.

CHART: Public sector net wealth

(1) *The discussion paper, "A Code for Fiscal Stability", is available from the Treasury's Public Enquiry Unit (seepage4 for details)*. Back

(2) *The discussion paper, "Fiscal policy: lessons from the last economic cycle", is available from the Treasury's Public Enquiry Unit (see page 4 for details)*. Back

3 Competition, Innovation and Investment

3.01 Achieving the Government's central economic objective of high and stable levels of growth and employment requires a partnership in the widest sense between government and business. That means ensuring that the respective roles, skills and experience that government and business can bring to bear complement each other across the economy. And it means ensuring that the world-class standards reached by many UK companies become the benchmark for all. The President of the Board of Trade has already launched a dialogue aimed at helping British business reach the standard of the world's best. The Government is committed to making a success of this model of partnership, as the means of meeting its objective of raising the trend rate of growth of the UK economy.

The historical legacy

3.02 In pursuing the objective of improved economic performance and growth, the Government and business must jointly tackle an overall record of poor performance. Although the causes of growth are only imperfectly understood, during the post-war period our record on growth and productivity has fallen behind those of broadly comparable economies.

3.03 During the post-war period up to the mid 1970s, sometimes described as a golden age of growth, the UK's growth rate, though high by historical standards, was significantly lower than that of the US, Japan, Germany and France (see Chart 3.1). In part, this gap arose because some of these economies were catching up with the UK, as post-war reconstruction gathered pace. From the 1970s, as this process of catching up came to an end, the gap between the growth rates of the UK and these economies narrowed but still persisted. Over the post-war period as a whole, many comparable economies not only caught up with the UK, but went on to overtake us.

CHART 3.1: GDP growth

Low productivity

3.04 Figures for GDP per head of the population help demonstrate the size of the gap that persists: since 1960, GDP per head in Japan, Germany and France has increased considerably, to levels well above those in the UK (see Chart 3.2). Most of the differences in GDP per head reflect relatively low levels of productivity (i.e.output per worker) in the UK, compared, for example, to other European economies.

CHART 3.2: Relative GDP per head

3.05 UK productivity is around 10 per cent behind the OECD average and up to 30 per cent behind that of the best (see Chart3.3). That means that we are failing to make best use of our skills and physical assets.

CHART 3.3: Productivity (GDP per worker) levels in 1996

Causes of poor performance

3.06 A number of factors appear to be important in explaining this relatively poor performance. For example:

- the UK's track record of macro-economic instability has discouraged long-term planning and investment; the extremes of boom and bust have also meant that capacity and skills have been lost permanently to the economy during periods of recession;
- the legal and regulatory framework has in some areas failed to do its job of protecting the public whilst encouraging competition;
- in some areas of the economy we have been slow to exploit the commercial potential of new technologies;
- a failure by business to measure performance against high standards and make use of best practice;
- our record on investment has been poor by international standards;
- the workforce has not had the skills necessary to adapt to changing economic conditions and to innovate.

Role of government

3.07 Reversing this legacy represents a significant challenge. The Government's role is not to pick winners, but to improve the conditions within which all businesses and employees operate. Under its new model of partnership with business, the

Government is therefore acting to promote economic stability, improve the legal and regulatory framework, and promote innovation, high-quality investment and employment opportunity.

3.08 Chapter 2 describes the measures the Government is taking to ensure economic stability. The Government's other priority areas for action can be summarised as:

Setting the framework

- putting in place a legal and regulatory framework which will promote fair and open competition whilst protecting the interests of consumers, employees and the environment;
- taking the lead in promoting an open and competitive world economy.

Fostering innovation and entrepreneurship

- removing obstacles in the economy which stand in the way of businesses becoming more innovative and enterprising, for example by reforming the tax system and improving access to finance;
- where government action can add value, fostering networks between different sectors of the economy, promoting partnerships between the private and public sectors and facilitating the development of fast-growing, creative companies;
- providing high-quality public services that provide individuals with the support and security which will help them develop their skills, take risks and innovate.

Encouraging best practice

- encouraging the use of benchmarking with the aim of helping British business to reach the standards of our many world-class companies.

Promoting high quality investment

- forming public-private partnerships to invest in a modern and efficient infrastructure;
- investing in the skills of the workforce;
- ensuring that the tax system promotes high quality business investment.

3.09 Chapter 4 describes the steps the Government is taking to provide employment opportunities in the modern labour market.

Setting the framework

Competition

3.10 Competitive markets are essential to a strong, wealth-creating economy. Competition keeps up the pressure on businesses to raise their game - thereby stimulating innovation and creating new business and employment opportunities. And competition brings benefits to consumers, reflected in prices, quality and choice.

3.11 The Government has a key role to play in setting a legal and regulatory framework which promotes competition. It has already acted in two areas.

Competition Bill

3.12 The Government has made reform of the UK's outdated competition law a top priority: in August, the President of the Board of Trade published proposals for a new legal framework; and a Bill was introduced into Parliament in October. The Government's intention is that the new law should come into effect in 1999.

3.13 The Bill will create a modern and effective framework for competition policy. It is based on a tougher and more rigorous approach to abuses, whilst increasing transparency and accountability.

3.14 The main provisions of the Bill involve:

- introduction of a prohibition-based approach: certain types of anti-competitive behaviour will be prohibited and subject to penalties;

- extending and strengthening the coverage of the law;
- allowing action against abuses while an investigation proceeds;
- making use of EU experience: the legislation will bring UK and EU competition law broadly into line;
- special rules for small firms, to avoid unnecessary burdens;
- strong incentives not to act in an anti-competitive manner: there will be new rights of appeal for third parties, enforcement powers and effective penalties.

3.15 The success of these new arrangements depends on effective implementation. The Government will therefore ensure that the Office of Fair Trading has the necessary resources and uses them effectively, focusing on those areas where its activity will generate the greatest economic return.

Utilities review

3.16 High quality utilities are a pre-requisite for business success. The Government has a central role to play in ensuring effective, independent regulation of the utilities in areas where competition cannot provide sufficient incentives. The windfall tax put right failures in the way the sector was privatised. To set the framework for the future, the President of the Board of Trade established a review of utility regulation in June.

3.17 The Government's main objective for the review is to ensure that the regulatory framework delivers improvements in customer service, value and choice through a greater emphasis on the interests of the consumer. Regulation at arm's length from government will be preserved within a framework set by Ministers. The issues which the review is addressing include:

- increasing the effectiveness of consumers' input to the regulatory system;
- improving the transparency, consistency and predictability of the regulatory regime, to help business make long-term judgements about investment;
- providing incentives for managers to innovate and improve efficiency;
- promoting investment which enhances quality of service.

There will be full consultation on proposals arising from the review.

Better regulation

3.18 Government regulation to protect the interests of consumers and employees underpins an efficient market economy. The Government is determined to improve the quality of regulation in the UK, so that it meets the objective of protecting the public while promoting business success. To take forward this work the Government has established an independent advisory task force, whose members are drawn from a wide range of backgrounds, including the small firms sector. Its initial work programme will cover employment law, consumer affairs, social services and the voluntary sector. It will publish its conclusions in these areas in September 1998.

3.19 The regulation of the financial services industry should promote well-regulated, efficient and honest markets which maintain confidence in the financial sector and protect consumers. The Financial Services Reform Bill will establish a new Financial Services Authority to do so. The new regulatory structure will also help ensure that the financial services industry can develop products and services for UK industries and entrench UK financial markets as world leaders.

Corporate governance

3.20 Improving the way in which firms take decisions can help improve the quality of their investments. The Government therefore attaches high priority to working with business and investors to bring about improvements in standards of corporate governance. It is primarily for businesses to improve the way they work. But government can promote best practice, for example by encouraging long-term investment decisions by companies and major institutional investors, promoting responsible policies for the pay of senior managers and fostering better communication between companies and shareholders, employees and the wider public.

3.21 The Government will judge the issues involved against the objectives of promoting growth and investment and improving transparency and accountability. It will set out its response to the final Hampel report in early 1998.

The international dimension

3.22 It has always been true of the UK that we depend on trade for our economic well-being: the UK today exports more goods and services as a proportion of GDP than any comparable country. As the process of economic globalisation gathers pace, our trading relations with the rest of the world are becoming more important than ever. Moreover, exports, imports and inward investment all have a central part to play in enhancing economic growth and allowing countries to catch up with the performance of others - for example through technology transfer and learning from best practice in other countries. Achieving increases in our economic prosperity therefore depends on others' prosperity and on the existence of an open world economy; in the long run, protectionism helps no-one. Chart 3.4 demonstrates the substantial benefits that more open trading systems can deliver, taking catch-up in GDP per head between the original six EEC member states as a case study.

CHART 3.4: Trade liberalisation and catch up

Twin EU and G7 presidencies

3.23 The Government is playing a leading role in arguing for improvements in the efficiency of the world economy, through reductions in barriers to the free flow of goods, services and investment. The UK's twin presidencies of the EU and G7 in 1998 will provide an opportunity for the Government to take the lead in pursuing these objectives.

3.24 As discussions on enlargement of the EU begin, the Government will argue vigorously for an approach based on the principle of openness: promoting trade both within the single market and with the rest of the world. Reform of the Common Agricultural Policy is a top priority.

3.25 The Government will also press for completion of the single market: the Single Market Action Plan identifies a number of areas in which further progress is needed.

3.26 The Government will work to ensure that the EU's position in the World Trade Organisation (WTO) reflects a commitment to reducing trade barriers and opening markets. An immediate priority is completion of discussions on financial services. Beyond that, the UK will press for progress on competition policy and agriculture and will push at a WTO ministerial meeting in May 1998 for multilateral liberalisation. The Government will pay special attention to the development of trade with developing countries.

3.27 The UK also plays a leading role in the work of international financial institutions. Priorities for the Birmingham G7 summit include a report on economic development in Africa, improving bilateral standards of financial regulation and combating international financial crime.

Tax treaties

3.28 The UK's tax treaties play an important part in opening markets for trade and investment, and are welcomed by business as a means of reducing tax-related barriers and providing certainty of treatment. The Inland Revenue continues to expand and modernise this network: earlier this year the UK passed the landmark of having tax treaties with one hundred countries, giving us the most extensive network of tax treaties in the world.

Innovation and entrepreneurship

3.29 The key to economic success in the global economy lies in responding to competitive pressures by identifying and developing commercial opportunities. If the UK is to raise its levels of income and productivity, we therefore need individuals and businesses to become more innovative and entrepreneurial. That depends in large part on their own efforts. But through its partnership with business, the Government can help remove obstacles to economic success.

Research and development

3.30 A key input to commercial success is research and development (R&D). Though the UK generates much world-class R&D, particularly in high-technology areas, our investment in R&D has been overtaken by that of our main competitors since the 1980s (see Chart 3.5).

CHART 3.5: Research and development

3.31 The Chancellor and President of the Board of Trade will be taking a wide-ranging look at ways of improving the UK's record on investment in R&D. As a first step the Paymaster General is sponsoring a new group looking at ways of improving access to finance for high-technology companies (see box below).

3.32 The President of the Board of Trade has established competitiveness working parties to identify barriers to investment and innovation: the investment working party will look at issues including the cost and availability of capital.

3.33 A steering group supported by DTI, the Treasury, the CBI and the Bank of England will oversee action to identify barriers to growth faced by small, high-technology businesses.

Access to finance: the McCullagh group

The Paymaster General is sponsoring a group examining the financing of high-technology companies, particularly in the start-up stage. The group aims to identify any barriers that may exist in that context to their growth; and make practical proposals within six months. A key focus will be providing the right environment for encouraging R&D. It will be chaired by Dr Keith McCullagh, Chief Executive of British Biotech plc, and include senior figures from high-technology companies, financial services and the venture capital sector.

Making better use of our science base

3.34 The UK also needs to do better at translating investment in R&D and other inputs into commercial success. We already have a world-class science base, which makes a very significant contribution to the economy. For example, business funding on a commercial basis of academic research is higher in the UK as a share of GDP than in most other OECD countries. But we need to do better still, through more emphasis on the development and marketing of high-quality commercial applications. The Government has launched a number of measures aimed at helping our scientists and businesses meet this challenge:

Foresight programme

- a new ministerial group, chaired by a DTI Minister, will provide coordination for the Foresight Programme, which brings together business, scientists and government. And under the new Foresight Link Awards scheme the Government will provide £10 million for projects that make good commercial use of scientific research.

Business incubators

- the Government is supporting the business incubators movement, which provides start-up help for small firms working in high-technology areas: the President of the Board of Trade announced challenge funding in May for the Centre for Business Incubation Policy.

Helping scientists go into business

- the Treasury, DfEE and DTI, including the Office of Science and Technology, are examining ways of developing on a commercial basis the work of scientists in government research establishments and the universities.

Small firms

3.35 Small firms play a vital role in the UK economy: they account for almost half of non-government employment and are an important source of dynamism and innovation. Their size means that they are more vulnerable than larger firms to fluctuations in demand - they will therefore gain most from the Government's commitment to economic stability.

3.36 The Government is also taking direct measures to promote the interests of the sector. For example, the culture of late payment is a source of concern to many small businesses. In the light of a recent consultation exercise undertaken by the President of the Board of Trade, the Government will shortly introduce legislation creating a legal right to interest on late payment of commercial debt.

3.37 The Government is also examining ways of improving the services it provides to business through Business Links.

High-growth and innovative firms

3.38 High growth and R&D-based firms make a particularly important contribution to economic growth. Such firms face problems not encountered to the same extent by others, notably in gaining access to finance. The work the Government is doing on capital gains tax, which is discussed below, is looking at ways of increasing the incentives for investment in entrepreneurial firms.

3.39 The Government is looking at further ways of improving access to finance in the following areas:

- the Small Firms Loan Guarantee Scheme is being reviewed with the aim of improving access to finance for technology-based firms;
- in Europe, the UK was instrumental in securing agreement on the establishment of a new European Technology Facility (ETF), with a budget of 125 million ecu. The objective of the ETF is to help finance small firms involved in high-technology work, through investment in venture capital funds;
- the Government is examining ways of achieving better targeting of equity investment by private individuals in high-growth firms. In this context, an announcement will be made by the end of this year on the current review of the Venture Capital Trust scheme and Enterprise Investment Scheme;
- in the comprehensive spending review, the DTI is considering how to focus government activity more on helping business to innovate.

British creative industries

The creativity of the British people is one of our greatest strengths. This creativity has fostered industries which are, or have the potential to become, world leaders and which will increasingly contribute to employment. For example, the music industry has generated commercial successes across the musical spectrum.

The Government is now acting in partnership with the industry to identify ways of achieving greater commercial success. This work will be overseen by a Creative Industries Task Force, made up of Ministers and senior industry figures. It will be complemented by the establishment of the National Endowment for Science, Technology and the Arts (NESTA), with significant funding from the National Lottery. NESTA's objectives include turning British creativity into products which can be exploited in the global market.

As one element of this partnership, the Government is working with the UK film industry. A three year tax incentive announced in the last Budget will stimulate investment and further growth. There have also been substantial awards of National Lottery money to three groups of producers and distributors to assist with the process of industry restructuring.

Encouraging best practice: business in the competitive economy

Benchmarking

3.40 The test of these policies lies in how business responds. However, the Government can add value, working closely with business, by spreading best practice within and between commercial sectors. The President of the Board of Trade published a report this month entitled "A Benchmark for Business", which represents an important contribution to this work. The report shows that, although there are some world-class UK companies, the generality of firms perform less well on average than those in our major competitors. The purpose of the report is to increase business awareness of ways of making good these lags in performance. The President of the Board of Trade is consulting business through her Competitiveness Advisory Group on practical ways in which government can work with business on this agenda.

"A Benchmark for business": seven major sectors

The DTI's report on benchmarking reviews the performance of seven major sectors of the UK economy. It finds that in many sectors, such as chemicals and telecommunications, UK companies match the world's best. It also finds that in traditional sectors such as textiles, the intense pressures of globalisation have encouraged firms to become world class through innovation and investment in high quality, value added products. However it goes on to show that the productivity of many UK firms remains well below world-class standards.

Investment

3.41 A competitive economy will create incentives for improved investment performance. And an innovative, entrepreneurial culture will foster high-quality investment. Investment which releases the commercial potential of leading edge technologies has a particular importance: it can entrench a virtuous circle in the UK economy of innovation and entrepreneurship feeding through to sustained higher growth.

3.42 However, the UK's record on investment has been poor by international standards. UK total investment as a share of GDP has been consistently below the OECD average since at least 1960. Over the last international economic cycle, the other major industrial economies have invested significantly more per worker than the UK (see Appendix A).

3.43 Business and other non-residential investment is vital to the economy's productive potential. Appendix A shows that the UK's record in these areas is less clearly out of line with that of other major industrial economies, with the exception of Japan (see Appendix A). Nevertheless, there is evidence that the UK has a relatively low ratio of non-residential capital to GDP, reflecting a legacy of poor performance (see Chart 3.6). To catch up with the productivity levels of our competitors, we would need to invest more than them to make good the gap in capital stock.

3.44 Moreover, it is not simply the quantity of investment that counts - quality is also important. That is, outputs depend on the efficiency with which the inputs of capital and labour are used. To catch up with the best performing economies the UK needs not only to invest more, but to ensure that it maintains - and improves - the quality of its investment.

CHART 3.6: Ratio of non-residential capital stock to GDP, 1992

Public-private partnerships (PPPs)

3.45 Business investment by the private sector must be complemented by public sector investment to provide high quality infrastructure and public services. In the past, public investment has tended to fall victim to short-term public expenditure planning. The implementation of the golden rule of public borrowing described in Chapter 2 will help redress this problem: decisions on the Government's capital spending will be taken on the basis of the returns offered over the long term.

3.46 The process of improving infrastructure and public services is now under way, for example with the allocation of some of the proceeds of the windfall tax to improving the fabric of schools.

3.47 Investment in the nation's economic future requires partnerships between the public and private sectors, which will make best use of the skills and resources of each. PPPs unlock the possibility of higher quality projects and services, delivered more quickly, than would be possible if the public sector acted alone. The Government is now pursuing a range of initiatives to extend the range and quality of PPPs.

PFI

3.48 Within a week of taking office the Government announced its plans to reinvigorate the Private Finance Initiative (PFI). The findings of an external review led by Malcolm Bates are now being implemented. Action in hand includes the establishment of a new Treasury Taskforce to provide a focal point for PFI projects across government. The Taskforce will test all significant projects for commercial viability before they enter the market. And all government departments are now focusing on a manageable number of important projects.

3.49 The new approach is producing results. Since May, over half a billion pounds' worth of contracts have been signed, including for two major hospitals. More are in the pipeline: for example, the Paymaster General is coordinating work on developing private finance contracts which will deal with the repair and maintenance backlog in schools.

Maximising value from public assets

3.50 The Treasury is developing a new approach to commercial activity by government departments and agencies, designed to help maximise value from public assets. It is intended that larger and more complex projects should be taken forward in partnership with the private sector. Guidance on the new approach will be available shortly; the Government would welcome the input of the private sector in identifying and developing commercial opportunities in areas covered by it.

Removing legal obstacles

3.51 Recent legislation will remove legal obstacles to PPPs undertaken by local authorities and NHS trusts. Further legislation will be introduced to allow agencies constituted as trading funds to establish PPPs.

London Underground

3.52 Ministers are considering options for a PPP involving London Underground, which will improve the quality of service that can be provided for passengers and guarantee value for money for the taxpayer.

A Tax system that promotes high quality investment

Capital gains tax

3.53 In his Budget speech on 2 July, the Chancellor invited comments on reforms to capital gains tax which would reward long-term investment and be fair to all. The consultation process has now been completed and evaluation of the comments is continuing; the Government is grateful for the comments received. The Government remains committed to a system that rewards long-term investment, particularly by entrepreneurs. Ways by which the costs of any changes could be contained also need to be considered.

3.54 In the Spring 1998 Budget, the Chancellor will respond to the comments received and bring forward measures to achieve these objectives.

Corporation tax

3.55 In the July Budget, the Chancellor also made changes to corporation tax to help create the right environment for long-term investment by companies. Corporation tax rates were cut by 2 per cent and payments of tax credits were abolished to remove the distortion that encouraged companies to pay out dividends rather than reinvest their profits.

3.56 Advance corporation tax (ACT) currently distorts the tax system because, for some companies, surplus ACT results in double taxation of their overseas profits. Many companies have told the Government they would like to see ACT abolished in favour of payment by instalments for larger companies.

3.57 In the light of these concerns the Chancellor is proposing further significant changes to corporation tax, to improve the tax system for companies and UK investment funds. The Chancellor is acting now to set out his intentions, to remove uncertainty:

- **abolition of advance corporation tax (ACT).** In the next Budget the Chancellor intends to abolish ACT from 1999. Abolition of ACT will solve the problem of surplus ACT for the future and reduce the complexity of the current system;
- **a fair deal for existing surplus ACT.** The Chancellor intends to preserve substantially companies' current expectations for using surplus ACT;
- **quarterly payments of corporation tax for larger companies.** To replace ACT, the Chancellor intends to introduce a system of quarterly payments for corporation tax. Instalments would be phased in over four years, beginning in 1999. Small companies would remain subject to the same tax treatment as at present. Once the four-year transition is completed, medium-sized companies would pay half of their corporation tax through instalments starting in month seven of their accounting periods and the rest subsequently. Large companies would pay all their corporation tax by instalments, with 50 per cent due in-year (beginning in month seven) and the rest subsequently;
- **a 1per cent cut in the main rate of corporation tax.** As part of this package, in the next Budget the Chancellor will cut the main rate of corporation tax to 30 per cent from April 1999. This will ease the transition to quarterly payments of corporation tax by larger companies.

3.58 The Inland Revenue will consult business on the details of how the system of quarterly payments will work; it is today issuing a consultative document[1] to inform this process.

Individual savings accounts

3.59 Chapter 5 describes the Government's intentions for consulting on the introduction of the individual savings account. By encouraging individuals to save, the ISA will help underpin long-term investment.

(1) *The consultative document, "A modern system for corporation tax payments", is available from the Inland Revenue Information Centre, 0171 438 6420/6425*.back

4 Employment opportunity in a changing labour market

4.01 The Government has reaffirmed the commitment to the 1944 Employment White Paper aim of high and stable levels of employment. But the old policy agenda has become obsolete, and in many ways counter-productive. We need a new approach which reflects the changes that have occurred in the labour market, in society and in the global economy. It is no longer sufficient to rely on the management of aggregate demand. Governments in the past have given inadequate weight to structural reforms, skills, work incentives and benefit traps, and welfare to work policies. They failed to recognise the role of basic skills and lifelong learning in making labour markets work more effectively. For much of the post-war period the focus was almost exclusively on men.

4.02 In the circumstances of the immediate post-war period this approach was able to guarantee low unemployment and a high proportion of long-term jobs, with predominately full-time work. Skills mattered less when unskilled workers had access to good job opportunities. Flexible working practices were required less when fewer people needed to balance work and family responsibilities. Welfare to work policies were less important when a high proportion of the unemployed were only out of work for a short time. And the focus on the claimant unemployed was valid when those outside the labour market were there from personal choice, rather than lack of opportunity.

4.03 To meet the challenges of the new labour market, the Government is modernising the welfare state to help people into jobs and to make work pay. The strategy covers:

- the Welfare to Work programme;
- investment in skills;
- the minimum wage;
- a new 10p starting rate of income tax; and possibly
- a new tax credit paid to working families on low incomes.

The state of the labour market

4.04 We need a deeper understanding of how the labour market works and where it fails. We will therefore publish papers on the modernisation of Britain's tax and benefit system, the first of which will cover employment opportunity in a changing labour market. Appendix A sets out the latest evidence on labour market prospects. It argues that we are now at a critical stage in the economic cycle, where wage inflation and skills shortages have in the past prevented unemployment from falling further. There remains an unacceptably high level of structural unemployment in the UK. After five years of economic recovery, unemployment stands at 7.1 per cent on the International Labour Organisation definition - around 2 million people, including almost 1 million under 25 years of age.

4.05 The headline picture on unemployment also hides a more complex, dynamic picture. Most unemployment spells are short, and part of the normal process of labour market adjustment in the face of structural change. But a significant proportion of the labour force are at risk of repeated or prolonged periods of unemployment, amounting to a significant detachment from work.

4.06 The picture also needs to be broadened to include other groups excluded from the labour force altogether - neither employed nor unemployed. Of course, many of them do not want to work, either because they have retired early, or are in full-time education and training. It is certainly not the Government's objective to have all those of working age in work. But many others would work if they had the opportunity and incentive to do so. There are:

- **over 1 million lone parents on income support.** Over one-fifth of all families with children in the UK are headed by a lone parent. Despite the widespread availability of part-time work in this country - a factor which ought to help labour market participation by lone parents - the UK has one of the lowest employment rates for lone parents in the developed world. In the UK just over 40 per cent of lone parents work, compared with 82 per cent in France and 60 per cent in the USA;
- **½ million spouses of the unemployed, also without work.** Spouses of people without work are much more likely to be unemployed than the spouses of people in work. One of the reasons for this is that people with poor labour market prospects tend to partner with other people with poor prospects, and many couples actually meet at their place of work. But the partners of the unemployed are also not helped or encouraged by the benefit system;
- **over 1 ½ million people on long-term Incapacity Benefit,** some of whom would choose to work if the right

opportunities were available. The numbers of people of working age out of work because of sickness and disability has increased dramatically over the last 20 years, and public spending on disability-related benefits is now over two-thirds the amount spent on the National Health Service;

- **many older workers - particularly unskilled men - displaced from declining industries.** The growth in the numbers on long-term sickness and disability benefits is an element of the sharp fall in the labour market participation of older men. The trend has been concentrated on those with lowest skills; often after displacement from a declining industry. Only 54 per cent of men aged 50-64 with no qualifications are in work.

4.07 These figures for individuals' unemployment and labour market participation have important implications when viewed across households. The Labour Force Survey suggests that there are 3 ½ million working-age households with all adult members out of work. Since 1979 the proportion of working-age workless households has risen from 9 per cent to 18 ½ per cent. Workless households contain about 5 million adults and 2.7 million children. Despite the fact that the UK has a relatively high overall employment rate, the number of workless households is higher than in most other developed countries.

CHART 4.1: Unemployment and non-pensioner workless households 1979-97

4.08 Evidence on the dynamics of the labour market also establishes a clear link between unemployment and low pay: a low pay-no pay cycle. The growth of wage inequality has been faster in the UK than almost any other developed economy. Earnings mobility is low at the bottom end of the labour market and, taken together with the evidence on worklessness, it is clear that many people do not have the opportunity to climb onto the earnings ladder and escape low pay.

4.09 The same people who experience unemployment may also face a variety of other problems. Unemployment, poor educational attainment and benefit dependency often interact with other social problems such as bad housing, crime and substance misuse to create a vicious circle of disadvantage. The concentrations of disadvantage and deprivation in small and specific local areas are of particular concern. Some of the worst effects of worklessness and low pay are felt by children - whose position has been strongly affected by increases in unemployment and lone parenthood.

The wider context

4.10 Since the immediate post-war Government first set out a commitment to high and stable levels of employment, there have been important changes in the global economy and in society.

The decline in demand for unskilled labour

4.11 One important trend has been a shift in the demand for labour away from those without skills - a trend which is shared with most of the developed world. Chart 4.2 highlights the dramatic decline in employment rates of people with relatively low skills. There are two main explanations of the relative shift in labour demand away from low-skilled and manual workers:

- the rapid development and diffusion of new technology, and new forms of work organisation, is biased against those with poor skills; and
- the shift in patterns of demand, production and trade across the world is leading developed countries, like the UK, to specialise further in products that require skilled labour.

4.12 The two explanations are not mutually exclusive: for example, the growth in international competition may itself be a spur to technological innovation; and the effect of new technology on the availability of low cost transport and communication is one of the main explanations for the growth in international trade. In both cases these trends are an important source of growth and better living standards - and attempts to resist them would do damage to the economy.

CHART 4.2: Employment rates by highest qualification - change since 1979

Social change and the labour market

4.13 At the same time as these economic changes, important social changes have left the single male breadwinner the exception rather than the rule. The growth in female labour market participation has been dramatic - with the main source of growth being from married women whose husband was already in work. At the same time there have been changes in household composition, the growth in lone parenthood and increased family breakdown. Accompanying these trends has been the growth in part-time and other forms of flexible working.

A new approach for the 21st century

4.14 These fundamental changes in the economic and social context, and in the nature of the labour market problems we face, mean a new approach is needed. The Government has recently reasserted the commitment to high and stable levels of employment - and the modern definition of full employment for the 21st century. High and stable levels of employment cannot be achieved by resisting structural change and preventing necessary adjustment. Neither is it sufficient to ensure an adequate level of labour demand. In the modern labour market the government needs to accept five key responsibilities:

- to ensure **macroeconomic stability and growth;**
- to promote a **flexible and adaptable labour market;**
- to help people from **welfare to work;**
- to encourage **investment in skills;** and
- to **make work pay.**

Macroeconomic stability and the labour market

4.15 The boom and bust cycle has inflicted immense damage on the labour market. Long and severe downturns have led to large numbers of people experiencing periods of unemployment. For many, this meant long and repeated spells of detachment from the labour market - during which they lost vital skills, motivation and work experience. Employers may also - rationally or otherwise - discriminate against people without a recent work history. Recessions can also lead to people - particularly older people - giving up the search for work and withdrawing entirely from the effective supply of labour. Young people whose first experience of working life coincides with a recession can find their prospects damaged for years to come. The labour force has been, as a consequence of boom and bust, less able to sustain a recovery without running into skill shortages and wage inflation. So not only has the labour market sustained immense damagefrom the boom and bust cycle, its structural weaknesses have in part contributed to it.

A flexible and adaptable labour market

4.16 There are a number of aspects to a flexible labour market, all of which are important in ensuring that the economy reacts effectively to external pressures and shocks, changing consumer demands, new technology, and the changing needs of workers and employers. To respond to structural change the economy needs flexibility in relative wages, and to be able to move factors of production - labour and capital - to exploit the new opportunities available. It also needs real wage flexibility - so that wage-setting processes take into account any excess supply of labour. Flexible working practices are also important but, to ensure fair treatment, they need to be underpinned by decent minimum standards at work.

Skills and employability

4.17 While there are clear benefits from a flexible labour market responding to economic and social change, not everyone is in a position to reap the benefits. For the labour market to be adaptable in the face of change, individuals need to have the necessary skills to remain employable. This requires:

- good basic skills - literacy, numeracy, communication and IT skills - particularly for those leaving school and entering the labour market for the first time;
- access to lifelong learning, so people can respond to structural change by re-skilling throughout their working life;
- employability - ensuring that people keep in touch with the labour market when they lose their job, continue to remain part of the effective supply of labour and avoid long-term benefit dependency.

4.18 Good basic levels of education are essential for all members of the modern labour force. But currently the British position is poor compared to many other countries. In 1996 the Skills Audit compared UK skill levels with France, Germany, the US and Singapore; and found that only at the highest level did the UK perform consistently as well as all the other countries. The problem begins at school, often in the early years. In 1997, no more than two-thirds of 11 year olds gained the expected levels of achievement in English and maths. While that was a marked improvement on 1996, many more children need to reach and exceed the expected levels. The education system needs to ensure that the skills acquired at school help to equip young people for the needs of employers. Given the rapidly changing nature of the modern economy, this means the acquisition of good basic skills in literacy, communication, numeracy and IT.

4.19 For people already in the labour force, the problem is compounded by the fact that many have not participated in any form of education or significant training for many years. By 1996, 8 per cent of skilled manual workers suffered from low literacy levels and 18 per cent from low numeracy. For the semi-skilled the figures were 15 and 34 per cent respectively, almost the same as for the unskilled. The poor levels of education and training achieved in the past are one of the main reasons why significant areas of skill shortage currently exist alongside continuing high levels of unemployment.

Implementing the strategy

4.20 Considerable progress has already been made on the key elements of this strategy:

- **macroeconomic stability and growth.** The progress made towards macroeconomic stability described in Chapter 2 is crucial for the success of the Government's employment objectives, because a stable economy is an essential precondition for social cohesion and for the success of the welfare to work strategy;
- **flexibility and adaptability.** The Government is promoting greater flexibility in the UK economy, and in Europe through the "Getting Europe to Work" initiative. It is introducing new competition legislation, and supporting the completion of the single market in Europe. It also aims to set in place a framework of minimum standards to ensure fair treatment at work.

The new European way - growth and jobs for Europe

We continue to face unacceptably high unemployment across the European Union. We are starting to see strong growth and yet 18 million people are still unemployed - barely changed on a year ago. The "Getting Europe Back to Work" initiative has put the focus on employability and adaptability. Employability is vital because the economy of the future will be based on knowledge, skills and creativity. But policies based on either excessive deregulation or social protection will not help. We need the right balance between economic efficiency and social inclusion to create lasting jobs.

The new European way recognises that stability and sound public finances are vital for businesses and individuals to flourish. But stability is not enough on its own. We need to examine how policies contribute to employment and undertake reforms where there are obstacles to job creation. In examining policy we must cast the net widely, looking at education and training, how the employment potential of small firms can be maximised - for example through venture capital - and an effective single market. We need too to share best practice with other countries. That is why the Government launched its own Employment Action Plan in October and suggested other EU member states do the same. We are close to final agreement on the first EU employment guidelines which implement one of the main provisions of the new employment chapter agreed at Amsterdam in June and which give effect to the EU employment strategy. Member states will report back during the UK Presidency of the European Union on how they are implementing the guidelines. The Chancellor and Secretary of State for Education and Employment will ensure that employability is at the heart of discussions during our Presidency of the EU.

Collective discussions with our partners are not confined to the EU. The Government will discuss these issues in the G8 too, including at a major conference in London on 21-22 February, on "Growth, employability and inclusion" attended by economic/finance and employment ministers.

Reform of the welfare state

4.21 The Government is modernising the welfare state, through:

- **Welfare to Work.** The July 1997 Budget set out a New Deal for young people, the long term unemployed, lone parents and the disabled, financed by the Windfall Tax. The Government has also announced that it is developing a **national childcare strategy** to enable more parents to be available for work for longer periods of the day. The Government is also encouraging innovative new solutions to the problem of high concentrations of unemployment through **employment zones**.

A New Deal for young people - progress report

In the Budget last July, the Government set out an ambitious programme to help 250,000 young people from welfare to work, financed from the windfall tax on the privatised utilities.

The New Deal starts in January in 12 pathfinder areas, with the national start in April 1998. The Government has taken steps to ensure employers make the most of the New Deal, and recognise the role it can play in relieving labour shortages at this key stage in the economic cycle. The response has been very encouraging, with a large number of household names - including Sainsburys, Tescos, British Airways, British Telecom, Lloyds TSB, Prudential, WHSmith, Unipart and Allied Domecq - coming forward with ways to support the programme. The response from smaller firms has also been very promising. Also some transport companies have agreed to provide discount travel. The Government has also run an extensive programme of consultation, and many Members of Parliament are heavily involved in supporting local initiatives and encouraging employers.

The implementation of the programme is the responsibility of the Employment Service, who are charged with coordinating the local partnerships required to make the New Deal a success. In ten districts, the delivery of the programme will be led by private sector organisations. The Government is also working on an extensive evaluation strategy to provide detailed evidence on what works and what does not, to learn from mistakes, and to build on success.

Developing Welfare to Work

A New Deal for sick and disabled people

In the last Budget, the Chancellor announced that the Government would extend its welfare to work policies to include those on long-term sickness and disability benefits. The Government will provide help to enable them to get back into work if they choose. Specialist personal advisers will develop tailored packages of help; for example, work trials and support for employers. The programme will begin in the Spring with a series of innovative initiatives involving private and voluntary sector organisations.

Skills shortages

As Appendix A shows, the economy is now at the point of the cycle where, in the past, skills shortages put a break on further falls in unemployment. The Secretary of State for Education and Employment is setting up a Skills Task Force to examine the question of skills shortages and advise the Government on how they might be addressed. High up-front training costs can be one cause. The New Deal for the unemployed will go some way to alleviating the problem. In addition, some of the subsidies to employers will be brought forward to help them meet the costs of training.

Childcare

The Government will increase childcare provision, including out of school provision. The lack of such provision has a key impact on the ability of many parents - especially lone parents - to move from welfare to work, and then to stay in work. Since May, the Government has been systematically examining new ways of improving childcare provision. Over the next five years, our plan will give a significant boost to the supply of out-of-school childcare across Britain.

Lone parents

As well as increasing childcare, the Government is pursuing other policies to help lone parents move from welfare to work. The New Deal for lone parents is already offering, in eight areas, personalised assistance with job search, training and childcare. It will be introduced nationwide from October 1998. The Government will make two further changes to improve it. From April, every lone parent seeking to claim Income Support for the first time will be offered an interview and advice on job and training opportunities and childcare. The second improvement follows from the success of the eight pathfinder areas. Although the New Deal is primarily aimed at lone parents with school-age children, many lone parents with younger children have asked to participate. We do not want to turn these lone parents away, and the Government is therefore allocating a further £25 million from the windfall tax to enable those lone parents with pre-school children who wish to take part in the New Deal to do so.

- **investment in skills.** An extra £1 billion has already been allocated to schools from the 1998-99 contingency reserve, and £1.3 billion over the parliament from the receipts of the Windfall Tax to renovate school buildings, with expenditure linked to increased standards. The Secretary of State for Education and Employment produced a White Paper, "Excellence in Schools", in July, setting out the Government's approach to raising standards of attainment for all pupils. He is also developing a range of policies for lifelong learning, enabling access to learning via the internet, and through the University for Industry. Reforms to higher education funding have allowed the cap on student numbers to be lifted, and the Government has set a target for an extra 500,000 people into further and higher education by 2002.

4.22 And making work pay, through:

- **the national minimum wage,** to tackle exploitation and promote greater decency and fairness in the workplace. The Government will decide on the level and coverage of the national minimum wage when it has received and considered the evidence of the Low Pay Commission. In reaching its decisions, the Government will take into account the wider effects on the economy and seek to find the right balance between promoting fairness and avoiding any adverse effects on employment or inflation;
- **reform of the tax and benefit system.**

Tax and benefit reform

4.23 The Government is committed to streamlining and modernising the tax and benefit system to fulfil the objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening family and community life. Last May, a Task Force was set up under the chairmanship of Martin Taylor, chief executive of Barclays.

Does work pay?

The tax and benefit system plays an important role in determining whether work pays. Over the last century, tax and social security benefits have tended to evolve to meet different objectives. Traditionally, the main aim of the tax system has been to raise revenue, while the benefit system has aimed to address individual and family needs. But both systems can contribute to the same objectives. In particular, they both provide means for promoting work incentives and for relieving poverty - objectives which are particularly important in the changing labour market.

The unemployment trap. Although attempts have been made in recent years to ensure that the tax and benefit system makes people better off in work than out of work, and thus to minimise the "unemployment trap", financial disincentives to work remain - particularly for those with high in-work costs and low potential wages;

The poverty trap. But action to make work more rewarding than welfare must also take into account the existence of the "poverty trap" - when people in work cannot improve their income by working longer hours or for higher pay. As people earn more, they start to pay tax, and they lose entitlement to in-work benefits, such as Family Credit, Housing Benefit and Council Tax Benefit. In extreme cases combined tax and benefit withdrawal rates can be as high as 97p in every extra pound of wages. And, in the case of national insurance contributions, people earning just below the lower earning limit (LEL) of £62 a week face a "charge" of £1.24, or 2 per cent of the full LEL, when their earnings cross this threshold.

The transition into work. Aside from the poverty and unemployment traps, there can be other disincentives to move into work. There can be cash flow difficulties while people wait for their first pay cheque, particularly if they face additional costs of, for example, work clothes or travel costs.

Rights and responsibilities. The administration and delivery of benefit payments can be as important a determinant of labour supply as the financial incentives. Different groups of benefit recipients face different sets of support and obligations. For many it offers little help and support to those who want to work; and in some cases penalises them if they do.

CHART: How much better off are people in work than out of work

Taken together, these disincentives amount in some cases to a significant barrier to work. They also send out entirely the wrong messages about the value society places on work. Reform requires us to confront some difficult policy dilemmas and obstacles. But it is a vital component of the overall strategy for jobs.

4.24 With the help of the Taylor Task Force, the Government is considering a coordinated strategy of tax-benefit reform, focusing in particular on four key areas:

- first, a new tax credit paid to families on low incomes, directly through the wage packet. In principle, a **working family tax credit** has a number of attractions. It could reinforce the effect of the minimum wage by making work pay. It could build on the success of Family Credit, increasing potential in-work incomes and therefore the incentive to work. As a tax credit, rather than a welfare benefit, it should result in higher take-up, while its clear link with the pay packet and the tax system should help demonstrate rewards of work over welfare. The new credit would provide the opportunity for helping working mothers by improving further the support given for childcare. A working family tax credit could therefore provide a highly effective way of targeting help at low-income families: as well as improving work incentives, it could also help reduce poverty and strengthen the family. A critical test will be whether it can be delivered effectively and efficiently;

- secondly, **national insurance contributions**, the current structure of which places a heavy burden on low-paid workers and risks distorting the labour market. There is scope for bringing the national insurance structure more into line with income tax to ease administrative burdens on employers, to improve work incentives and to encourage the hiring of additional employees. However, the pace of any reform must depend on the availability of resources;
- thirdly, the **10p rate of income tax** which the Government is committed to introducing as soon as it is prudent to do so. A lower starting rate of income tax would create a fairer tax system, reducing the tax burden on the low-paid;
- fourthly, the Government is determined that the working poor should benefit from the 10p rate and any future reductions in income tax. It is therefore considering what action is necessary on **tapers** and other features of the benefit system to ensure that the lower starting rate of income tax benefits all the low-paid.

5 Fairness in tax

5.01 The Government has explained that its tax policy will be based on clear principles. These are to encourage work, savings, investment and fairness. Fairness means that the tax system evolves in ways which benefit the many, not just the few, and by ensuring that it is seen to be fair. Over time, and respecting the need to maintain a stable environment in which individuals and companies can plan their futures, the Government will therefore seek to develop a tax system which more closely matches these principles.

5.02 The Government is also keen to consult more fully on tax, whenever this can be done without causing loss of tax revenue or market disruption. To that end, the Inland Revenue, Customs & Excise and the Treasury will be issuing a code of practice on tax consultation next month, making clear the normal procedures that will be followed.

Fairness in people's tax

Income Tax

5.03 The Government has started work towards building an income tax system that is fair to all and can be seen to be fair to all: a system that will encourage people's efforts by helping to make sure that work always pays. A system that will benefit everyone, and not just the higher paid few. That is why it is committed to introducing a 10p starting rate of tax as soon as it is prudent to do so. This will help give people on lower incomes a fair reward.

5.04 The fairer tax system the Government is working towards will make sure that everyone pays their fair share of tax. But changes to the tax system are not enough to bring a fair result for everyone, including families on lower incomes. That is why, when the 10p starting rate is introduced, changes will also be made to the benefits system to make sure that all the low paid benefit from a lower starting rate of income tax. And that is why the Chancellor has asked Martin Taylor to look at the scope for streamlining and modernising the tax and benefit system. Any changes flowing from the review will also have a part to play in shaping a fairer system overall. So will the new minimum wage.

Fairness in people's pensions, savings and investments

The Government's pensions review will report next year. In the meantime, for this year and next, the Government is determined to help pensioners where they need help most: with winter fuel bills.

For this purpose, a sum of £20 will be paid to pensioner households. Pensioner households who are receiving income support will be paid £50. The payments are in addition to the Christmas bonus and will be paid as soon as possible. About 7million pensioner households will benefit, of whom 1.7million (covering 2 million pensioners) will receive £50 and the rest £20. The cost will be £190million for each of the next two years.

A number of pilot projects will start next year to identify the best ways of providing more automatic help to the estimated one million pensioners not currently receiving the income support to which they are entitled. In the light of the experience of the pilots, the Government will consider how best to deliver more automatic help on a national basis.

5.05 The Government is conducting a number of inter-related reviews, looking at the whole range of incentives to encourage pensions, savings and investment. The reviews have already found some instances of good practice, but also some significant gaps. The intention is, in time, to produce a range of measures to create the right incentives across the pensions, savings and investment spectrum.

Pensions

5.06 The Secretary of State for Social Security recently published, on 19 November, a consultation document on "stakeholder pensions", as part of the process of consultation on modernising the nation's pensions to encourage greater fairness and adequate provision for all.

Savings

5.07 The Chancellor announced in the July Budget his intention to consult on the introduction of a new individual savings account (ISA) to be introduced in 1999. This account will reflect the Government's core objectives: to develop a fair tax system and to promote saving, while taking account of the need for a simple tax system that raises sufficient revenue.

5.08 The taxation of savings should reflect the Government's wish to develop a tax system that benefits the many and not the few. So everyone should have the opportunity to save in a tax favoured environment. The ISA will extend the principle of the Tax-exempt Special Savings Account (TESSA) and the Personal Equity Plan (PEP), which have attracted many savers. But it will look to extend the benefits of saving beyond these investors, particularly to those on lower incomes, while ensuring a fair treatment of investors in existing tax-advantaged accounts. The Government sees the stakeholder pension and the ISA as different but complementary products. Ongoing work in both areas will take careful account of their complementary natures.

5.09 The Government is concerned that around half the population have hardly any savings. It wants to encourage more people to save. This should help them to secure their own financial welfare for the future and to underpin long-term investment. The ISA is an opportunity to spread the savings habit and to encourage long-term saving.

5.10 The Government has already received many interesting and useful contributions on the proposal to introduce an ISA. It is now keen to consult on some specific proposals and will be launching a consultative document on 2December. Its proposals will be guided by the following broad principles:

- fair distribution of tax relief;
- the incentive for people on lower incomes to save for the future;
- simplified tax treatment of savings;
- improved access, flexibility and attractiveness of savings products.

Investment

5.11 As noted in Chapter 3, the Government is also reviewing capital gains tax to produce a fairer tax, which encourages long-term investment, especially by entrepreneurs.

Fairness to future generations and the world in which we live

5.12 The tax system must be fair to future as well as to present generations. Inthe July Budget, the Government issued a statement of intent on environmental taxation that makes clear that the objective of securing economic growth means growth that is environmentally sustainable. Additionally, the Government is committed to exploring the scope for using the tax system, where it is effective to do so, to deliver environmental objectives.

5.13 In line with the principles of the statement of intent, the July Budget also contained a range of specific announcements relating to environmental taxes. Anumber of these related to reviews and potential new economic instruments, on which there is now progress to report.

Water pollution

5.14 A consultation paper on options for helping to deal with water pollution(1) is being issued on Thursday 27 November by the Department of the Environment, Transport and the Regions. This will outline a number of possible instruments, including water pollution charges linked to the nature and amount of pollutants discharged to our watercourses. The potential for charges, or another instrument, in relation to pesticides and nutrients is also explored. Views are sought so as to feed into consideration for the Spring Budget.

5.15 Linked to this, the Deputy Prime Minister has commissioned research to test the feasibility, and develop specific proposals, for the kind of water pollution charging scheme outlined in the consultation paper. This work will proceed in stages, but again with a view to informing proposals for the next Budget.

Extraction of minerals

5.16 It was announced in the July Budget that research would be carried out to assess the environmental costs attached to quarrying, and in particular the supply of aggregates. As the statement of intent recognises, tax is only one instrument. Others include regulation and the research will consider the extent to which planning consents and regulation currently address environmental costs. The research has now been commissioned and the work is already underway. It will report in the new year and inform consideration of whether there is a case for further measures, which might include new tax measures.

Landfill tax

5.17 A Customs & Excise review of the operation of the landfill tax is underway. The issues for examination include the impact of the tax in reducing the amount of waste sent to landfill; the scope of the exemptions; the level of tax; and whether the current two rates are sufficient to distinguish between different wastes. Contributions to the review, by the end of November, have already been invited from interested parties.

Energy efficiency

5.18 A report is being published tomorrow on the effects of a reduced rate of VAT for schemes helping the less-well-off insulate their homes and keep warm.(2) The Spring Budget will introduce a 5 per cent reduced rate of VAT for the installation of energy saving materials carried out under certain Government- funded energy efficiency schemes. This combines effective targeting of those least able to keep warm, ease of administration, and legal certainty.

5.19 The Government also intends to explore the possibility with European Union partners and the European Commission for a reduced rate of VAT for a broader range of energy saving materials.

Vehicle excise duty

5.20 The Chancellor confirmed in the last Budget that a scheme would go ahead to reduce, by up to £500, the vehicle excise duty paid by lorries with clean exhausts. The scope of this proposal was also extended to include buses. The aim is to encourage lorry owners and bus operators to introduce technologies such as "particulate traps" or to switch to gas power. In conjunction with the Department of the Environment, Transport and the Regions, consideration is being given to how such a scheme might operate. A document outlining proposals will be issued shortly. The next Budget will return to this measure.

Cars and road fuels

5.21 As regulations relating to the standards of new vehicles have tightened, emissions of many pollutants can be expected to fall over the next 10 years. However, as recent urban smog episodes demonstrate, environmental concerns continue. Transport is also the fastest growing source of CO_2 emissions. TheChancellor will return to transport tax issues in the next Budget, in the light of the international environmental discussions at Kyoto led by the Deputy Prime Minister and of the review of National Air Quality Standards.

Fairness in all the taxes we pay

5.22 A wide range of tax reviews are currently in progress, many of them working towards possible measures in the Spring Budget. Several have already been discussed in the earlier chapters of this document, notably the tax-benefit review in Chapter 4 and the capital gains and corporation tax reviews in Chapter 3, as well as the pensions, savings and various environmental tax reviews and projects outlined above. But several others are in progress, also intended to create a fairer, simpler tax system, where people pay a fair share and what Parliament intended them to pay.

Anti-avoidance

5.23 The broad intention behind the systems of direct tax and VAT in the UK is that they should apply widely and generally. Businesses and individuals should all be taxed on their profits, income and gains; VAT should be borne on all taxable supplies of goods and services to non-business consumers and exempt businesses. Yet there has been a succession of tax avoidance schemes and tax planning devices which have deferred, reduced or eliminated tax liabilities. Parliament's intentions have been frustrated.

5.24 These schemes and devices lead to a greater share of the overall tax burden falling on the majority of taxpayers. One person's successful tax dodge is another person's higher tax bill. If left unchecked, this creates unfairness for the many while the few get away with paying much lower tax bills than they should. In the end, the system will fall into disrepute among those who find themselves shouldering the increased burden. That is not a situation this Government can tolerate. It is essential to reinforce the principle of fairness in taxation and public confidence in the tax system. The tax system must be tightened to counter avoidance and other tax abuses.

5.25 There will always be some legitimate scope for people who wish to ensure that they organise their business or private affairs in a tax-efficient way. But there is a limit to what can be regarded as acceptable behaviour in minimising tax bills. That limit is breached when people take advantage of tax breaks in a way that Parliament had not intended, or when they use contrived tax avoidance schemes, or blatantly exploit loopholes in the law, or hide or distort the facts. Those who do so must be prepared for Customs & Excise and the Inland Revenue to clamp down on them, often before their schemes have matured.

5.26 The Government is committed to detecting, deterring and preventing tax avoidance. Since the last Budget, the Inland Revenue has been carrying out a wide-ranging review of tax avoidance. This has identified many areas where there may be scope for tightening the law and closing loopholes. Action on some of those areas will be announced in the next Budget.

5.27 With new structures and more resources now being given to anti-avoidance, Customs & Excise are also reviewing and improving their procedures for finding, reporting, preventing and countering avoidance. As a result, a number of reviews are being taken forward leading towards action in the Spring Budget or even earlier.

5.28 But although there will always be a need for specific legislation targeted at known avoidance schemes, this is no longer a fully satisfactory response to the continual inventiveness of tax planners. As requested by the Chancellor in the July Budget, the Inland Revenue and Customs & Excise have been looking atamore strategic approach to countering tax avoidance through general anti-avoidance legislation. This would be a major development of tax law and it raises difficult practical issues. Officials are continuing to discuss these issues with representatives of business and the tax professions. Such legislation would be proposed only after a full consultation exercise. On the basis of the work done so far, it may be possible to publish draft clauses in the summer.

Strengthening tax rules for multinationals

5.29 In parallel with other changes to combat tax avoidance announced in theJuly Budget, the Chancellor said that he intended to modernise the transferpricing and controlled foreign company regimes, with prior consultation on the detail. Consultative documents have been issued in respect of the changes proposed to both regimes and discussions are now well under way withinterested parties. The necessary legislation will be included in the next Finance Bill.

North Sea oil

5.30 The July Budget announced a review of the North Sea fiscal regime. This is being conducted by the Inland Revenue, Treasury and Department of Trade and Industry. The aim of the review is to ensure that an appropriate share of North Sea profits is being taxed while continuing to maintain a high level of oil industry interest in the future development of the UK's oil and gas reserves.

5.31 Following the announcement, there has been wide consultation with the oil industry about the existing fiscal regime. Oil industry representative bodies, oil and gas producing companies and others have provided their views both in writing and at a number of meetings. The representations received have been very helpful in establishing the industry's current views, and are now being considered along with our analyses of the profitability of North Sea oil and gas fields. No decisions have yet been taken about any changes which might emerge from this review.

Self assessment

5.32 It was always intended that self assessment for companies would follow the introduction of self assessment for personal taxpayers. The Government has decided that self assessment will apply to companies' accounting periods ending on or after 1 July 1999. Announcing this now means that companies and their advisers will have certainty, as well as further time to prepare for the change. There will be consultation about the further legislative changes that will be needed to cater for self assessment for companies.

5.33 The start of self assessment for companies will coincide with the introduction of payment of corporation tax by larger companies in quarterly instalments, discussed in Chapter 3. Quarterly instalment payments will bring them closer into line with when individuals pay their tax. And it will bring us closer into line with practice in other major industrial countries.

Charities

5.34 The aims of the Review of Charities' Taxation are to seek a simplified taxation system for charities, and to inform the Government of the views of charities for any future European review of VAT social reliefs. The review covers direct and indirect taxation as well as business rate relief, although the main focus is on VAT. Suggestions for improvements to the system are still being received from charities, businesses and other interested parties, and some key contributions are not expected until shortly before the closing date for initial consultation of 1 December. These will be carefully considered by

Customs & Excise, the Inland Revenue and the Treasury, with a view to producing a consultative document for publication in Spring 1998.

Alcohol and tobacco fraud

5.35 A report on alcohol and tobacco smuggling and fraud is being prepared by Customs & Excise for the Financial Secretary by 31 December 1997, in consultation with the trade and other government departments. The review is considering measures which include strengthening and extending customs controls and procedures, increasing customs powers, an increased civil penalty and more consistent application of criminal penalties, and requiring clearer identification of products both on commercial documentation and on packaging where destined for sale in the UK. The review is also considering how closer working with the trade, police, Benefits Agency, and other government departments and agencies can improve effectiveness in combating revenue fraud.

The Spring Budget

5.36 This chapter, along with the previous chapters which discussed the review of tax and benefits systems and capital gains and corporation taxes, has sought to outline the principles underlying the Government's approach to developing a fairer tax system. In the process, this Pre-Budget Report has outlined a further major reform of corporate taxation and described progress in a wide range of tax reviews and work that are likely to lead to measures in the Spring Budget. This should not, however, be taken as an indication of all the tax areas where the Government may act in the Budget. In some cases - for instance, where consulting on tax measures could cost the exchequer loss of revenues due to forestalling, or disrupt markets - it may not be appropriate to give advance notice, and in other areas policy may well develop between now and the Spring. But the intention has been, wherever it is sensible to do so, to use this Report to develop greater openness in the development of tax policy, to further consultation, and to encourage a national debate on what should be done to create a fairer tax system.

(1) *The consultation paper, "Economic instruments for water pollution", is available from the Water Quality Division of the Department of the Environment, Transport and the Regions (0171 276 8266)*. Back

(2) *The report, "Energy saving materials: the scope for a reduced rate of VAT", is available from Customs & Exercise VAT Policy Directorate (0171 865 4794)*. Back

Appendix A: The Economy

Introduction

A.01 This appendix reviews recent economic developments and prospects in a longer-term perspective. It includes projections for the path of the economy over the next three years[1].

A.02 Projections for GDP growth and its components are presented as ranges. This is not intended to represent the degree of uncertainty associated with such forecasts - indeed, past forecast errors on these variables have been larger than the ranges presented here (see Table A3). Rather, the ranges are intended to give an indication of how differing degrees of supply side improvement offer the prospect of a more favourable path for the economy over the next few years. The Government can, and will, play its part in bringing this about, as described in the main chapters of this report. But it will also depend on the actions of private individuals and businesses - for example, in avoiding excessive wage pressure.

Table A1: Summary of forecast

				Forecast	
	1996	1997	1998	1999	2000
GDP growth (per cent)	2 ½	3 ½	2 ¼ to 2 ¾	1 ½ to 2	2 ¼ to 2 ¾
RPI ex MIPs inflation (per cent, Q4)	3 ¼	2 ¾	3	2 ½	2 ½

A.03 It is the Government's declared aim to raise the economy's trend growth rate. But the growth figures at the lower end of the ranges are intended to be deliberately cautious, and make no allowance for any underlying improvement in supply side performance. As such, they are the figures which have been used for projecting the public finances. They are consistent with a projected trend growth rate of around 2 ¼ per cent a year.

A.04 However, the Government is aiming for a better outcome. One means of achieving this is through a decline in the sustainable rate of unemployment (or NAIRU - the non-accelerating inflation rate of unemployment) amounting to an increase in labour supply at any given real wage. This would add to the economy's level of potential output, providing a temporary boost to the trend rate of growth, and allowing a faster rate of actual GDP growth and higher employment to be consistent with meeting the inflation target. The upper ends of the forecast ranges for GDP growth are based on the assumption that improved labour market performance is such as to deliver a fall in the NAIRU of ½ percentage point a year through both 1998 and 1999 and ¼ percentage point through 2000, equivalent to trend output growing by 2 ¾ per cent a year through 1998 and 1999 and gradually reverting to the assumed trend rate of 2 ¼ per cent by the end of 2000.

A.05 The extent to which the economy evolves along a path closer to the upper end of the range will depend partly on the success of Government policies, such as the New Deal for the young and long-term unemployed and action on skills shortages. But it will also depend on other factors affecting wage determination, which are in the hands of the private sector. Responsible wage bargaining offers the opportunity to promote jobs.

A.06 The forecast ranges therefore illustrate the potential for higher levels of prosperity through policies aimed at getting people from welfare into work, and moderation of wage pressure. However, the Government also has a much wider agenda for raising the economy's trend rate of growth through a partnership with business to promote competition, innovation and investment, as set out in Chapter 3. This addresses the challenge of and opportunities for permanently raising the trend rate of growth through enhancing productivity growth. Given the timescale of the forecast, the ranges do not embrace the potential benefits of removing many of the barriers to growth, which will pay off over the longer term.

A.07 Within the range of outcomes for GDP growth, the forecast path for inflation is assumed to be invariant. This is a highly stylised assumption that is made for the illustrative purpose of focusing on the real benefits of improved labour supply behaviour. It amounts to assuming that these benefits show up quickly in employment and output, abstracting from transitional adjustment through wages and prices. In practice, lower wage pressures, for example, would be likely for a time to show up partly in lower inflation before the full effects on employment and output came through. Ratios of demand components to

GDP are also assumed to be largely invariant within the forecast ranges for GDP growth[2].

Trend output growth

A.08 The UK economy is now into its sixth year of expansion from the low point of the early 1990s recession. Total output has risen by 17 ½ per cent from its trough, or about 3 per cent a year on average, and growth has been particularly strong this year. GDP rose by almost 4 per cent in the year to the third quarter. Without supply side improvement, which is the key objective of the Government's economic policy, the economy cannot sustain such rates of growth after having used up its spare capacity.

A.09 In the 1950s and 1960s, UK economic growth averaged around 3 per cent a year. However, this "Golden Age" was very much the exception. Longer-run comparisons show that growth since the mid-nineteenth century has averaged around 2 ¼ per cent, although the economy has gone through a number of phases over the last 150 years:

- growth in the second half of the nineteenth century, associated with continued industrialisation, began to tail off in the early twentieth century;
- between the wars there was a recovery in the average growth rate, though this masks the severe booms and slumps occurring over the period. The inter-war years saw trade cycles averaging around seven years in duration;
- the post-war period to 1973 saw continuous expansion, with growth averaging around 3 per cent. Growth recessions, i.e. output growth which is positive but below trend, rather than absolute falls in output, were typical of this period. The length of each cycle was also much shorter, averaging only around four years;
- since the mid-1970s, the cycle has become longer and more severe. It has averaged about nine years, not very different from the pre-war trade cycle, and output has fallen in each of the last three downturns.

A.10 These trend growth rates can be thought of as consistent, on average, with the absence of excess demand or supply. In the shorter term, the rate at which the economy can grow without putting upward pressure on inflation also depends on the amount of slack in the economy - the output gap. Actual output could be above or below trend output for some considerable time, although this would not represent a sustainable position for the economy. The concept of the NAIRU is closely related to the concept of trend output. It is likely that when the economy is on trend, unemployment will be close to the NAIRU, and any fall in unemployment will require a fall in the NAIRU, or otherwise it will tend to put upward pressure on inflation.

CHART A1: Historical trends in output (average growth over peak-to-peak cycles)

A.11 The trend rate of GDP growth can be decomposed into three components: trend labour productivity growth, trend labour supply growth, and changes in the sustainable rate of unemployment (the NAIRU). That is, potential output depends on how productive each worker is, how many workers are available, and how fully this labour force can be employed without putting upward pressure on inflation. The Government is taking measures to dismantle obstacles to growth in each of these areas by pursuing policies to promote investment, competition and innovation, to enhance employability for all, and to reform the tax and benefit systems.

A.12 Quantitatively, the most important of the components of growth is productivity, which grew at around 1 ¾ to 2 per cent a year over the last economic cycle. With sufficient investment, such a rate of productivity growth should be improved upon over the medium term.

A.13 The labour supply contracted during the early 1990s. This mainly reflected higher participation in further and higher education, early retirement, and increased claims of Incapacity Benefit. The population of working age was growing relatively modestly at the time. But it is now growing almost twice as fast as in the early 1990s, and this rate of growth is expected to continue. With a resumption of past trends in labour force participation, i.e. a small fall in male participation more than offset by a steady rise in female participation, the labour supply may be able to grow by as much as ½ per cent a year over the medium term. The extension of the New Deal for lone parents is just one aspect of policies designed to underpin higher participation.

A.14 A fall in the NAIRU would also add to the level of potential output, with a temporary positive effect on the trend rate of growth. This would permanently boost the level of employment, and is exactly what measures such as the New Deal for the young and long-term unemployed are designed to achieve. Moderation in wage bargaining would add further to the economy's productive capacity and promote employment without putting upward pressure on inflation. The upper end of the range for the fall in unemployment shown in TableA2 is intended to illustrate the potential for improved labour market performance brought about by such developments.

Table A2: Contributions to trend growth, 1998--2000

Per cent per annum

Labour productivity	Labour supply	Total ongoing contribution	Fall in unemployment(1)	**Estimated trend growth**
1 ¾ to 2	¼ to ½	2 to 2 ½	0 to ½	2 to 3

1 A positive sign indicates a fall in the NAIRU, temporarily boosting trend growth.

A.15 On this basis, trend growth of between 2 and 3 per cent a year could be sustained over the period 1998--2000, with the upper half of this range reflecting some contribution from a fall in the sustainable rate of unemployment. As a cautious estimate, a figure of 2 ¼ per cent - towards the lower end of the range - is used in projecting the public finances. This is in line with the average rate of growth over the post-war period as a whole, and also in line with the average over the last full cycle, between the estimated on-trend points in the first half of 1986 and the first half of 1997. This is also the assumption which underlies the lower end of the forecast ranges presented for actual GDP growth. It makes no allowance for a possible further decline in the NAIRU.

A.16 However, as discussed above, the trend rate of growth might actually be towards the upper end of the 2 to 3 per cent range over the next three years. This would then allow a faster rate of actual output growth to be consistent with meeting the inflation target. Trend growth of 2 ¾ per cent a year through 1998 and 1999, consistent with the NAIRU declining by ½ percentage point through each year, is the basis of the upper end of the forecast ranges for GDP growth.

The degree of spare capacity

A.17 At the time of the July Budget, evidence suggested that the output gap was close to zero in the first quarter of 1997 - i.e. the economy was at or very close to its trend level. With above-trend growth since then, some tightening of capacity and increasing labour market pressures would have been expected.

A.18 But, contrary to expectations, indicators of capacity utilisation marked time in the second quarter, and underlying earnings growth eased back, despite unemployment continuing to fall and vacancies continuing to rise.

A.19 Weighing up the various indicators of the pressure of demand in the economy, it is difficult to discriminate between the first and second quarters of 1997 as points when output was on trend. The economy is therefore now assumed to have been on trend, on average, in the first half of the year.

CHART A2a: CBI capacity utilisation in manufacturing

CHART A2b: BCC survey of capacity utilisation

A.20 In the third quarter, the labour market tightened further; earnings growth edged up again; firms continued to report recruitment difficulties; and the most recent CBI survey reported a sharp increase in skills shortages and capacity utilisation in manufacturing. Overall, these indicators tend to reinforce the view that the economy was on trend in the first half of the year and, with GDP growth of almost 1percent in the third quarter, has now moved above trend.

CHART A3a: CBI survey of skilled labour shortages

CHART A3b: BCC survey of recruitment difficulties

A.21 This view is consistent with a wide range of evidence from the labour market:

- both LFS and claimant unemployment - after adjusting the latter for the estimated downward effects of the Jobseeker's Allowance - are now only slightly above their previous troughs;
- the claimant unemployment rate in the South East is now down to just 3.2 per cent;
- short-term unemployment, which is what matters most for wage pressure, is now below its previous trough on the LFS measure;
- vacancies (adjusted for recent distortion) are at a similar level to their previous peak in late 1987;
- reported skills shortages in the service sector are at a similar level to their pre-recession peak (see paragraph A.54 for further discussion);
- earnings growth has picked up from 3 ¼ per cent in the second half of 1995 to around 4 ½ per cent this year.

A.22 There are, however, large margins of uncertainty surrounding estimates of the output gap. Taking the CBI survey at face value might suggest that the output gap turned positive as early as 1994, and output could already be significantly above trend. This possibility is reflected in the cautious assumption on the output gap for calculating the cyclically-adjusted PSBR in the box on page20 of Chapter 2. On the other hand, output could still be below its trend level if labour market participation was below trend. There could be a cyclically low element still waiting to unwind if some of the fall in participation during the 1990s is less permanent than assumed. This is discussed further in the box on labour market participation later in this appendix.

Economic prospects

Demand and output

GDP

A.23 The path of activity has been only fractionally stronger than expected at the time of the July Budget. GDP is now forecast to grow by 3 ½ per cent in 1997, compared to the Budget forecast of 3 ¼ per cent, though even by Budget time the choice between 3 ¼ and 3 ½ per cent had become finely balanced.

A.24 After growing at close to its trend rate for much of 1995 and 1996, GDP accelerated sharply at the end of last year, and has grown at an annualised rate of around 4 per cent for the past four quarters - well above its sustainable rate. This is estimated to have reduced the output gap by around 1 ¾ percentage points over this period.

A.25 By the end of this year, the positive output gap is expected to have increased to around ¾ per cent of GDP. But GDP growth is expected to slow to more sustainable rates from now on, as domestic demand growth slows in response to the rises in interest rates over the past six months and the tightening fiscal stance, and as net trade continues to exert a negative influence. In order to bring inflation down to its target, it is likely that GDP growth will need to slow below its trend rate for a time to generate a negative output gap. This implies growth a little below the trend rate through next year and the first half of 1999. At that time, a negative output gap of around ¾ per cent of GDP is projected.

A.26 Depending on the extent of any improvement in labour market performance, GDP is projected to grow by 2 ¼ to 2 ¾ per cent in 1998, 1 ½ to 2 per cent in 1999, and 2 ¼ to 2 ¾ per cent in 2000. The July Budget forecast for 1998 was in the middle of the present range.

CHART A4: Gross Domestic Product (GDP)

The personal sector

A.27 A key feature of the personal sector over the past five years has been its high level of saving. The personal sector saving ratio (saving as a percentage of disposable income) rose sharply in the late 1980s and the early 1990s with the onset of recession. But it has not fallen back as the economy has strengthened, averaging almost 11 ½ per cent since 1993, compared with an average since 1960 of 9 ¾ per cent.

A.28 The persistence of high saving in recent years has been surprising in view of large increases in wealth and low rates of inflation. There is no single explanation for this. It may partly reflect increased caution on the part of consumers, following their adverse experience of the late 1980s boom and the subsequent deep recession, and continuing perceptions of job insecurity. The growth in personal pensions has also led to higher saving. Strong growth of financial income in recent years, especially dividends, may also help to explain the high saving ratio. The recipients of such income tend to have relatively high propensities to save.

CHART A5: Personal sector saving ratio

A.29 Over the past year, consumers' expenditure has been growing at an annualised rate averaging almost 5per cent - well above its long-run average of around 2 ½ per cent. This has been mainly financed by strong growth of disposable income, despite the strong build up of wealth (personal sector net financial wealth has risen by almost 50 per cent over the past three years). Consumer spending was particularly rapid in the second and third quarters, reflecting transitory spending out of the "windfall" payments which people have received this year from the flotation of building societies and insurance companies. This is discussed further in the box opposite.

(1) *The forecast is based on the assumption that the exchange rate remains close to recent levels. A full set of charts and tables relating to the economic forecast and the projections of the public finances in Appendix B is included in a separate document, "The Economy and the Public Finances: Supplementary Material", available from the Treasury's Public Enquiry Unit (see page 4 for contact details)*.back

(2) *This stylisation is based on the assumption that factors affecting the NAIRU (and employment) are unlikely to have much effect on the sustainable real wage, which is mainly determined by productivity. In this case, income and expenditure shares in GDP would tend not to vary much within the forecast ranges for GDP growth*.back

Appendix B: The public finances

Summary

B.01 This Appendix first looks briefly at the current fiscal position. How large are budget deficits and debt burdens by past standards, and how do they stand in relation to the fiscal objectives set out in the July Budget and the Maastricht criteria? The section then considers the prospects for achieving these objectives, given the policies so far announced and the view of the economy outlined in Appendix A(1).

Prospects for 1997-98 and 1998-99

B.02 The PSBR has turned out lower than expected in the past few months since the Budget; but this seems mostly to reflect temporary factors, and the fiscal projections (summarised in Table B1) are generally little changed since the July Budget:

- budget deficits are likely to continue to fall this year and next, as the Government fulfils its Manifesto commitment to keep public spending within the limits it inherited for the first two years, and tax revenues rise in response to economic growth, the Budget measures and the annual real rises in fuel and tobacco duties;
- the general government financial deficit is expected to be comfortably below the 3 per cent Maastricht reference level, both for 1997-98 and calendar 1997;
- the current balance is likely to be in deficit this year, but is projected to move into surplus in 1998-99;
- even though privatisation proceeds are assumed to come to an end after the current year, the PSBR is projected to fall below 1 per cent of GDP by 1998-99 (even excluding windfall tax receipts).

Table B1: Budget deficits (including and excluding the windfall tax)

		£ billion	
	Outturn	Estimate	Forecast
	1996-97	1997-98	1998-99
Receipts(1)	286.8	308.2	326.3
Current expenditure(2)	306.0	312.0	322.3
Current balance	**-19.1**	**-3.7**	**4.0**
Current balance excluding windfall tax(3)	***-19.1***	**-6.1**	**2.6**
Net capital spending(4)	8.4	8.3	8.7
Public sector financial deficit	**27.5**	**12.0**	**4.7**
Privatisation proceeds and other financial transactions	4.9	2.5	0.2
PSBR	**22.6**	**9.5**	**4.5**
PSBR excluding windfall tax(3)	***22.6***	**11.9**	**6.0**
General government financial deficit(5)			
- £ billion	**30.1**	**11.8**	**3.6**
- per cent of GDP(5)	**4.0**	**1.5**	**0.4**
Money GDP - £ billion	752.2	800.1	836.9

1 Figures on a national accounts accruals basis. Includes capital taxes.
2 Includes depreciation of fixed capital.
3 Excluding windfall tax receipts and associated spending.
4 Net of depreciation and less capital transfer receipts and includes capital grants.
5 Definitions on a Maastricht basis.

The medium term

B.03 Because spending plans have not yet been set, illustrative projections are shown for years beyond 1998-99. On the July Budget assumptions that real public spending grows at or below the assumed trend rate of economic growth of 2 ¼ per cent a year, the public finances are projected to continue to improve. The current surplus grows, and the overall budget also moves into surplus from 2000-01. The debt burden declines and the public sector's balance sheet gradually improves.

Current position

The PSBR

B.04 The PSBR peaked at more than 7 per cent of GDP in 1993-94 - the highest level since the mid-1970s. Over the past four years it has been falling, partly because of tax increases and public expenditure restraint and partly because the economy has been growing faster than trend. The outturn for 1996-97 was £22 ½ billion, or 3 per cent of GDP, and a further sharp fall, to £9 ½ billion or 1 ¼ per cent of GDP, is now forecast for 1997-98. This is about £1 ½ billion lower than the Budget forecast.

B.05 The forecast for 1997-98 includes the £2.6 billion of receipts from the windfall tax and £0.2 billion of Welfare to Work spending. Without these receipts and spending, the PSBR would be about £12 billion, or 1 ½ per cent of GDP. To give a clearer indication of trends, projections for budget deficits in this chapter generally exclude windfall tax receipts and associated spending. Figures both including and excluding these items are given in Table B1.

Cyclically-adjusted PSBR

B.06 The cyclically-adjusted, or "structural", PSBR tended to rise throughout the 1980s and early 1990s, peaking in 1993-94 at almost 4 per cent of GDP. It fell to 2per cent of GDP by 1996-97, and is forecast to fall further to 1 ¼ per cent in 1997-98 (i.e. similar to the actual PSBR now that the economy is close to its estimated trend).

CHART B1: Public sector borrowing requirement

The Maastricht deficit

B.07 The general government financial deficit (GGFD) - the Maastricht measure - has tended to be larger than the PSBR because it does not take credit for privatisation proceeds. It was 4per cent of GDP in 1996-97, and is forecast to fall to 1 ½ per cent of GDP in 1997-98 (1 ¾ per cent of GDP in calendar year 1997, compared with the Maastricht reference level of 3 per cent). The fall is greater than for the PSBR because GGFD is not affected by the drop in privatisation proceeds. (The Maastricht definition used here does *not* exclude windfall tax receipts.)

The current balance

B.08 The current balance has been in substantial deficit for most of the period since the mid-1970s, the deficit averaging over 1 ½ per cent of GDP over the last economic cycle (1985-86 to 1996-97). It has improved less than the PSBR or GGFD over the past four years, as public investment has fallen as a percentage of GDP. The current deficit was 2 ½ per cent of GDP in 1996-97, but is forecast to fall to just ¾ per cent of GDP in 1997-98.

CHART B2: GGFD and current deficit

Public sector debt and net wealth

B.09 Between 1970 and 1991, net public sector debt declined, despite the generally high levels of government borrowing, from about three quarters to just over a quarter of GDP, mainly because of inflation. After 1991 it rose sharply again, to 45 per cent of GDP in March 1997, as borrowing rose and inflation fell. General government gross debt, the Maastricht measure, has risen similarly. In March 1997, it was 54 ¼ per cent of GDP, compared with a Maastricht reference level of 60 per cent. On current ONS estimates public sector net wealth has fallen sharply from about 70 per cent of GDP in the 1980s to less than 10 per cent by 1996. This is partly because of rising debt, and partly because privatisations and historically low levels of public investment have reduced the stock of government assets.

CHART B3: Public debt and net wealth

PROSPECTS

Assumptions

B.10 The projections assume:

- there are no tax changes beyond those already announced in past Budgets, including the real increases in excise duties, and the indexation of rates and allowances. No account is taken of tax proposals in this Pre-Budget Report;
- public spending is in line with cash plans in 1997-98 and 1998-99, and for later years is as in the three illustrative Budget projections (i.e. real growth in the Control Total of ¾ , 1 ½ and 2 ¼ per cent a year); and
- the economy follows the path described in Appendix A. In the interests of caution, the lower end of the range of projections of GDP growth shown in Appendix A has been used.

Table B2: Economic assumptions

	Percentage change on previous financial year					
	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Output (GDP)	3 ½	1 ¾	1 ¾	2 ¼	2 ¼	2 ¼
Prices						
RPI excluding MIPs	2 ¾	3	2 ½	2 ½	2 ½	2 ½
GDP deflator	2 ¾	2 ¾	2 ½	2 ½	2 ½	2 ½
Money GDP (£ billion)	800	837	873	915	960	1,006

B.11 The assumptions on "Spend to Save", privatisation, unemployment, output and interest rates are those introduced for the July Budget projections and audited by the National Audit Office (NAO). Unemployment is assumed flat at its October level and interest rates are projected in line with market expectations.

B.12 To build on the audit of the new assumptions for the July Budget projections, the Comptroller and Auditor General, Head of the NAO, was invited to audit four additional assumptions used in the current forecast: for equity and oil prices, the main price indices used for projecting and planning public expenditure, and VAT receipts in relation to consumers' expenditure. His report to the House of Commons was published on 25November.(2)

Receipts

Budget measures

B.13 The forecast incorporates the effects of the July Budget measures, which in aggregate increase receipts by about ¾ per cent of GDP in 1997-98 and subsequent years. No account is taken of tax proposals in this Pre-Budget Report.

Total receipts

B.14 After 1997-98, total receipts are projected to rise as a share of GDP by ¼ per cent per year on average. This wholly reflects the effects of real fiscal drag on income tax and the real increases in fuel and tobacco duty. All other taxes are projected to yield a fairly constant proportion of GDP in the medium term. However, non-tax receipts (such as interest and dividends) are projected to fall over time as a share of GDP, in part reflecting the contraction of the public corporations' sector.

VAT receipts

B.15 VAT receipts are especially hard to predict. The joint Treasury/Customs VAT study, published in September, found that, after allowing for the effects of Budget measures, the ratio of VAT receipts to consumer spending declined steadily between the late 1980s and 1995-96. However, the VAT ratio has stabilised over the last couple of years, and it is thus extremely uncertain whether the ratio will remain flat in future, continue to fall, or even possibly start to recover. The projections assume a modest downward trend in the VAT ratio - an assumption which the NAO has endorsed as `reasonable'. This reduces receipts by £1 ½ billion by 2002-03, compared both with a flat VAT ratio and the Budget projections (which also assumed a flat ratio).

Comparison with Budget forecast

B.16 Tax receipts are projected to be marginally weaker than at Budget time, by around £ ½ -1 billion this year and next, rising to about £2 ½ billion (¼ per cent of GDP) by the end of the period. The shortfall in 1997-98 mostly reflects lower receipts of income tax and excise duties. In addition, GDP growth in 1998-99 and 1999-2000 is now assumed to be slightly less than at Budget time, which tends to lower the growth of tax receipts.

Table B3 : Total receipts

			per cent of GDP				
	Outturn	Estimate			Projections		
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Income tax	9.2	9.4	9.9	10.2	10.4	10.5	10.7
Corporation tax	3.7	3.8	3.8	3.9	4.0	4.1	4.0
Windfall tax		0.3	0.3				
Value added tax	6.2	6.3	6.3	6.2	6.2	6.2	6.1
Excise duties(1)	4.1	4.1	4.2	4.3	4.4	4.5	4.6
Other taxes and royalties(2)	6.6	6.4	6.4	6.4	6.5	6.5	6.4
Social security contributions	6.3	6.2	6.2	6.2	6.3	6.3	6.3
Other receipts	1.8	2.0	2.0	1.8	1.7	1.5	1.6
Total receipts	**37.9**	**38.5**	**39.1**	**39.0**	**39.5**	**39.6**	**39.8**
Total taxes and social security contributions(3)	35.8	36.7	37.2	37.4	37.9	38.2	38.3
Total receipts (£bn)	**285.4**	**308.4**	**327.4**	**340.8**	**361.3**	**380.1**	**400.8**

1 Fuel, alcohol and tobacco duties.
2 Includes Council Tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes.
3 Measured on a national accounts (accruals) basis.

The tax burden

B.17 Chart B4 shows the tax burden - total accruals of taxes and social security contributions as a percentage of GDP - since the 1970s. The tax burden tends to behave procyclically, rising (with a lag) when the economy is growing above trend and falling (with a lag) during economic slowdowns. (This is obscured in the chart by the effects of Budget measures, especially the tax reductions in the second half of the 1980s and the increases in the early 1990s.) There is also an underlying upward trend, reflecting real fiscal drag.

B.18 The projected increase of nearly 1 percentage point in the tax burden this year is mostly accounted for by the July Budget measures including windfall tax. The underlying tax burden rises by about 0.2 percentage points, in line with the normal expectation. The increase in the tax burden is expected to be somewhat greater than normal in 1998-99, mostly reflecting the effects of past Budgets (especially the "Spend to Save" measures). Thereafter, the tax burden is projected to rise roughly at its usual annual rate.

CHART B4: Tax burden

Government expenditure

B.19 Table B4 shows the 1996-97 outturn and forecasts for 1997-98 and 1998-99 for general government expenditure and its main components.

Table : B4 General government expenditure(1)

	£ billion		
	Outturn	Estimate	Forecast
	1996-97	1997-98	1998-99
Control Total	259.9	265.8	273.5
Welfare to Work spending		0.2	1.2
LA spending under the capital receipts initiative		0.2	0.7
Cyclical social security	14.0	12.7	13.5
Central government debt interest	22.0	24.6	25.0
Accounting adjustments	11.5	11.1	11.5
GGE(X)(2)	**307.3**	**314.6**	**325.4**
Privatisation proceeds	-4.4	-2.0	0.0
Other adjustments	5.2	6.1	6.6
GGE	**308.1**	**318.7**	**332.1**

1 See supplementary document for conventions and definitions.
2 Excluding privatisation proceeds and lottery-financed spending and net of interest and dividend receipts.

Control Total

B.20 The outturn for Control Total spending in 1996-97 of £259.9 billion, or 34 ½ per cent of GDP, represents a small cash overspend of £0.4 billion on plans, but a fall in real terms of ¾ per cent on 1995-96.

B.21 For 1997-98, the Control Total spending plans imply a fall of ½ per cent in real terms, or by 1 ¼ percentage points to 33 ¼ per cent of GDP. However, the fall is exaggerated by two special factors (the sale of the MOD married quarters and the student loan book) which score as negative expenditure. After adjusting for asset sales, spending is unchanged in real terms.

B.22 Spending plans over the medium term (1999-2000 onwards) will be set only after the Comprehensive Spending Review has been completed. As in the July Budget, stylised projections for public spending are based on three illustrative assumptions for spending growth:

A) real growth in the Control Total of ¾ per cent a year from 1999-2000 onwards (the real growth assumed from 2000-01 in the 1996 Budget);

B) real growth in the Control Total of 1 ½ per cent a year - roughly the average over the past 20 years;

C) real growth in the Control Total of 2 ¼ per cent a year, the same as the estimated trend rate of economic growth.

Table B5 : Government expenditure(1)

	per cent of GDP						
	Outturn	Estimate			Projections		
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
(A) ¾ per cent real CT growth							
Control Total	34.5	33.2	32.7	32.4	31.9	31.4	30.9
Cyclical social security	1.9	1.6	1.6	1.6	1.6	1.6	1.6
Central government debt interest	2.9	3.1	3.0	2.7	2.5	2.3	2.0
GGE(X)(2)	40.9	39.3	38.9	38.3	37.6	36.8	36.0
(B) 1 ½ per cent real CT growth							
Control Total	34.5	33.2	32.7	32.6	32.4	32.1	31.9
Cyclical social security	1.9	1.6	1.6	1.6	1.6	1.6	1.6
Central government debt interest	2.9	3.1	3.0	2.8	2.6	2.4	2.1
GGE(X)(2)	40.9	39.3	38.9	38.5	38.1	37.6	37.1
(C) 2 ¼ per cent real CT growth							

Control Total	34.5	33.2	32.7	32.9	32.9	32.8	32.8
Cyclical social security	1.9	1.6	1.6	1.6	1.6	1.6	1.6
Central government debt interest	2.9	3.1	3.0	2.8	2.6	2.4	2.3
GGE(X)(2)	40.9	39.3	38.9	38.8	38.6	38.4	38.2

1 See supplementary document for conventions and definitions.
2 Excluding privatisation proceeds and lottery-financed spending and net of interest and dividend receipts.

Debt interest

B.23 Reflecting high public sector borrowing, central government net debt interest, as a ratio to GDP, has risen by almost 1 per cent during the 1990s - to £22.0 billion, almost 3 per cent of GDP, in 1996-97. It is projected to peak at £25.0billion in 1998-99, and fall thereafter to 2-2 ¼ per cent of GDP by 2002--03, reflecting a projected repayment of debt over the medium term.

Cyclical social security

B.24 With unemployment declining, spending on cyclical social security has been falling over the past three years, and is forecast to fall in real terms by a further 11 ½ per cent in 1997-98. On the assumption that claimant unemployment remains flat at its October level, cyclical social security spending is projected to grow in real terms at approximately 2 ¾ per cent per year from 1998-99 onwards, as underlying spending on the non-unemployed continues to rise.

GGE(X)

B.25 The GGE(X) ratio fell by 1 ¼ percentage points of GDP in 1996-97 to 40 ¾ per cent, and is projected to fall by a further 2 percentage points over the next two years. Over the medium term, the GGE(X) ratio continues to fall in all three cases.

CHART B5: Projections of general government expenditure - GGE(X)

(1) *More detail on the outturn for 1996-97 and the forecasts for 1997-98 and 1998-99 is given in "The Economy and the Public Finances: Supplementary Material", available from the Treasury's Public Enquiry Unit (see page 4 for contact details)*. Back

(2) *Audit of Assumptions for the Pre-Budget Report, HC 361*. Back

List of tables

List of charts

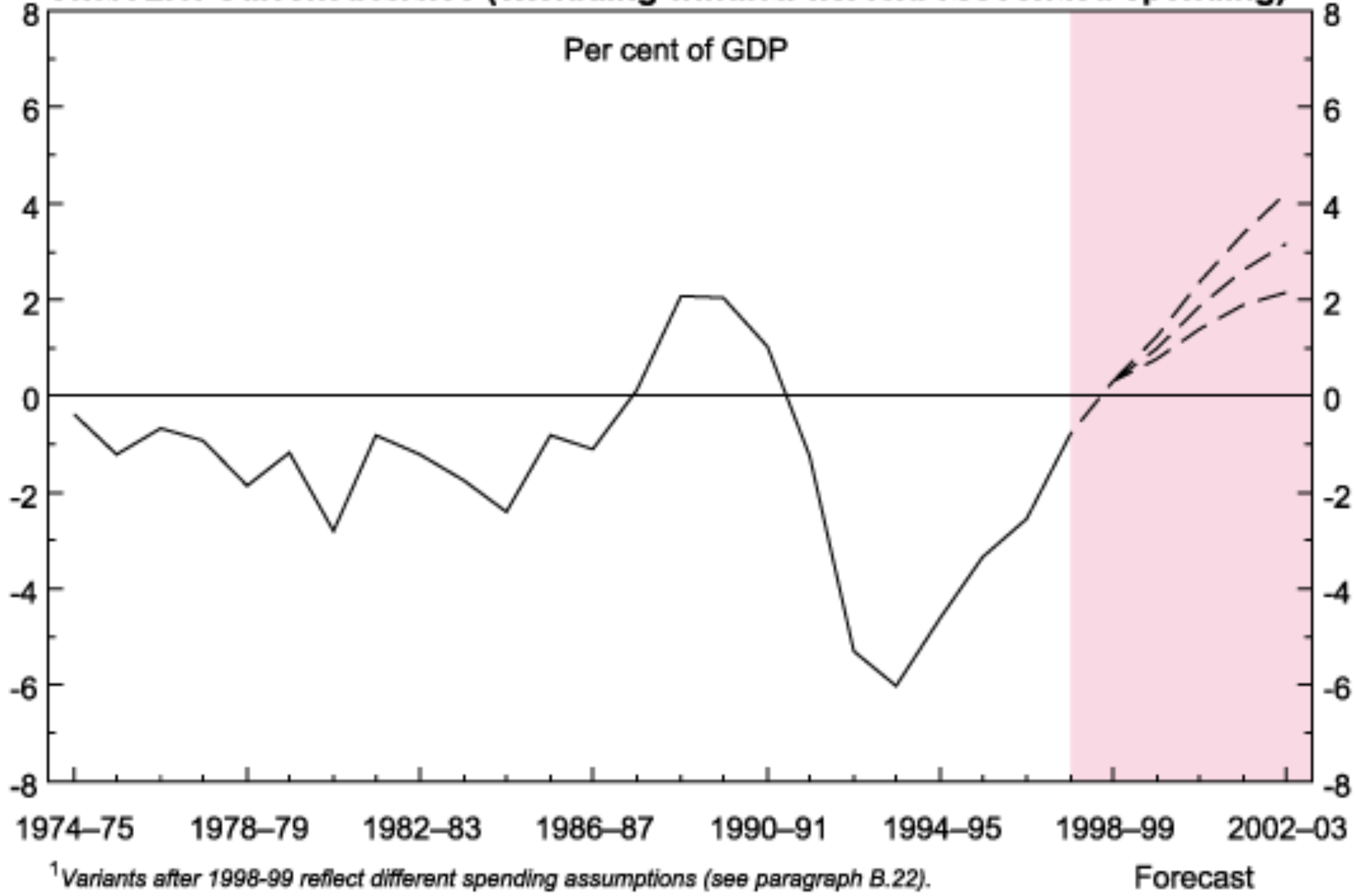
The Government's key economic priorities

For high and stable levels of growth and employment, and for fairness:

- strengthening the economic framework to deliver low inflation and low government borrowing - the long-term stability that is the foundation of growth and employment;
- removing barriers to growth and employment creation wherever they exist, for example by promoting competition, improving regulation, and encouraging investment and savings;
- modernising the welfare state and tax and benefit systems so that they promote employment and support the flexible working patterns of the modern economy, rather than discouraging work and trapping people in poverty;
- developing a tax system which is fair and seen to be fair;
- delivering high quality public services efficiently.

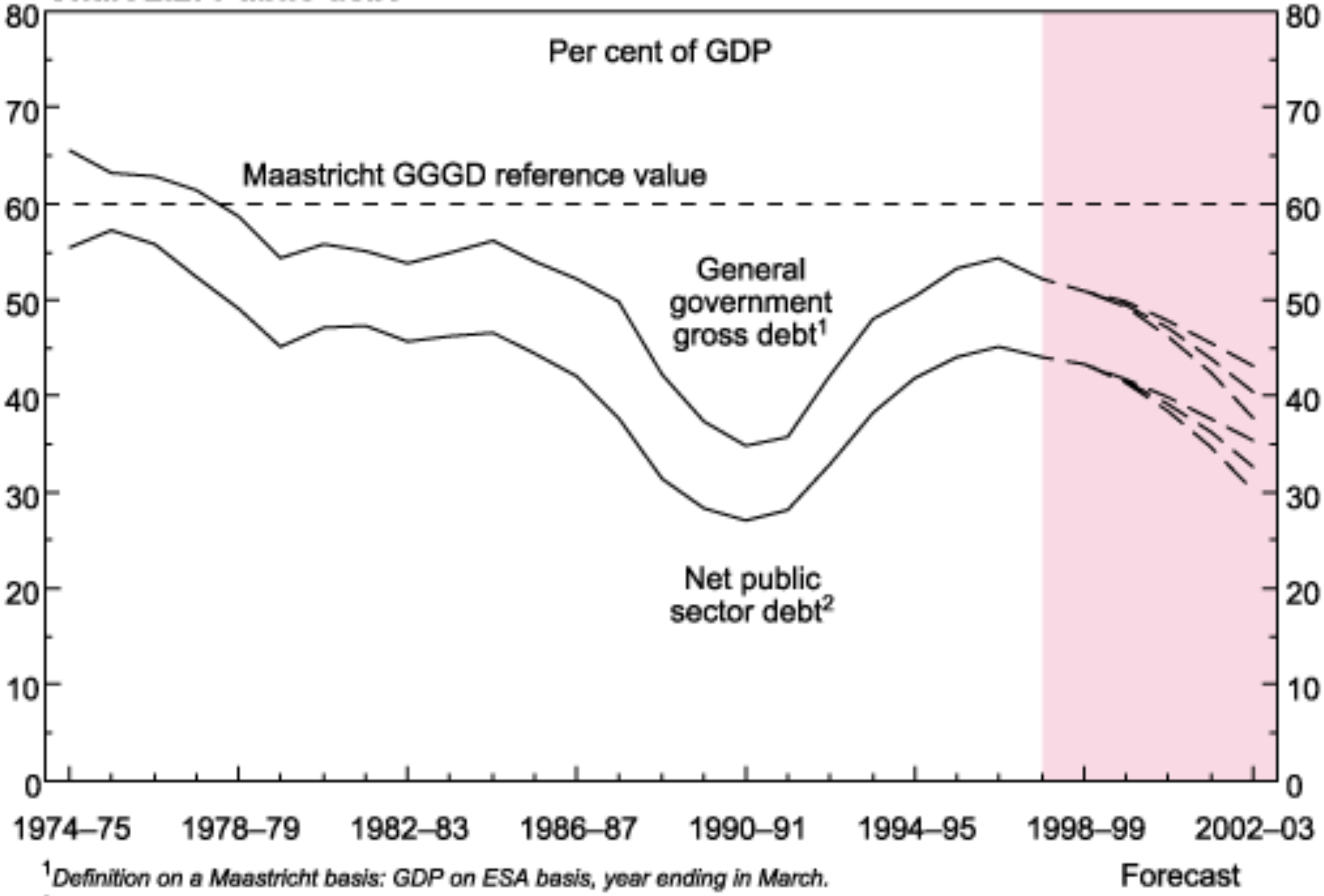
All subject to ensuring that economic development takes place in a way which is consistent with high standards of environmental protection.

Chart 2.1: Current balance (excluding windfall tax and associated spending)[1]



[1] *Variants after 1998-99 reflect different spending assumptions (see paragraph B.22).*

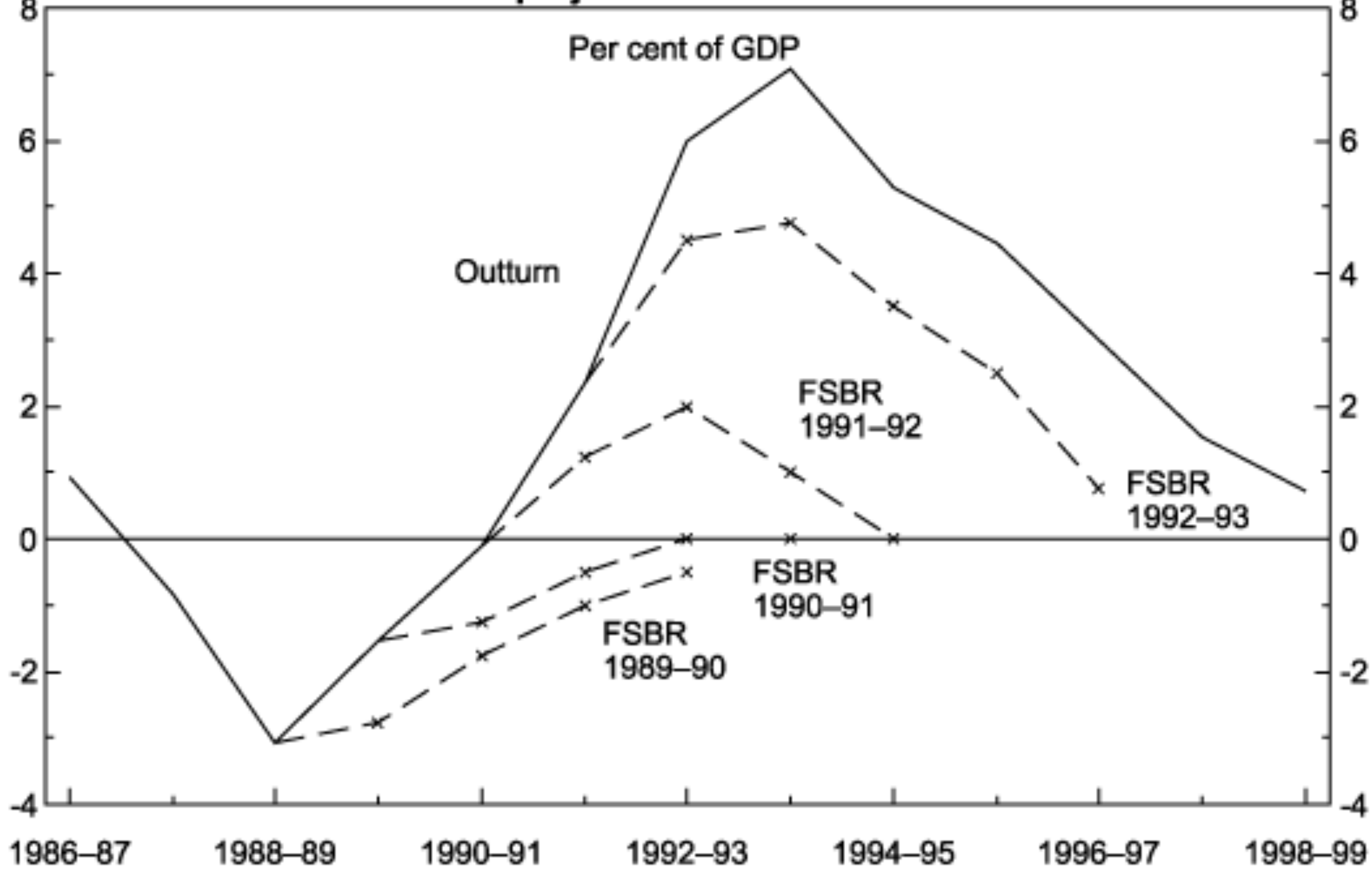
Chart 2.2: Public debt



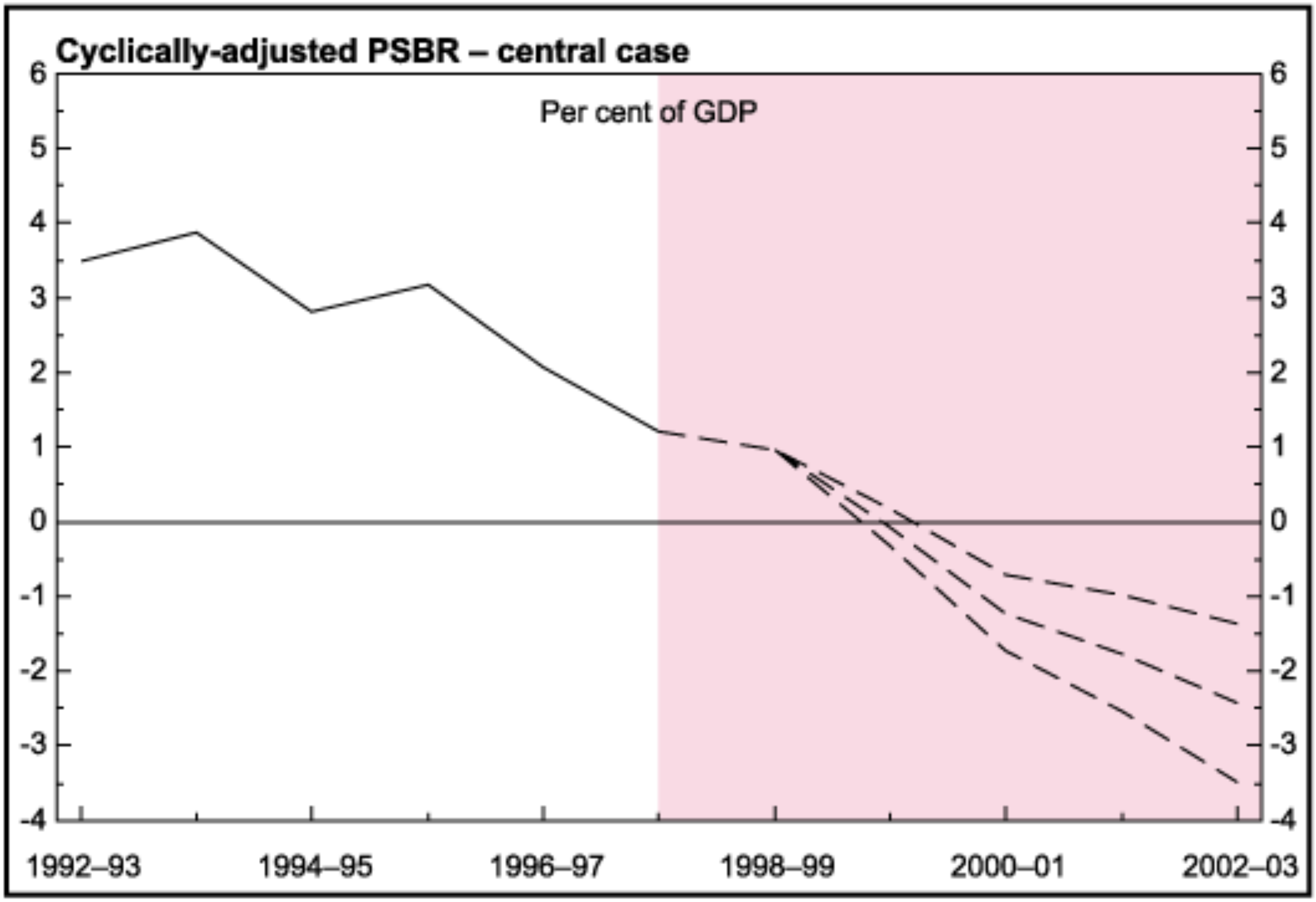
[1] *Definition on a Maastricht basis: GDP on ESA basis, year ending in March.*

[2] *End-March debt as per cent of GDP in four quarters centred on end-March.*

Chart 2.3: PSBR illustrative projections 1989–92[1]



[1] *Forecasts and illustrative medium-term projections taken from successive Budgets.*


Cyclically-adjusted PSBR – central case
Per cent of GDP
6
5
4
3
2
1
0
-1
-2
-3
-4
1992–93
1994–95
1996–97
1998–99
2000–01
2002–03

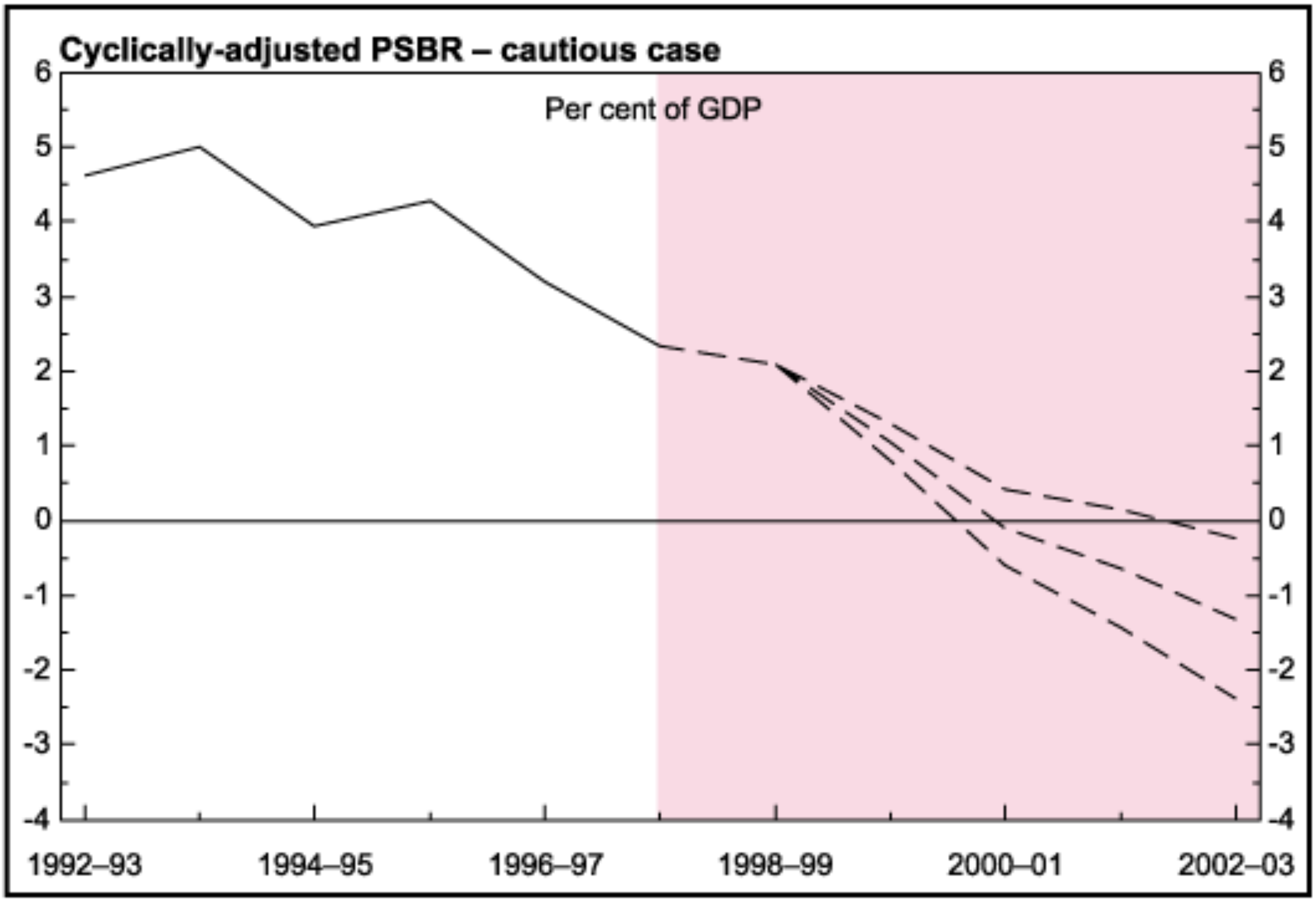
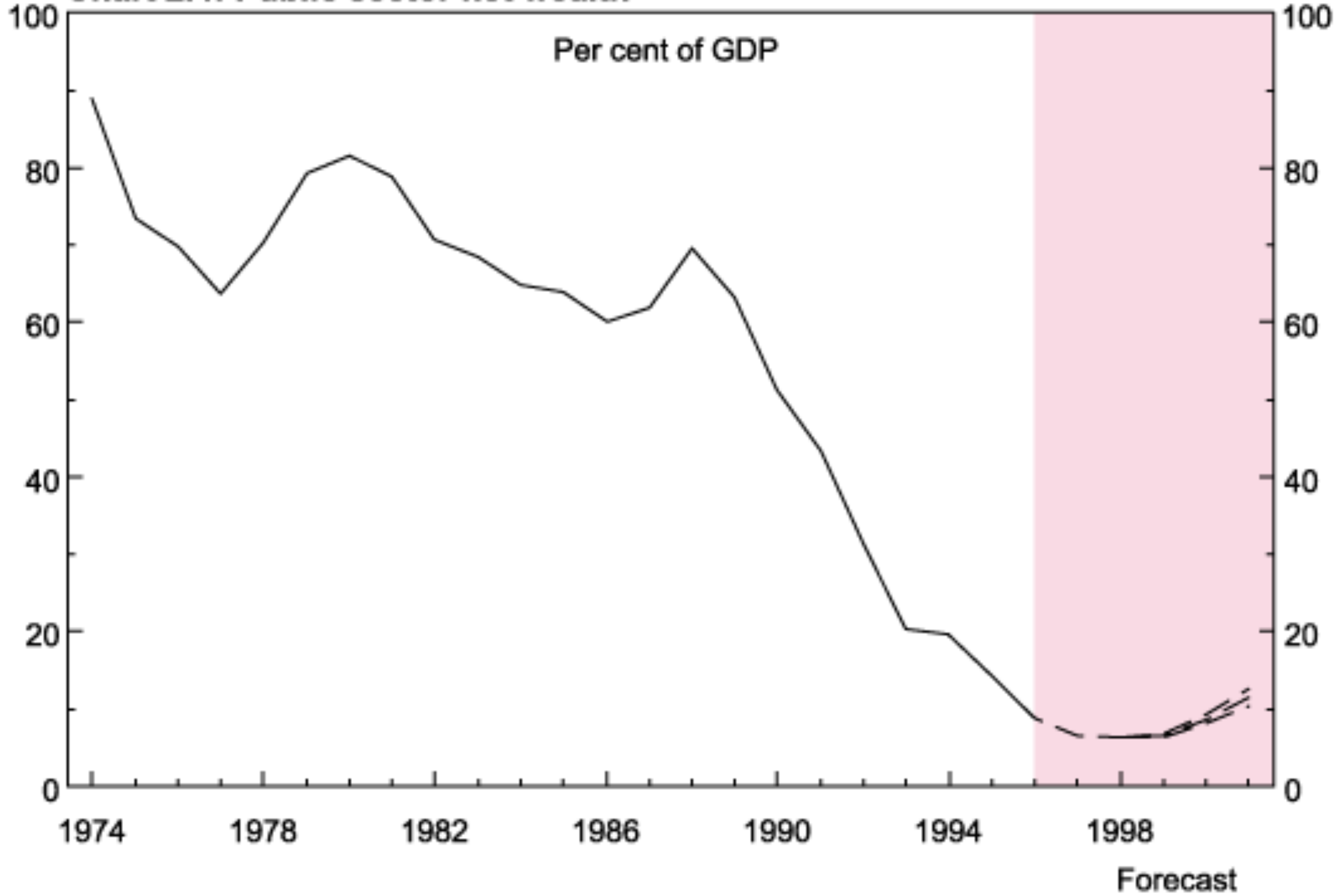

Cyclically-adjusted PSBR – cautious case
Per cent of GDP
6
5
4
3
2
1
0
-1
-2
-3
-4
1992–93
1994–95
1996–97
1998–99
2000–01
2002–03

Chart 2.4: Public sector net wealth



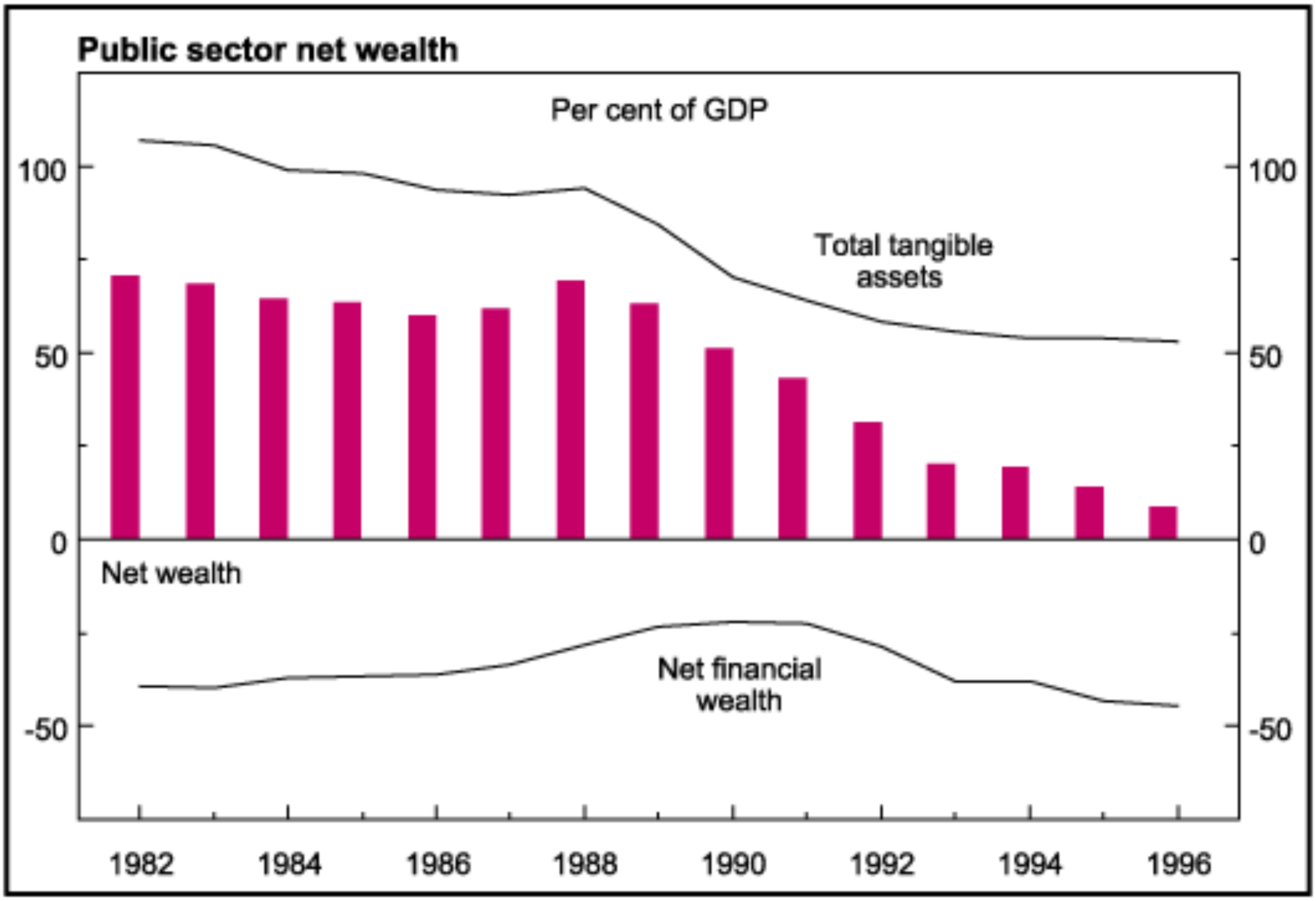
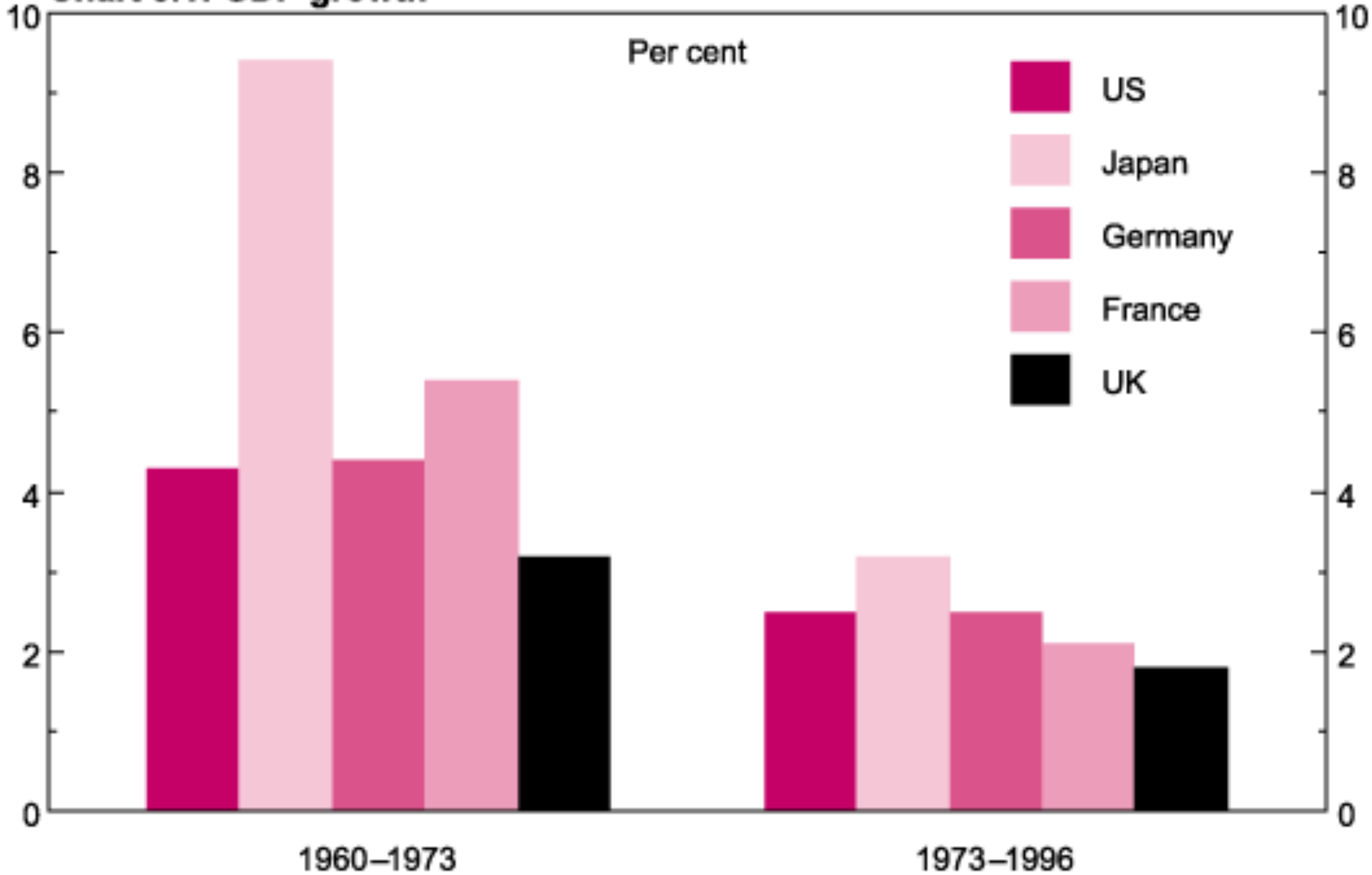

Public sector net wealth
Per cent of GDP
Total tangible assets
Net wealth
Net financial wealth
100
50
0
-50
1982
1984
1986
1988
1990
1992
1994
1996

Chart 3.1: GDP growth

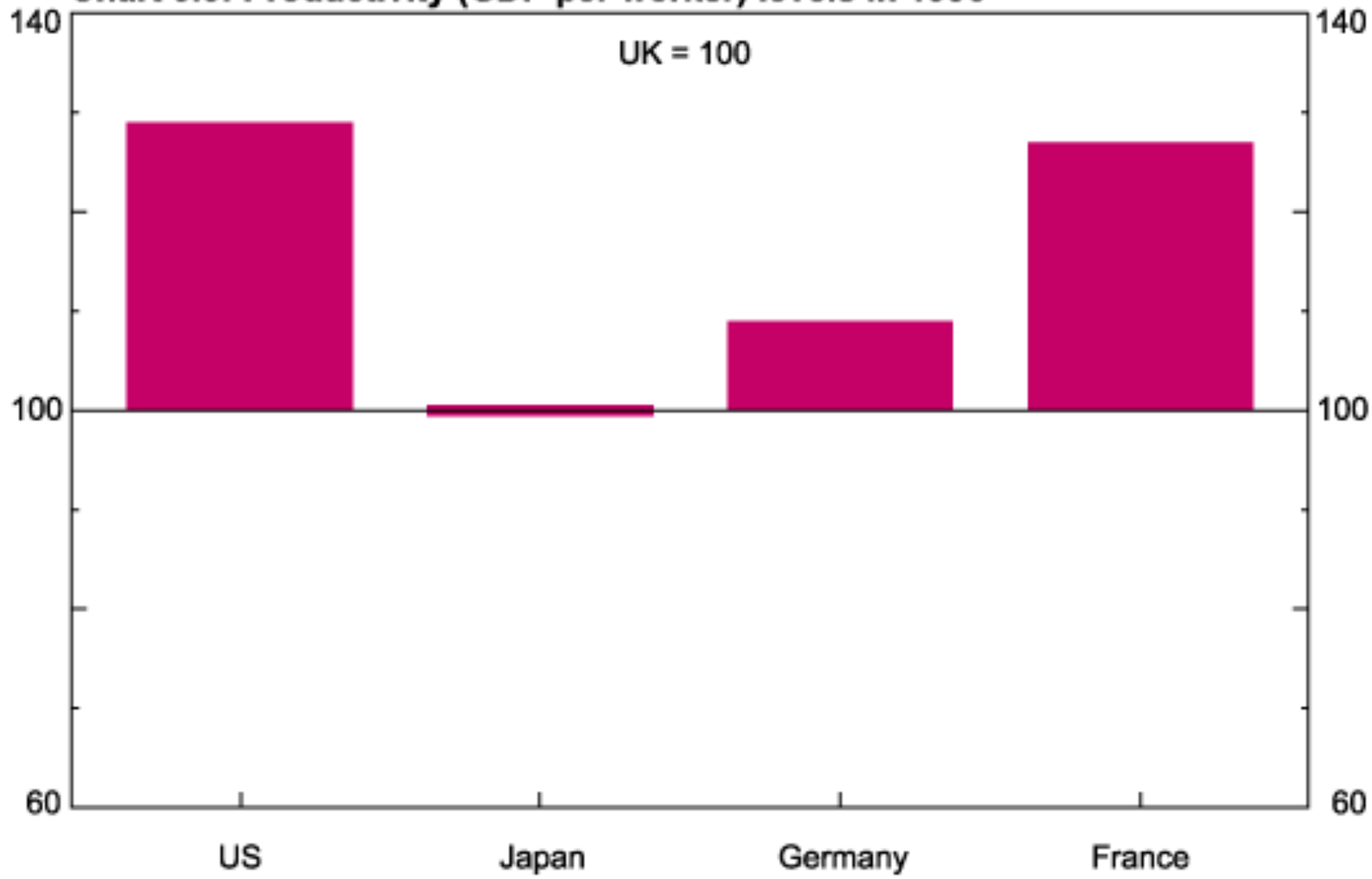


Source: OECD.

Chart 3.2: Relative GDP per head

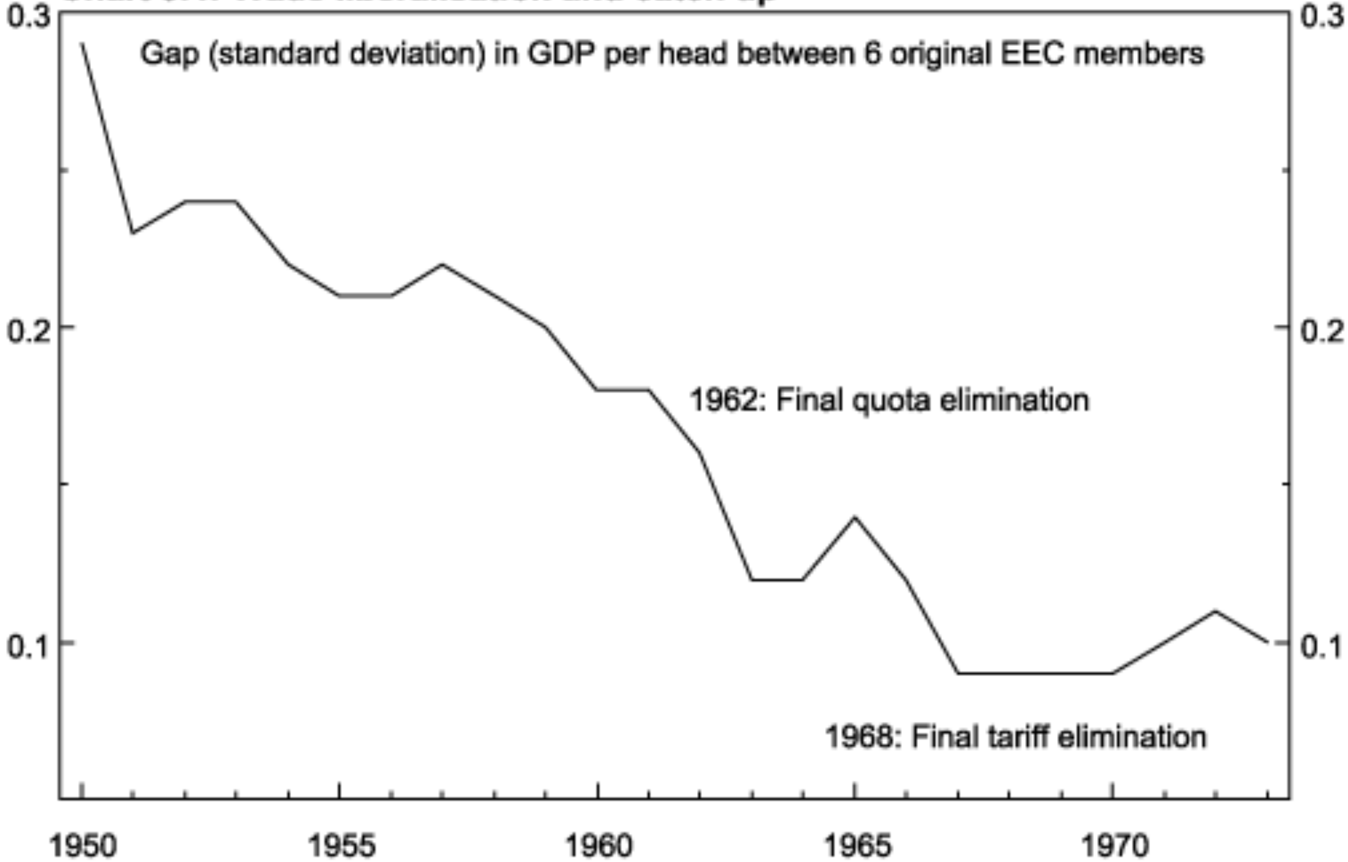
Source: OECD.

Chart 3.3: Productivity (GDP per worker) levels in 1996



Source: OECD.

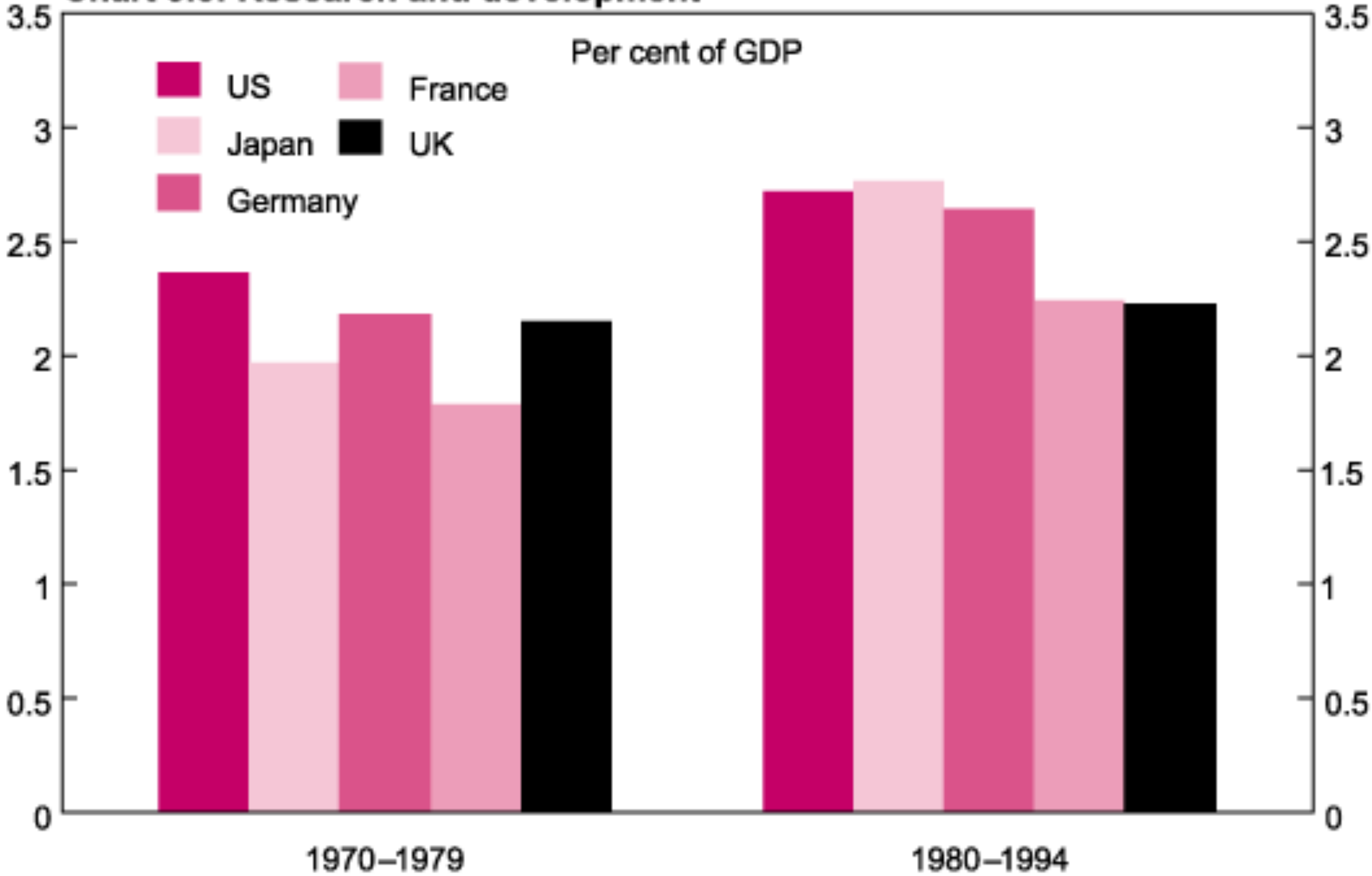
Chart 3.4: Trade liberalisation and catch up



Source: Penn World Tables.

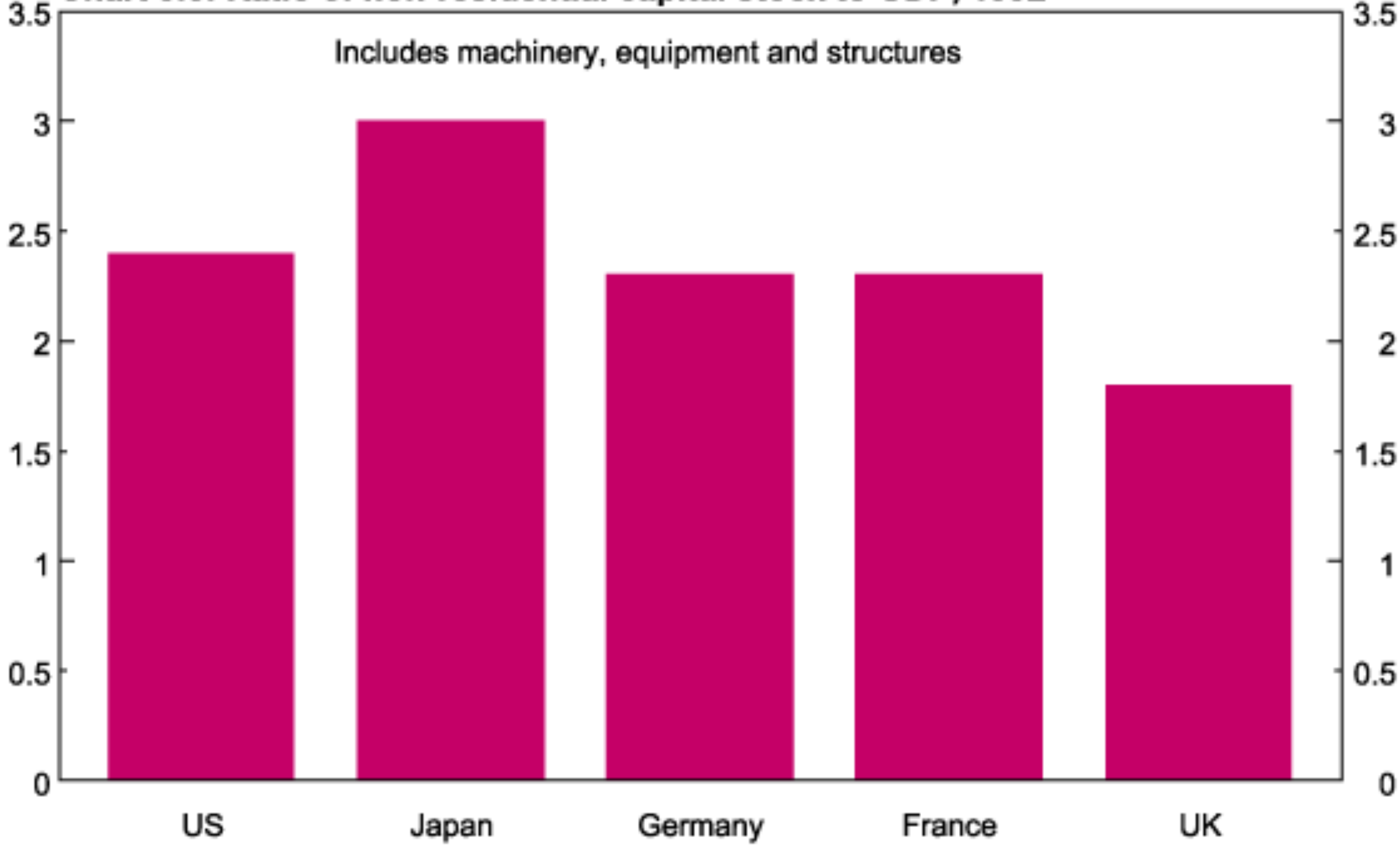
Based on a chart by Dan Ben-David, Quarterly Journal of Economics, August 1993.

Chart 3.5: Research and development



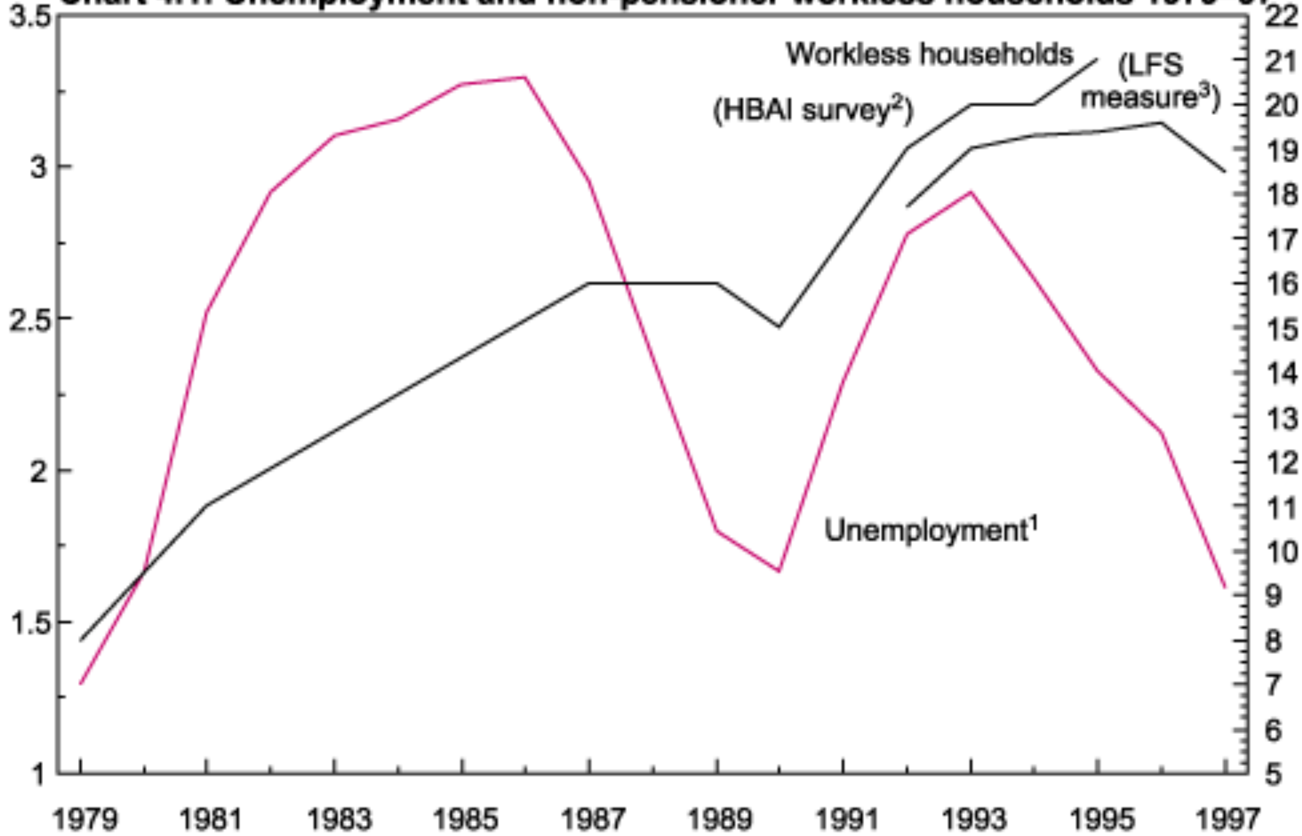
Source: OECD.

Chart 3.6: Ratio of non-residential capital stock to GDP, 1992



Source: Maddison, OECD Development Centre, 1995.

Chart 4.1: Unemployment and non-pensioner workless households 1979–97

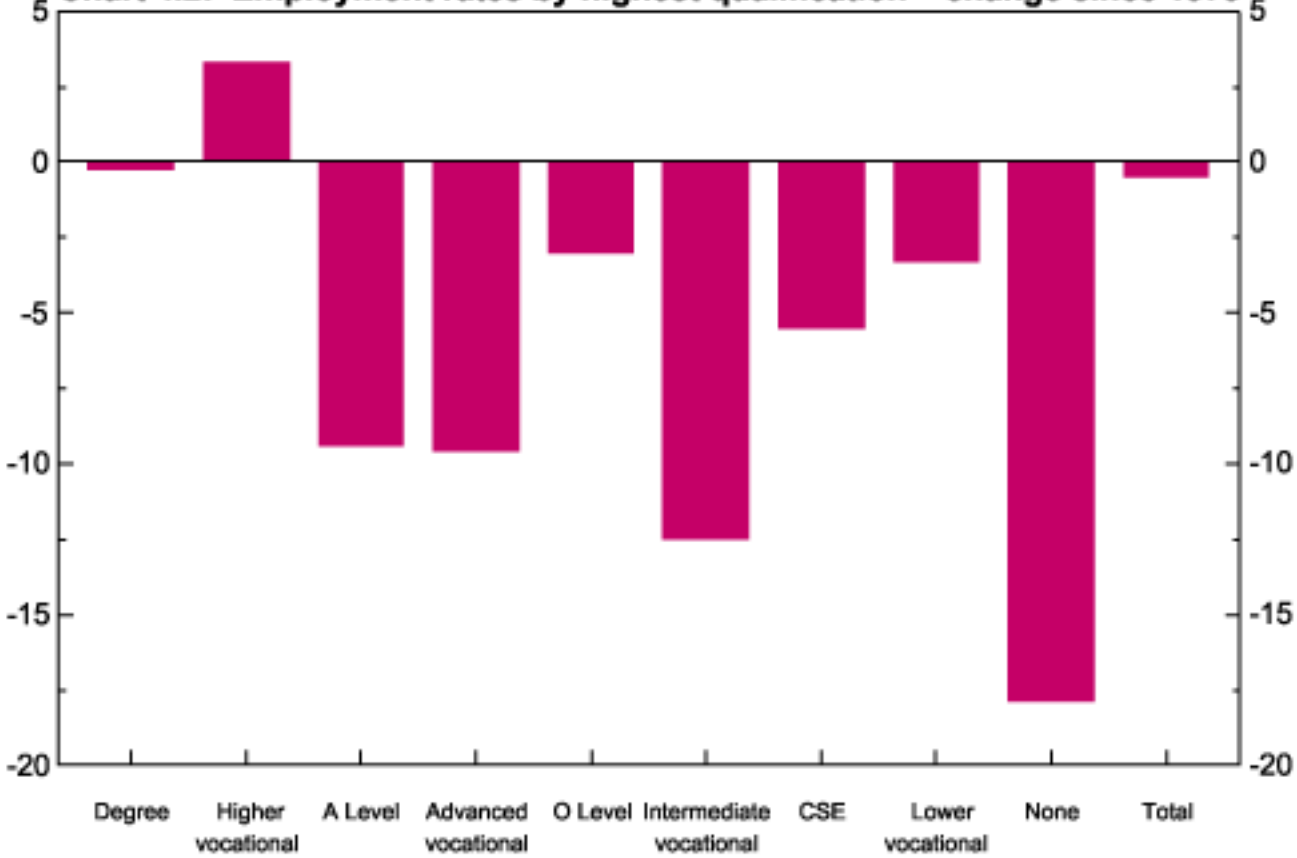


[1] *Claimant count measure, left hand scale, millions.*

[2] *Workless households estimated using Households Below Average Income survey, right hand scale, per cent.*

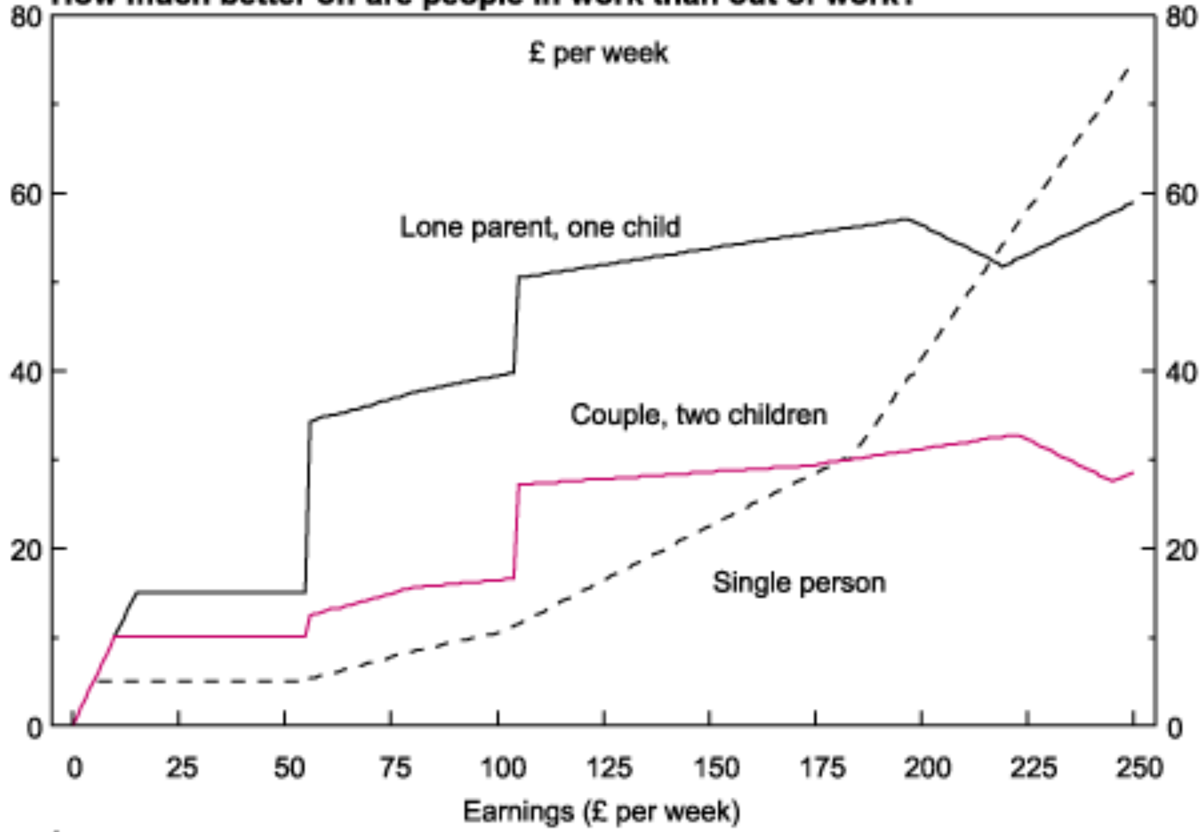
[3] *Workless households estimated using Labour Force Survey measure, right hand scale, per cent.*

Chart 4.2: Employment rates by highest qualification – change since 1979[1]



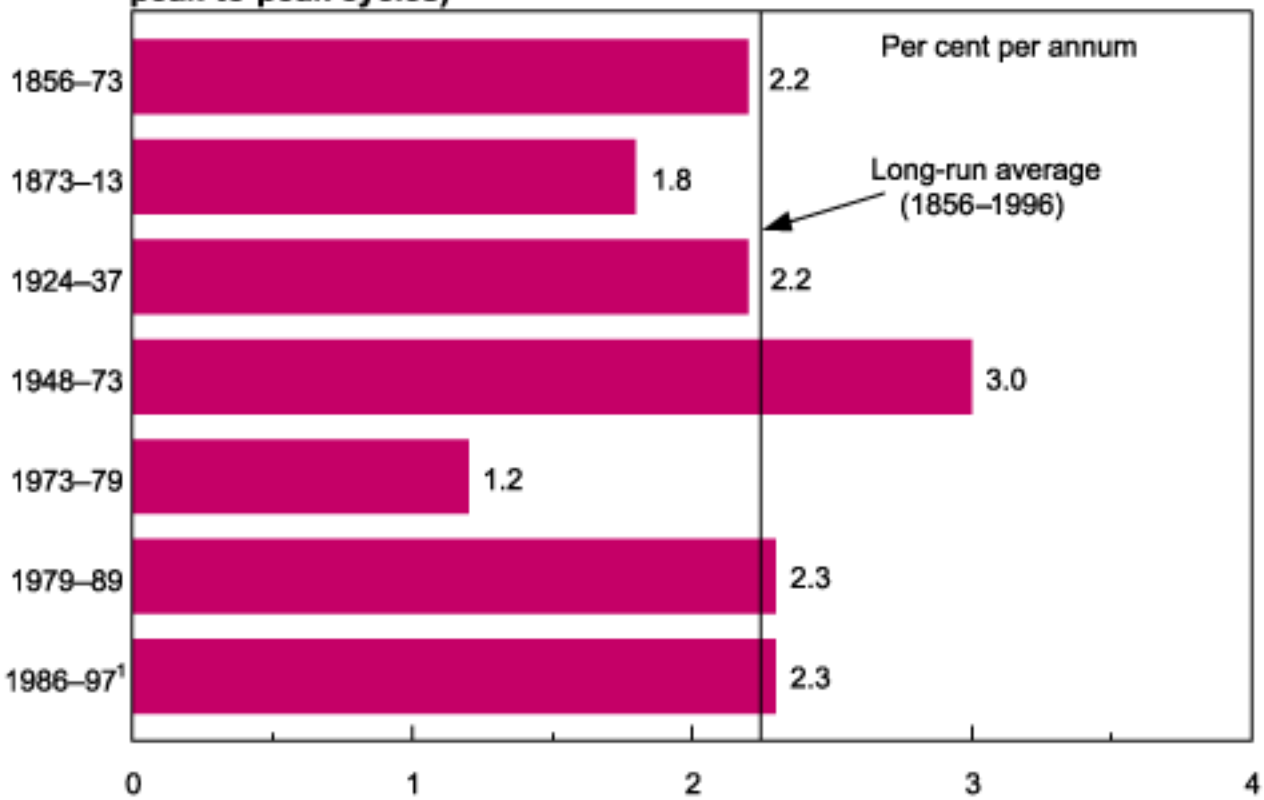
[1]*Percentage point change in the employment rate among people of working age Source: Labour Force Survey; analysed by Peter Robinson, Employment Policy Institute.*

How much better off are people in work than out of work?[1]



[1] *Difference in cash income, assuming a typical private sector rent, children aged under ten, earnings of £3.50 an hour, no other income or capital.*

Chart A1: Historical trends in output (average growth over peak-to-peak cycles)



[1] Between estimated on-trend points.

Source: Data before 1948 from Matthews, Feinstein and Odling-Smee, "British Economic Growth 1856–1973" and The Economist, "One Hundred Years of Economic Statistics".

Chart A2a: CBI capacity utilisation in manufacturing

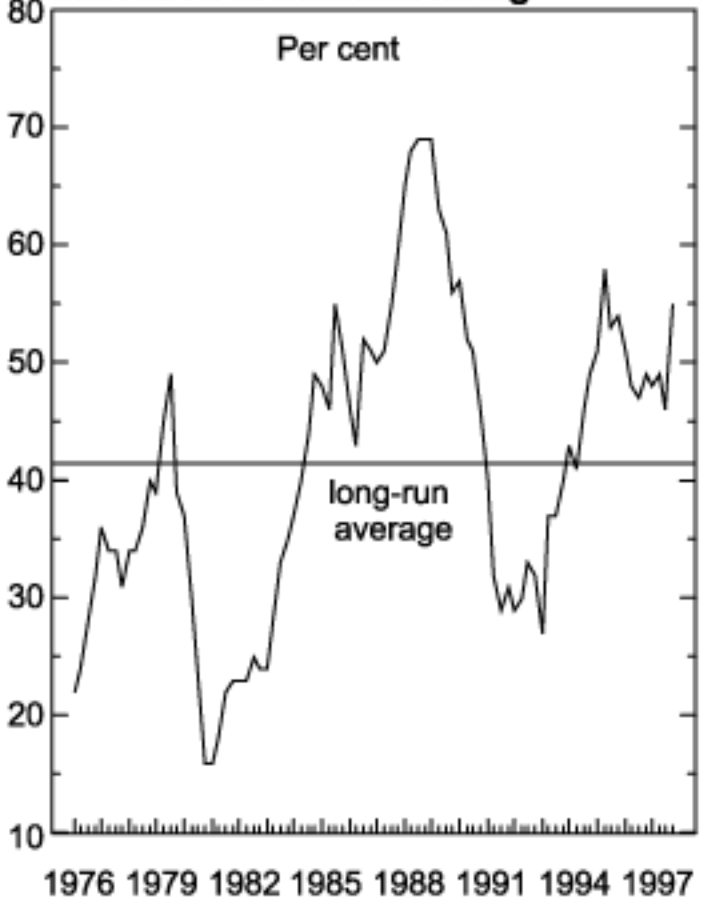


Chart A2b: BCC survey of capacity utilisation

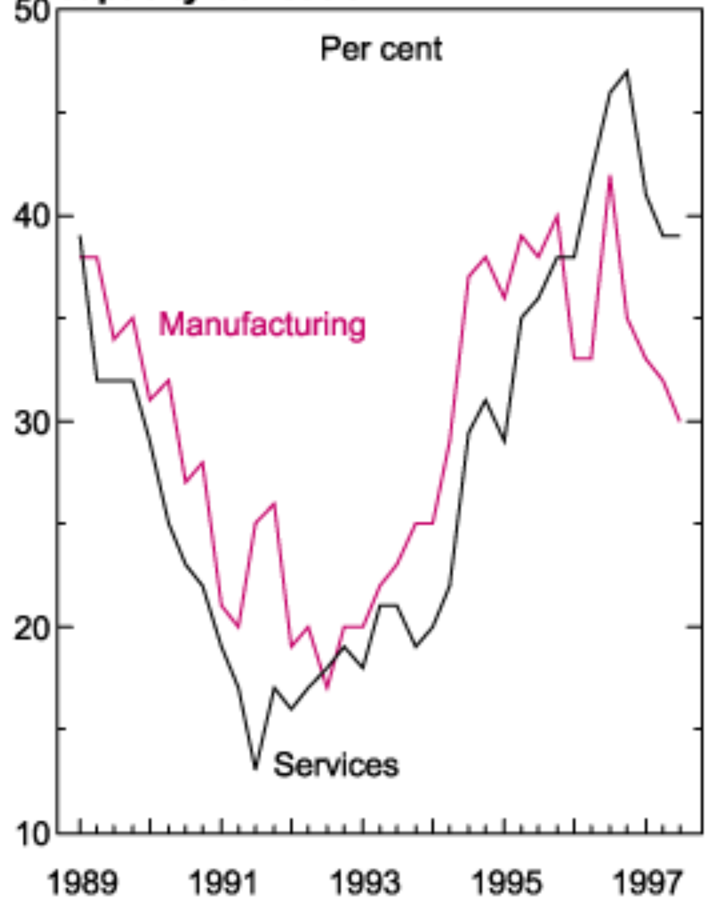


Chart A3a: CBI survey of skilled labour shortages

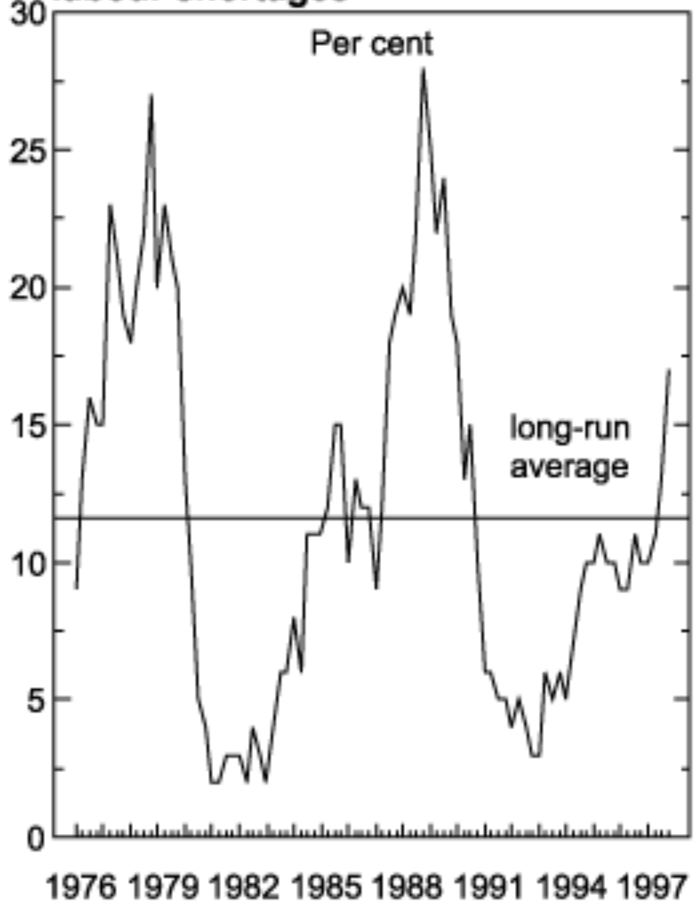


Chart A3b: BCC survey of recruitment difficulties

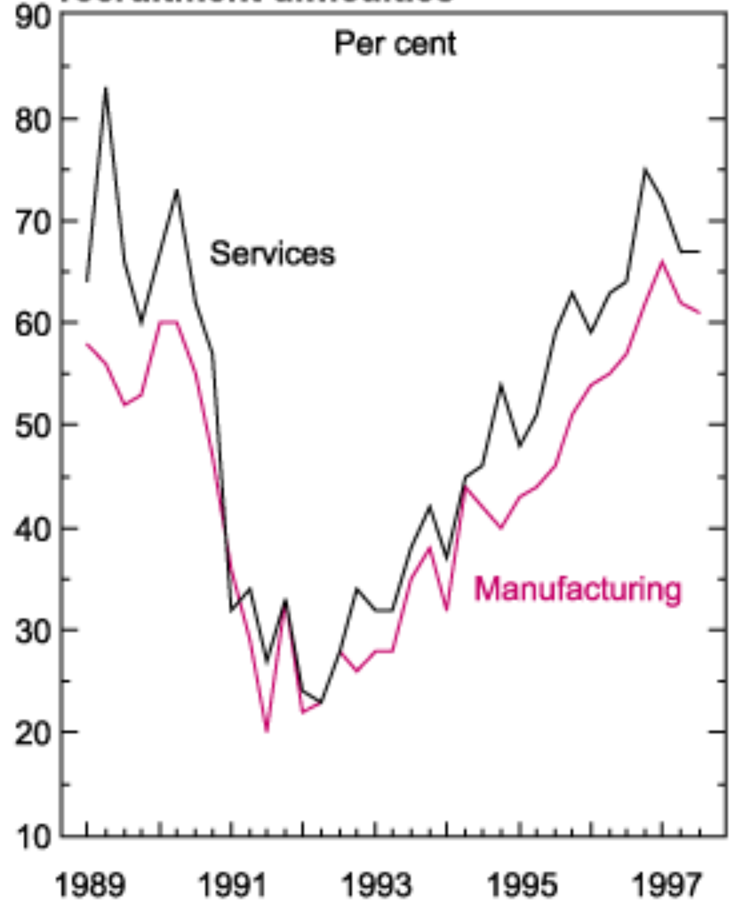
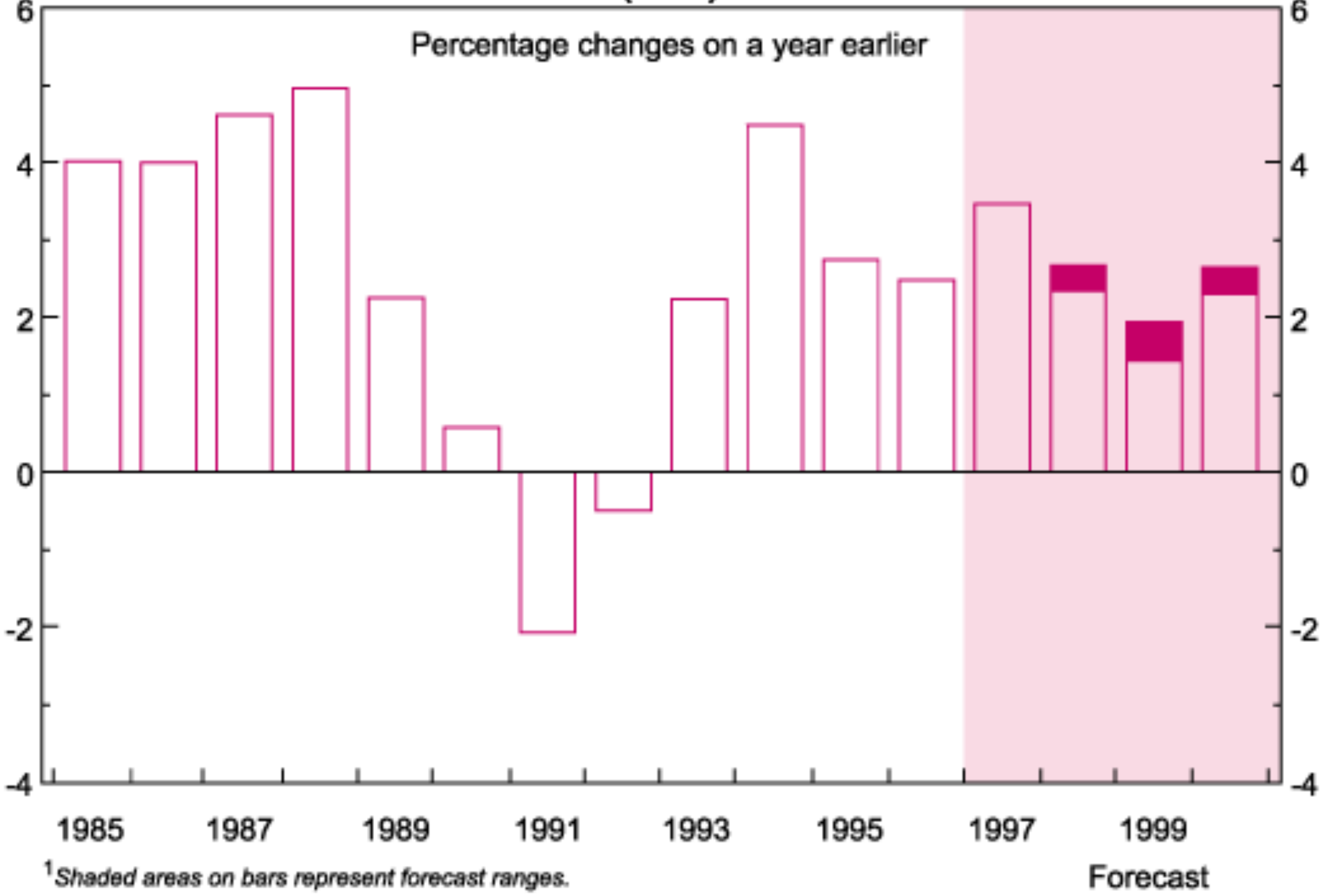
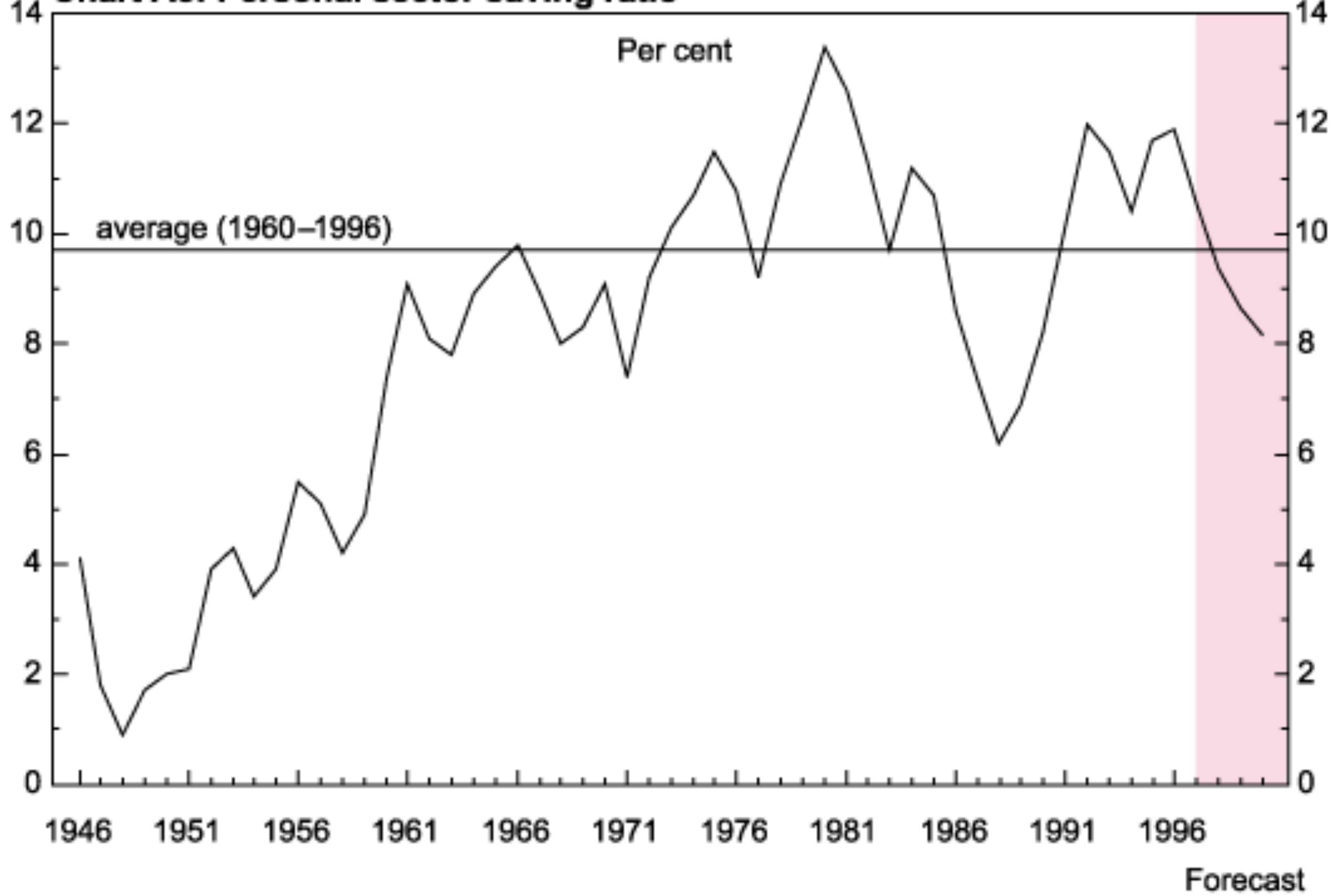


Chart A4: Gross Domestic Product (GDP)[1]



[1] *Shaded areas on bars represent forecast ranges.*

Chart A5: Personal sector saving ratio



WINDFALL PAYMENTS

People have received about £34 ½ billion this year in "windfall" payments associated with the de-mutualisation of various building societies and insurance companies. This represents huge potential spending power - equivalent to around 7 per cent of nominal consumers' expenditure in 1996. But both theory and evidence (from previous flotations and consumer surveys) has suggested that most of the capital sum was likely to be saved, not spent.

In the July Budget forecast, it was assumed that annual spending would amount to about 15 per cent of the payouts (then estimated to total around £30 billion), though this effect was not expected to build up fully until 1998. By the end of 1997, consumer spending was expected to be approaching 1 per cent higher than otherwise, with about £2 billion extra spending this year and about £4 ¼ billion next year, adding around ½ percentage point to the annual growth rate in each year.

But since Budget time there has been new information in the form of somewhat higher than expected windfall outturns and the MORI survey conducted by the Bank of England in late August, which provides the best evidence to date on spending out of windfalls. This survey indicated that around 16 per cent of the windfalls paid out had already been spent, but that over a third of this spending would have occurred anyway, implying additional spending of around £3 ½ billion (or about 10 per cent of the payouts). The survey also identified further spending out of windfalls amounting to some £1 ¾ billion that was likely to occur over the following 12months.

These results tend to confirm that the previous assumptions for total spending out of windfalls this year and next were in the right ball park, but suggest a different profile. It now appears that this spending has been a lot less spread out, concentrated mainly in mid-1997.

However, there is a case for not taking the MORI results entirely at face value because they may reflect an element of respondents' confusion between actual and planned spending. Accordingly, the forecast is based on the assumptions that **transitory** spending of windfall capital is likely to amount to around £3 ½ billion in 1997 and £1 ½ billion in 1998. In addition, allowance is made for a **permanent** boost to spending from the interest on unspent windfalls, which is assumed to add at least a further £ ¾ billion to the level of consumers' expenditure next year (but not this year). These assumptions amount to assuming that the overall effect of windfalls is to boost growth in total consumers' expenditure by ¾ percentage points in 1997 as a whole and to reduce it by ¼ percentage point in 1998.

A.30 Prospects for consumption depend on both the growth of incomes and the proportion of their incomes which consumers choose to spend. Real personal disposable income growth is expected to be around its long-term trend rate of 2 ½ per cent both this year and next, but to slow temporarily in 1999. This reflects both slower earnings and employment growth in response to slower output growth and a slowdown in the growth of dividend income.

A.31 The judgement on the saving ratio is particularly difficult. As a ratio to income, personal sector net financial wealth is currently at a record high. High consumer confidence and a strengthening housing market (with further rises in real house prices in prospect) should also underpin some fall in the saving ratio. But some of the factors described above, which seem likely to have kept the saving ratio high in recent years, will remain relevant. In addition, the recent tightening of monetary policy may limit the extent to which consumers are willing to save a lower proportion of their incomes through next year, as a result of the relatively high level of real interest rates.

A.32 Balancing these considerations, it seems likely that the saving ratio will fall back over the next three years, although to nothing like the extent seen in the late 1980s. It is assumed to decline to around 8 ¼ per cent in 2000.

A.33 After increasing by around 4 ½ per cent this year, consumer spending is forecast to decelerate through next year, as the saving ratio falls more slowly than this year and income growth begins to slow. It is projected to grow by 3 ½ to 3 ¾ per cent in 1998 and by 1 ½ to 2per cent in 1999. Thereafter, it is assumed to grow broadly in line with GDP.

Investment

A.34 The ratio of whole economy investment to GDP has averaged around 17per cent over the past 50 years, although this includes the low figures of the immediate post-war years. Since 1960, the ratio has averaged around 18 per cent. During the rapid expansion of the late 1980s it rose sharply, peaking in 1989 at a level similar to its previous high in the late 1960s, before falling back during the early 1990s recession. It has continued to fall over the past five years and is now around 1percentage point below its average since 1960. It is, however, currently similar to the level achieved at the equivalent stage of the last cycle in 1986/87.

UK INVESTMENT PERFORMANCE

The UK's overall investment performance has been poor by international standards. UK whole economy investment as a share of GDP has consistently been below the OECD average since at least 1960. This poor performance has reflected relatively weak government investment over the past 20 years and weak residential investment. Over the last international economic cycle, the other major industrial economies have invested significantly more per worker than the UK - Chart 1. Business investment has been less clearly out of line with the other major industrial countries with the exception of Japan - Chart 2.

CHART 1: Whole economy investment per worker (1982-1993)

But it is not simply the quantity of investment that is important - quality matters too. Output depends on productivity as well as the amount of capital and labour. OECD data suggest positive UK capital productivity growth in the business sector during the 1980s and the first half of the 1990s. This may have compensated to some limited extent for the UK probably having a relatively low capital--output ratio. However, it is likely also to have reflected opportunities to exploit previous inefficiencies in the use of capital. So the past trend in capital productivity growth cannot be relied upon to continue.

CHART 2: Business investment (1982-1993)

Even if the UK's business investment and capital productivity performance offers some reassurance, the UK remains well behind other major industrial countries in terms of the level of GDP per head. If this is to be improved upon, then the investment ratio almost certainly needs to be increased. Even to support trend growth of 2 ¼ per cent a year, it seems likely that some increase in the investment ratio will be required.

To this end, the Government is developing measures to tackle capital market barriers to investment and pursuing reform of the corporate tax system, building on the platform of macroeconomic stability.

CHART A6: Whole economy investment - GDP ratio

A.35 The fall in the whole economy ratio in recent years reflects falling general government investment and also relatively subdued residential investment. Business investment, which accounts for around 65 per cent of the total, has been stronger. It has been rising as a proportion of GDP since 1994. Within business investment, recent growth has been led by the non-manufacturing sector, although manufacturing investment has risen strongly this year.

A.36 Nevertheless, business investment has still grown more slowly than in the 1980s recovery. While the increase in output from its 1992 trough has been slightly greater than that over the equivalent period of the early 1980s recovery, the increase in business investment has been smaller - up by 15 ¼ per cent so far in the current upswing compared with almost 27 per cent over in the first five years of the early 1980s upswing.

CHART A7: Business investment - GDP ratio

A.37 After the falls of recent years, general government investment is expected to stabilise over the next two years, partly because of the additional capital spending announced in the July Budget as part of the local authority Capital Receipts Initiative. Business investment is expected to continue to rise as a proportion of GDP, although its growth is expected to slow as firms respond to the high exchange rate and the recent tightening of monetary policy.

A.38 Overall, this implies a reversal of the decline in the whole economy investment--GDP ratio seen in recent years, with the ratio rising to around 18 ¼ per cent by 2000, a little above its long-run average.

Exports of goods and services

A.39 Export volumes have so far shown little sign of being affected by the appreciation of the exchange rate since mid-1996, continuing to grow strongly - at a similar rate to that seen during 1995 and 1996.

A.40 This behaviour of exports is perhaps not as surprising as first meets the eye. There are both cyclical and structural reasons for thinking that volumes might hold up better in the wake of the current appreciation than following the last similarly large appreciation in 1979/80, when export volumes fell continuously between mid-1980 and mid-1981. The recent appreciation has occurred with relatively modest wage pressures, while the earlier appreciation came at a time of rapid growth in labour costs. The current appreciation has also occurred against a background of stronger, and strengthening, world trading conditions. (Details of world economic developments and prospects are set out at the end of this appendix.) Moreover, much of British industry is undoubtedly in better shape than in the early 1980s and better placed to cope with the appreciation.

A.41 Looking back to the fall in sterling in September 1992, export volume growth was little changed over the following year, as exporters apparently concentrated more on increasing their profit margins than on taking the opportunity to compete for increased sales volumes. Export profit margins remained quite high subsequently and it appears that this has enabled some exporters to respond, at least temporarily, to the recent appreciation by cutting margins (although export prices have remained higher than might have been expected). It is also likely that many exporters have so far been largely insulated from the effects of the appreciation by long order books and by forward contracts and hedging against foreign currency exposure.

A.42 Nevertheless, business surveys have shown a considerable deterioration in export orders since the spring. Despite strengthening UK export markets, it seems likely that the growth of export volumes will begin to slow from the end of this year and into next. After growth of around 7 ½ per cent this year, export volumes of goods and services are expected to grow by between 5 and 5 ¾ per cent a year in 1998 and 1999. Thus, the forecast now shows stronger growth in 1997 than the Budget forecast of 6 ¼ per cent, reflecting a combination of stronger than expected UK export market growth and the element of unexplained resilience in export volumes.

A.43 The UK's share of world trade in manufactures is forecast to fall over the next two years, as exports of manufactures weaken in response to the high real exchange rate at a time when world trade is expected to accelerate.

CHART A8: Ratio of UK manufactured export volumes to world trade in manufactures

Imports of goods and services

A.44 Import volumes have been growing quite quickly over the past year, but stronger growth might have been expected on the basis of past experience, given the strength of domestic demand and the appreciation of the exchange rate. Although sterling is assumed to remain close to recent levels over the forecast horizon, slower domestic demand growth through next year is expected to result in a modest slowdown in import volume growth. The upward trend in import penetration - defined as the ratio of manufactured imports to total final expenditure - is projected to continue over the forecast period, reflecting OECD-wide trends in international specialisation.

Pattern of financial balances

A.45 The public sector moved sharply into deficit in the early 1990s, with its financial deficit reaching almost 8 per cent of GDP - exceeding the peak of the mid-1970s deficit. The main counterpart to this was the emergence of a large private sector surplus, reflecting increases in the surpluses of both the personal and company sectors. With the current account of the balance of payments having been close to balance since 1994, the subsequent rapid fall in the public sector deficit from its 1993 peak has been accompanied by a decline in the private sector surplus.

A.46 After a small surplus this year, the current account is forecast to move into deficit from next year, reflecting both an increase in the deficit on goods and services and a smaller surplus on net investment income. Deficits of around ¾ to 1 per cent of GDP are projected over the next three years. With the public sector moving back to balance over this period, the counterpart to this is the private sector moving into small deficit.

CHART A9: Financial balances and the current account

The labour market

A.47 The sustainable rate of unemployment, or NAIRU, is believed to have risen in the UK during the 1970s and 1980s, but there is broad agreement that this increase has been partly reversed since the late 1980s. Although the magnitude of any fall is very difficult to estimate, most estimates of the current level of the NAIRU lie in the range of 6 to 8 per cent on the LFS measure of unemployment. However, considerably lower levels should be achievable in the long run through re-integrating the long-term unemployed back into the labour market, upgrading skills, and reforming the tax and benefit systems to promote work incentives.

A.48 Long-term unemployment is likely to be particularly important in explaining the NAIRU. UK unemployment rose enormously from the late 1960s to the late 1980s, with each successive peak in unemployment higher than the one before. The persistence of high unemployment has been associated with an increased duration of unemployment. An individual's effectiveness in the labour market is widely believed to be related to the duration spent in unemployment - the longer people are unemployed, the more difficult it is for them to find work. There is clear evidence that long spells of unemployment lead to loss of motivation, work discipline, and skills, and progressively weaker attachment to the labour market. Relatively low levels of skills and education are also common characteristics of those who become long-term unemployed. The long-term unemployed are therefore likely to be relatively ineffective in competing in the labour market, putting little downward pressure on wages.

LABOUR MARKET PARTICIPATION

Raising the employment rate (the percentage of the working age population in employment) is central to the Government's strategy of reducing welfare dependency, extending opportunities to all and improving economic performance.

The UK's employment rate, currently around 73 per cent, is already well above the OECD and European Union averages, though within the G7 the US and Japan have higher rates. In part such variation between countries reflects cultural factors (e.g. in Spain and Turkey, where female participation is particularly low). But it is clear that with over 4 ¼ million people, one in eight of the population of working age, saying that they want work (2 million unemployed and over 2 ¼ million of the economically inactive), considerable scope exists for raising the UK's employment rate.

There are two routes towards achieving this: increasing effective labour supply through encouraging participation; and reducing the sustainable rate of unemployment. Improving work incentives through tax and benefit reform, and the New Deals for lone parents and the young and long-term unemployed, will together operate on both these fronts.

Currently the participation rate (the percentage of working age population either in employment or unemployed) is just under 79 per cent, 2 percentage points down on its pre-recession peak in spring 1990. It troughed in early 1995 but its failure to show any significant recovery since is perhaps surprising. There has been a modest long-term upward trend in the participation rate, with rising female participation slightly more than offsetting some downward trend in male participation. And typically there is a pronounced cycle around this trend as people are discouraged from looking for work when unemployment rises, and encouraged back into the labour market as unemployment falls. However, this pattern has not been observed in the current upswing.

The cyclical fall in participation in the 1990s coincided with strong expansion in the number of students going into further and higher eduction, and rising numbers of Incapacity Benefit claimants and people taking early retirement. These developments probably had the effect of translating what might otherwise have been a cyclical fall into a largely permanent step down in the participation rate. And more recently, changes to the administration of unemployment benefits (which probably also effect the survey measure of unemployment) may have contributed further to explaining why the participation rate has appeared to remain fairly stable while economic activity has accelerated. Normal cyclical effects may have been operating over the 1990s so far, but masked by the effects of these other factors. This would imply that the participation rate is currently close to its trend level, with little cyclically low element waiting to unwind, consistent with the view that the output gap has now closed.

CHART: LFS unemployment and participation rates

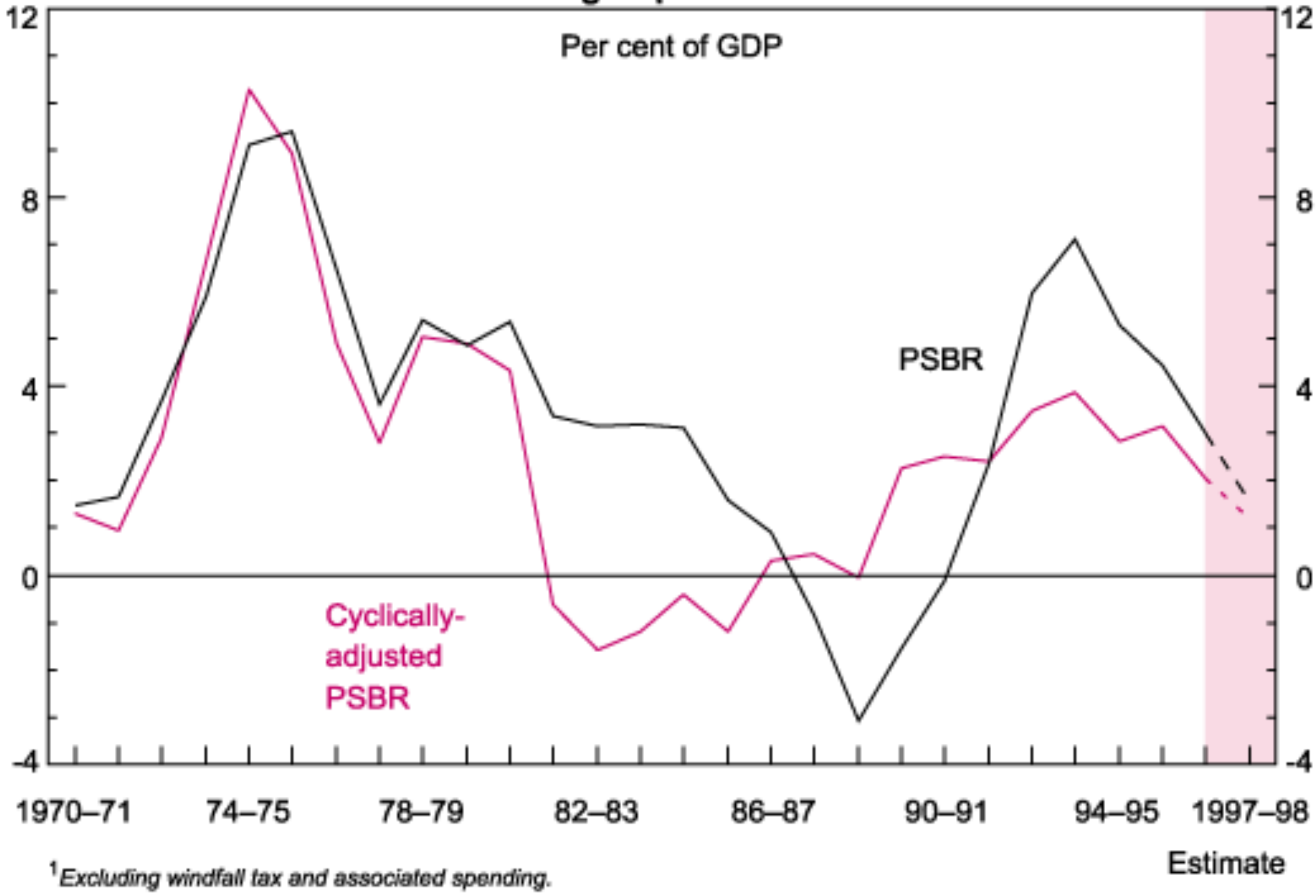
However, it is possible that, even if unemployment has reached the NAIRU, there may be some slack left in the labour market in the form of cyclically low participation. In other words, excess demand (output gap) pressures could be somewhat weaker than assumed, with the implication of less inflationary threat in prospect. But this does not square easily with other evidence on the current output gap.

Over the medium term, labour force participation is projected at least to return to its historical upward trend, with the participation rate rising by ½ percentage point over the next five years. Together with increases in the population of working age of about 0.3 per cent a year, this accounts for the assumption that trend growth in labour supply will be ¼ to ½ per cent a year. However, a cycle around this path is expected, with the participation rate rising significantly in 1997, turning down again during 1998 and 1999, and recovering thereafter.

Policy measures are also being put in place to boost the participation rate by promoting employability and work incentives.

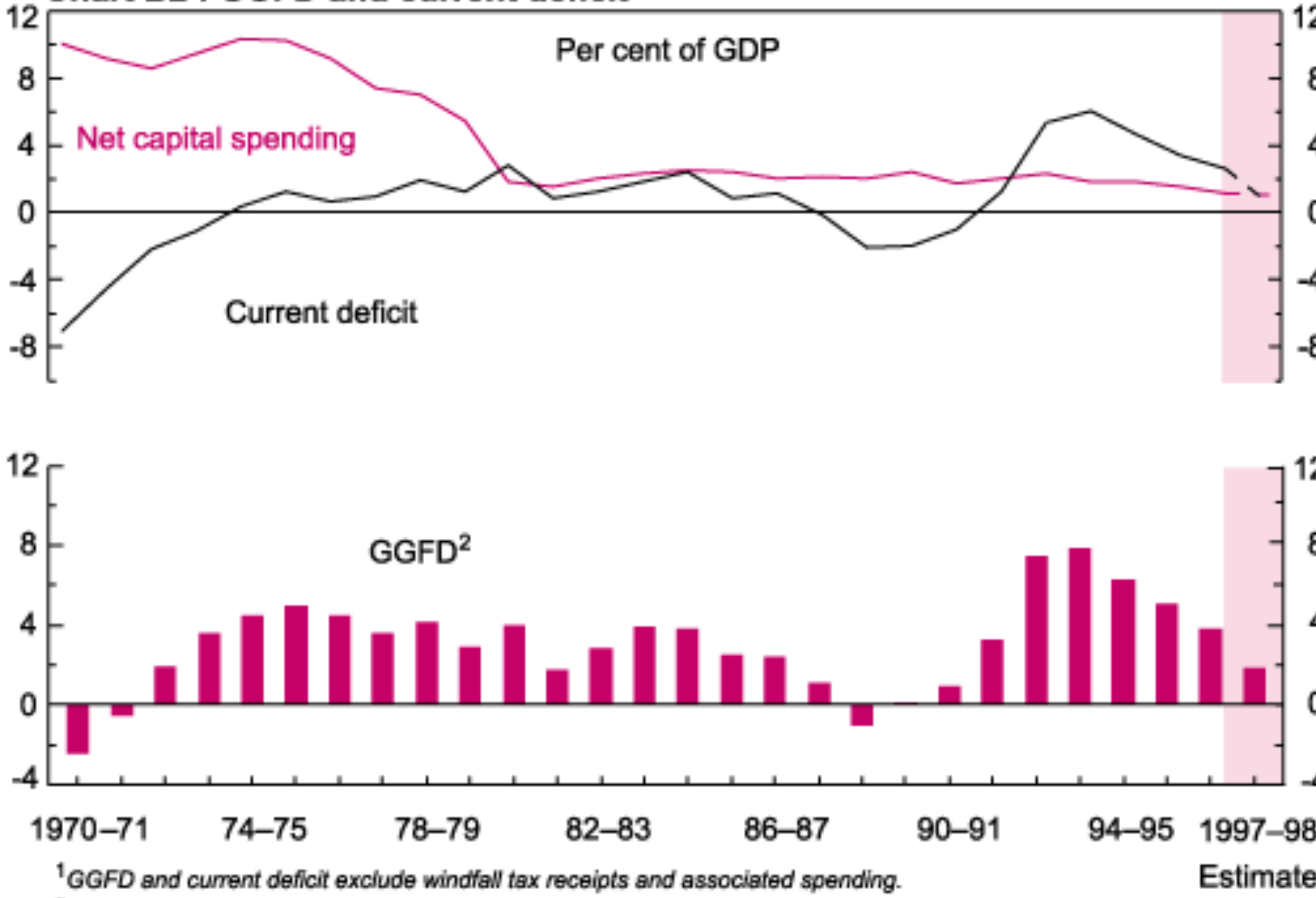
A.49 The avoidance of past large demand management errors will be important to achieving low unemployment. Beyond that, it will be necessary to look to responsible wage setting and microeconomic solutions, such as the New Deal, which seek to re-integrate the young and long-term unemployed back into the effective labour force.

Chart B1: Public sector borrowing requirement[1]



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

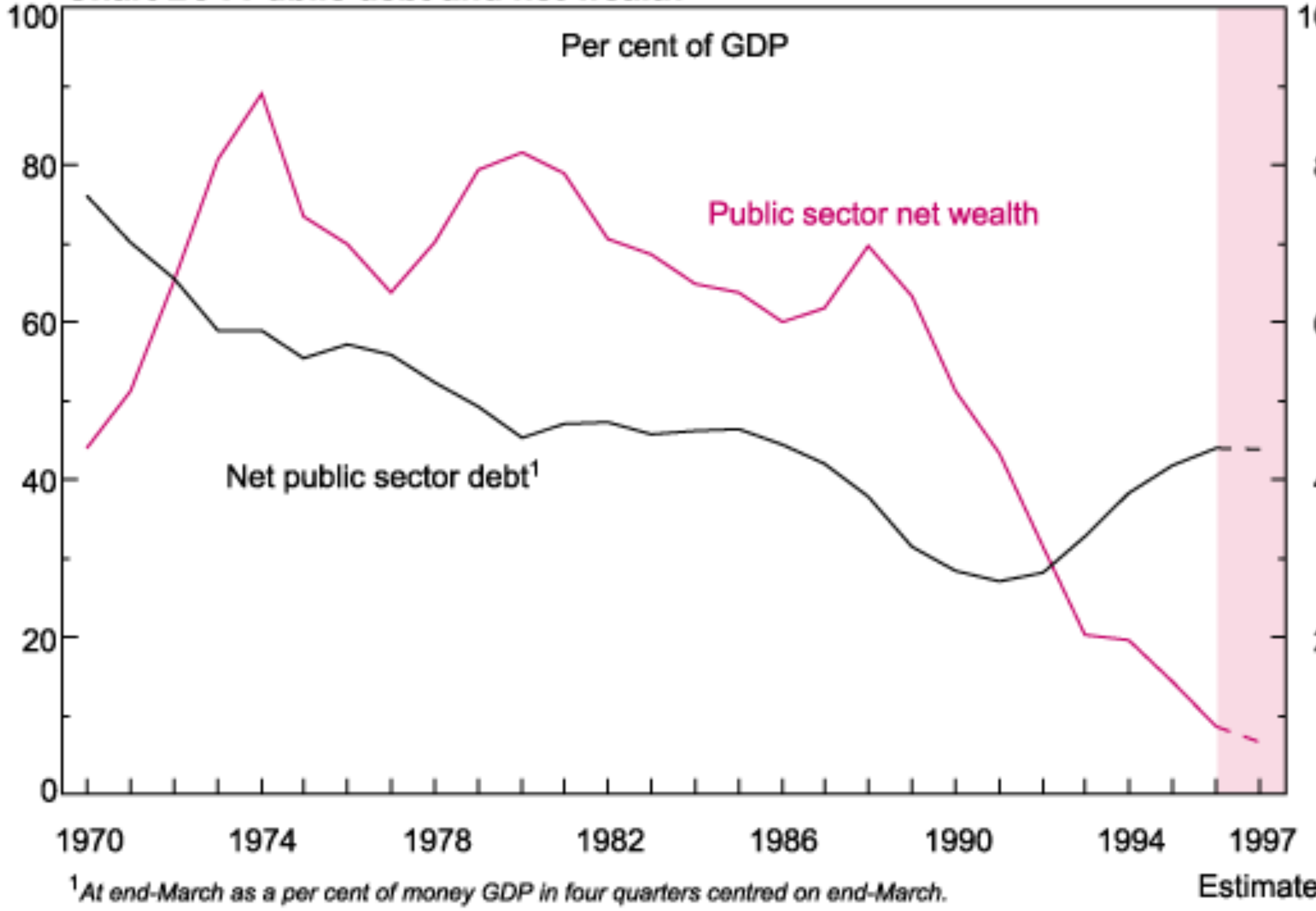
Chart B2 : GGFD and current deficit[1]



[1] *GGFD and current deficit exclude windfall tax receipts and associated spending.*

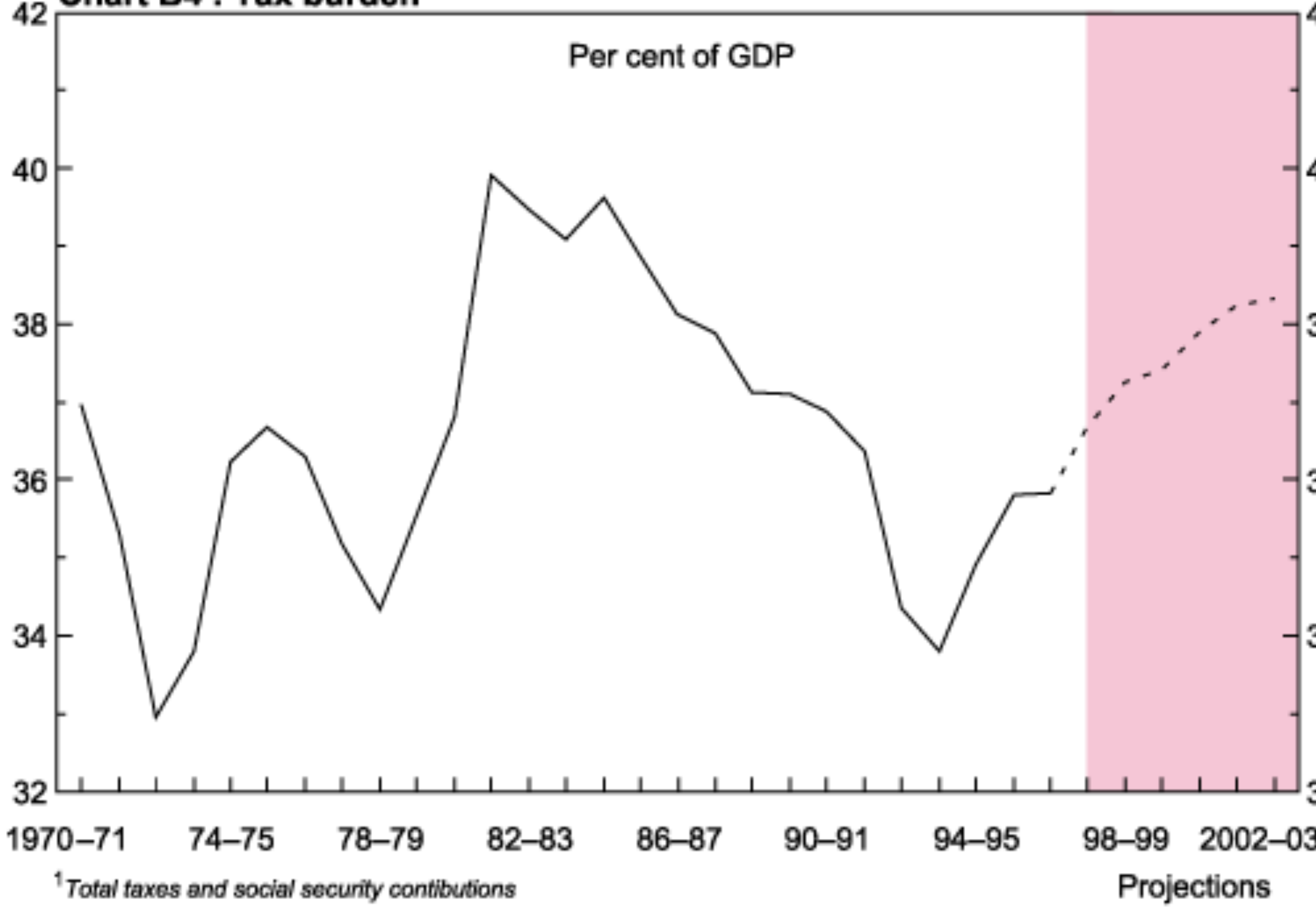
[2] *UK national accounts definition.*

Chart B3 : Public debt and net wealth



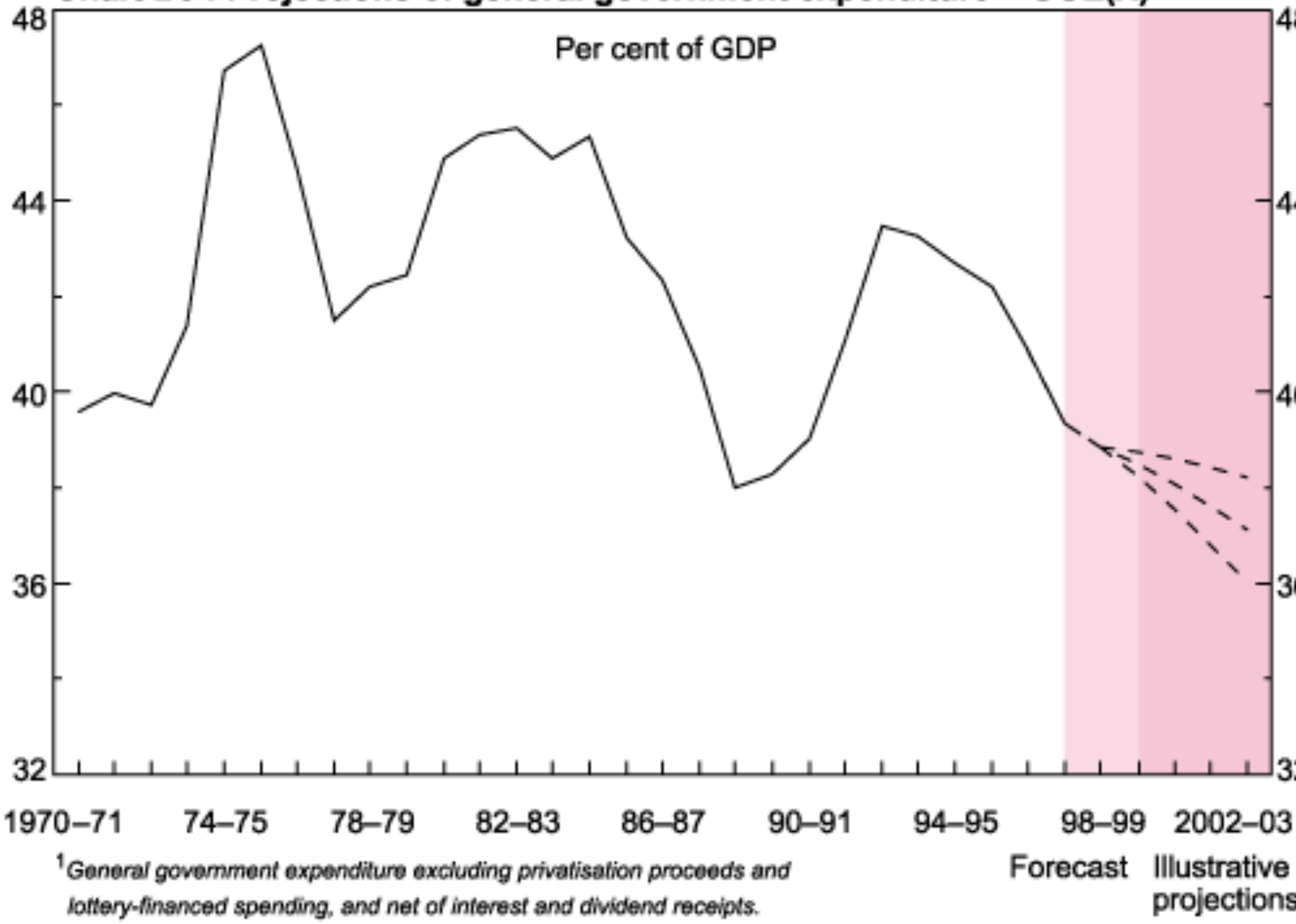
[1] *At end-March as a per cent of money GDP in four quarters centred on end-March.*

Chart B4 : Tax burden[1]



[1] *Total taxes and social security contibutions on a national accounts accruals basis.*

Chart B5 : Projections of general government expenditure – GGE(X)[1]



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

BUDGET DEFICITS

B.26 Table B6 shows forecasts for budget deficits and public debt for 1997-98 and 1998-99 and projections for later years under the three spending assumptions.

Table B6 : Projections of budget deficits and debt(1)

					per cent of GDP		
	Outturn	Estimate			Projections		
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
GGR	37.9	38.5	39.1	39.0	39.5	39.6	39.8
Tax burden	35.8	36.7	37.2	37.4	37.9	38.2	38.3
(A) ¾ per cent real CT growth							
GGFD(2)	3.8	1.9	0.7	-0.3	-1.4	-2.4	-3.3
Current balance	-2.5	-0.8	0.3	1.3	2.4	3.4	4.2
PSBR	3.0	1.5	0.7	-0.1	-1.3	-2.2	-3.2
Net public sector debt	45.1	44.0	43.1	41.3	38.5	34.8	30.2
General government gross debt(3)	54.3	52.2	51.0	49.3	46.3	42.4	37.8
(B) 1 ½ per cent real CT growth							
GGFD(2)	3.8	1.9	0.7	0.0	-0.9	-1.6	-2.2
Current balance	-2.5	-0.8	0.3	1.0	1.9	2.6	3.2
PSBR	3.0	1.5	0.7	0.1	-0.8	-1.4	-2.1
Net public sector debt	45.1	44.0	43.1	41.6	39.2	36.2	32.7
General government gross debt(3)	54.3	52.2	51.0	49.5	47.1	44.0	40.4
(C) 2 ¼ per cent real CT growth							
GGFD(2)	3.8	1.9	0.7	0.2	-0.4	-0.9	-1.1
Current balance	-2.5	-0.8	0.3	0.8	1.4	1.9	2.2
PSBR	3.0	1.5	0.7	0.4	-0.2	-0.6	-1.0
Net public sector debt	45.1	44.0	43.1	41.8	40.0	37.7	35.3
General government gross debt(3)	54.3	52.2	51.0	49.8	47.9	45.5	43.1

1 GGFD, current balance and PSBR exclude windfall tax receipts and associated spending.
2 UK national accounts definition.
3 Ratio on a Maastricht basis. GDP is on an ESA basis, year ending in March.

B.27 All measures of the budget deficit continue to improve. Current surpluses prevail from 1998-99 onwards.

CHART B6: Projections of current balance

B.28 Even in case C, where real spending rises fastest, the overall budget moves into surplus in 2000-01, both on the PSBR and Maastricht definitions.

CHART B7: Projections of public sector borrowing requirement

Public sector debt

B.29 Public sector debt declines (reflecting the improvement in the PSBR) and net wealth recovers gradually (reflecting the improvement in the current balance). But, in every case, the improvement in the public sector's balance sheet is small in comparison with the deterioration that took place over the early 1990s.

CHART B8: Projections of debt and wealth

Risks and error margins

B.30 These projections should be placed within realistic error bands. Errors are substantial even for forecasts a year ahead, and tend to grow as the period lengthens. The average absolute error (i.e., the average irrespective of whether errors are positive or negative) has been around 1 per cent of GDP for year-ahead PSBR forecasts. This rises to almost 4 per cent of GDP for projections four years ahead.

B.31 To a large extent, these errors have arisen because of errors in GDP forecasts (which were especially large in the late 1980s and early 1990s). If GDP forecasts had been exactly right, it is estimated that the average absolute error in projections four years ahead would have been substantially smaller - around 1 ¾ per cent of GDP. However, this is still large; and, moreover, the projections have suffered from a distinct optimistic bias (the average errors shown in brackets in Table B7 are all positive). This underlines the importance of basing projections on cautious assumptions.

Table B7: Errors in Budget projections of the PSBR(1)

		per cent of GDP
	Average absolute error(2)	Average error(3)
One - year ahead	**1.1 (1.1)**	**-0.1 (0.4)**
Two - years ahead	**1.9 (1.3)**	**0.1 (0.7)**
Three - years ahead	**2.8 (1.6)**	**0.9 (1.2)**
Four - years ahead	**3.9 (1.7)**	**1.8 (1.7)**

1 For the period 1985 to 1996. Figures in brackets are adjusted for the estimated effect of the errors in the GDP forecasts. This is done by using the estimates of the sensitivity of the PSBR to GDP given in HM Treasury Occasional Paper, No. 4, "Public Finances and the Cycle".
2 The average error ignoring signs.
3 The average error taking signs into account.

B.32 As pointed out in Appendix A, one major uncertainty concerns the current cyclical position of the economy. It is possible that output is currently more above trend than the economic projections are assuming (i.e. there was already a positive output gap in the first half of the year when it is estimated in Appendix A that the economy was on trend). If this were so, the outlook for the public finances would be less favourable. ChartB9 illustrates this point by showing alternative projections for the cyclically-adjusted GGFD and current balance on the more pessimistic assumption that output was 1 ½ per cent above trend in the first half of 1997. Under this assumption, the cyclically-adjusted current balance is not projected to move into surplus until 1999-2000 or 2000-01.

CHART B9: Cyclically-adjusted budget deficits

Historical series

B.33 Table B8 sets out historical series for the public sector current balance, financial deficit and borrowing requirement, and the general government financial deficit. Table B9 shows series for government receipts and expenditure.

Table B8: Budget deficits(1)

per cent of GDP

	Public sector current balance	Public sector financial deficit	Public sector borrowing requirement	General government financial deficit(2)
1970-71	7.1	-0.5	1.5	-2.4
1971-72	4.5	1.2	1.7	-0.6
1972-73	2.2	3.1	3.7	1.9
1973-74	1.1	4.7	5.9	3.6
1974-75	-0.4	6.8	9.1	4.4
1975-76	-1.2	7.5	9.4	5.0
1976-77	-0.7	5.8	6.5	4.4
1977-78	-0.9	4.4	3.6	3.6
1978-79	-1.9	5.0	5.4	4.2
1979-80	-1.2	4.0	4.9	2.9
1980-81	-2.6	5.0	5.4	4.0
1981-82	-0.8	2.1	3.4	1.8
1982-83	-1.2	3.1	3.2	2.9
1983-84	-1.8	3.8	3.2	3.9
1984-85	-2.4	4.2	3.1	3.9
1985-86	-0.8	2.3	1.6	2.5
1986-87	-1.1	2.1	0.9	2.4
1987-88	0.1	0.8	-0.8	1.1
1988-89	2.1	-1.5	-3.1	-1.0
1989-90	2.0	-0.5	-1.5	0.1
1990-91	1.0	0.7	-0.1	0.9
1991-92	-1.3	3.2	2.4	3.2
1992-93	-5.3	7.6	6.0	7.5

1993-94	-6.0	7.8	7.1	7.8
1994-95	-4.5	6.3	5.3	6.2
1995-96	-3.3	4.9	4.4	5.1
1996-97	-2.5	3.7	3.0	4.0
1997-98	-0.5	1.5	1.2	1.5
1998-99	0.5	0.6	0.5	0.4

1 Including windfall tax receipts and associated spending.
2 GGFD on UK national accounts definition prior to 1996-97 and a Maastricht basis thereafter.

Table B9: Historical series for government expenditure and receipts

per cent of GDP

	Non-North Sea taxes and NICs(1)	Total taxes and NICs	General government receipts	Control Total(2)	GGE(X)	GGE
1970-71	37.0	37.0	40.3		39.6	41.4
1971-72	35.3	35.3	39.9		40.0	41.8
1972-73	32.9	33.0	37.9		39.7	41.6
1973-74	33.8	33.8	38.5		41.4	43.4
1974-75	36.2	36.2	40.5		46.7	48.8
1975-76	36.7	36.7	40.2		47.2	49.3
1976-77	36.5	36.3	41.0		44.7	46.7
1977-78	35.6	35.2	39.7		41.5	43.0
1978-79	34.6	34.3	38.7		42.2	44.0
1979-80	35.5	35.5	38.8		42.4	43.9
1980-81	36.6	36.8	40.7		44.9	46.5
1981-82	39.1	39.9	43.7		45.4	47.0
1982-83	38.6	39.5	43.7		45.5	47.3
1983-84	38.1	39.1	42.9		44.9	46.1
1984-85	38.1	39.6	43.4	38.5	45.3	46.3

1985-86	37.2	38.9	42.3	36.0	43.2	44.3
1986-87	37.7	38.1	41.4	35.1	42.3	42.7
1987-88	37.6	37.9	41.1	34.7	40.5	40.7
1988-89	36.9	37.1	40.3	32.7	38.0	37.8
1989-90	37.2	37.1	40.1	33.7	38.3	38.9
1990-91	37.0	36.9	39.3	34.5	39.0	39.2
1991-92	36.7	36.4	38.3	36.5	41.0	40.6
1992-93	34.6	34.4	36.7	38.0	43.4	42.9
1993-94	34.1	33.8	35.9	37.5	43.2	43.2
1994-95	35.2	34.9	36.9	36.4	42.7	42.5
1995-96	36.1	35.8	37.9	35.7	42.2	42.7
1996-97	36.1	35.8	37.9	34.5	40.9	41.0
1997-98	36.9	36.7	38.5	33.2	39.3	39.8
1998-99	37.5	37.2	39.1	32.7	38.9	39.7

1 As a per cent of non-North Sea GDP.
2 Figures for the Control Total are only available on a consistent basis for the years shown.

A.50 From its peak in the winter of 1992--93, the Labour Force Survey (LFS) measure of GB unemployment has fallen by almost 1 million to just under 2million in the summer of 1997 (June to August), and is now only 70,000 above its previous trough in the spring of 1990. Moreover, LFS short-term unemployment (those unemployed less than a year) is now below its previous trough in 1989. The claimant count measure of unemployment has followed a similar pattern, although it has fallen more rapidly than the LFS measure since October 1996, amplified by the effects of the Jobseeker's Allowance. GB claimant unemployment has fallen by almost 1 ½ million from its December 1992 peak, to 1.4 million (5.0 per cent).

A.51 Long-term LFS unemployment (those unemployed for 12 months or more) fell by 180,000, to 690,000, in the year to summer 1997. However, at over 33 per cent of all LFS unemployed, it remains above its spring 1991 trough of 27 per cent. LFS youth unemployment (those under 25), which accounts for around 30 per cent of total unemployment, has also been declining and is 28,000 lower than a year earlier. But the youth unemployment rate remains more than double the overall unemployment rate of 7.1 per cent.

CHART A10: LFS employment and total and long-term unemployment

A.52 LFS employment has been rising strongly. In the summer of 1997, it was up by 1 ¼ million on its winter of 1992--93 trough, although still ¼ million below its pre-recession peak in spring 1990. Since the beginning of 1995, employment hasbeen rising faster than unemployment has been falling, implying an increase in labour force participation. However, participation remains 200,000 below itspre-recession peak despite a rising population of working age. Rising employment may have been persuading formerly inactive people to enter the labour market, some of whom will previously have exited because of a lack of job opportunities (discouraged workers). Nevertheless, this increase in the number of participants has only just outpaced the rise in the population of working age. So the participation rate (the proportion of the working age population who are either employed or unemployed) has done little better than stabilise since early 1995, and it remains well down on pre-recession levels.

A.53 Overall, there seems little doubt that the labour market is continuing to tighten, with both employment and unemployment close to the levels last seen at the late 1980s peak. Vacancies, which in the past have proved a reliable indicator of labour market tightness, are very high.

A.54 There is also increasing evidence of skills shortages:

- the latest CBI survey of manufacturers reported a significant pick-up in skilled labour shortages, to their highest level since the beginning of 1990;
- the recent British Chambers of Commerce surveys of the manufacturing and service sectors have reported recruitment difficulties at levels similar to their pre-recession peak;
- the October Construction Confederation survey reported labour availability as a problem for a growing proportion of companies. For example, 78per cent of respondents were experiencing difficulties recruiting bricklayers;
- the Bank of England's regional Agencies' survey in the summer reported 51per cent of service sector firms experiencing an increase in skills shortages in the past six months, compared with 45per cent of manufacturing firms;
- anecdotal evidence tends to corroborate the message from the surveys. Inparticular, skills shortages are reported as a particular concern in the ITsector.

A.55 To some extent current skills shortages reflect cyclical pressures. But these pressures themselves are partly a symptom of skills deficiencies. Evidence on skills training and educational attainment points to a fairly deep-seated structural problem, which the Government is taking steps to address.

CHART A11: Whole economy underlying average earnings

A.56 By historical standards, nominal earnings growth has been low during the current upswing. In part, this has reflected relatively subdued inflation, but it has also reflected lower real earnings growth. For example, whole economy real earnings growth has averaged around 1 per cent a year during the current upswing, compared with 2 ¼ per cent over the equivalent period of the 1980s recovery. Earnings growth slowed between 1990 and 1995, consistent with the view that unemployment was above the NAIRU over this period. It picked up last year, though this was probably due to factors such as short-term "bottlenecks", particularly in the service sector rather than unemployment falling below the NAIRU. After rising to 4 ¾ per cent at the turn of the year, boosted by bonuses, earnings growth has since been running at an annual rate of between 4 ¼ and 4 ½ per cent.

A.57 However, the economy is now at the stage of the cycle where rising earnings growth and emerging skills shortages have in the past ignited inflation and prevented unemployment from falling further. The latest survey of the service sector from the Chartered Institute of Purchasing and Supply, for example, is not encouraging in this respect, reporting growing skills shortages contributing to large increases in wages and salary costs. With unemployment now probably close to the NAIRU, and still falling, the economy needs to see the long-term unemployed helped back into the labour market, action on skills shortages, and responsible wage bargaining in order to prevent wage pressures rising and threatening employment.

A.58 The Bank of England noted in its latest Inflation Report (November 1997) that "Any increase in the current growth rate of nominal earnings would be difficult to reconcile with the inflation target of 2 ½ per cent." The rationale for this is that real earnings growth in excess of trend productivity growth cannot be sustained indefinitely; and so any significant rise in nominal earnings growth above current rates would need to be reined back by monetary policy in order to meet the inflation target, with adverse consequences for jobs.

Inflation

A.59 UK inflation has been low in recent years by the standards of the 1970s and 1980s. Since 1992, RPI excluding mortgage interest payments (RPI ex MIPs) inflation has averaged around 3 per cent, similar to the average between the mid-1950s and the late 1960s, and well below the post-war average of around 6per cent. This has not, however, been just a UK phenomenon. G7 inflation has also been low.

A.60 Nevertheless, the Government inherited a situation in which, in the absence of the corrective action which has been taken by the Monetary Policy Committee over the past six months, inflation was set to rise sharply over the next two years. Apart from April and May of this year, RPI ex MIPs inflation has remained above 2 ½ per cent since the end of 1994. Despite downward pressure from the exchange rate appreciation of over 20 per cent since summer 1996, inflation has been little changed over this period - with a smaller than expected fall-back in goods price inflation offset by higher services price inflation.

A.61 Over the past year, producer input prices have fallen sharply as the appreciation of the exchange rate has led to falling import prices. There are now, however, first signs that input prices may be levelling off. Producer output price inflation had been falling up to the beginning of this year (although by less than input price inflation), but has since stabilised. This probably reflects a combination of the continued rises in unit labour costs and manufacturers taking advantage of strong demand to expand domestic margins.

A.62 Retail price inflation has been little changed so far this year, with the temporary downward effect on inflation from lower input prices appearing to have offset the effects of increasing demand pressures as the output gap has turned positive. Although GDP growth has been in line with the Budget forecast, inflation has been a little higher than expected. While inflation had been forecast to remain broadly flat at around 2 ½ per cent over the second half of this year, it has risen to 2 ¾ per cent in the third quarter and is now forecast to remain there in the fourth quarter.

A.63 With little further feed-through expected from lower input prices to retail prices, and demand pressures increasing, RPI ex MIPs inflation is forecast to increase from its present rate of 2 ¾ per cent to a little over 3 per cent by the beginning of next year.

A.64 The relationship between the output gap and inflation is not simple, and the rate of inflation is also dependent on other factors (e.g. the real exchange rate and inflation expectations) in the short run. However, it is likely that the output gap, as a measure of excess demand, does provide useful information for assessing the prospects for inflation. Typically, when output has been above its trend level (a positive output gap), inflation has tended to rise; and in order to reduce inflation, output has typically had to grow at a below-trend rate for long enough to generate a negative output gap.

A.65 This implies that the economy will have to run below the trend level of output for a while to bring inflation down. As projected output growth slows below its trend rate next year, the positive output gap narrows. Subsequently the negative output gap generated by continued below-trend growth through the first half of 1999 begins to exert downward pressure on inflation. This path for output is judged to be sufficient to achieve the 2 ½ per cent target by the end of 1999.

CHART A12: RPI excluding MIPs

A.66 Over time, it is possible to look at the trade-off between the change in inflation and the cumulative output gap, i.e. the output cost of reducing inflation. In the course of bringing inflation down, the trade-off in the early 1990s showed no significant improvement on that experienced in the early 1980s. However, the economic policies being pursued by the

Government - creating economic stability based on low inflation and low government borrowing, and action to promote competition and increase labour market flexibility - together with responsible private sector behaviour, should deliver a more favourable outcome in the future. The projections imply a modest cycle much more similar to the experience of the 1950s and 1960s, where the downswings saw output growing below trend but remaining positive, rather than the full blown recessions seen since the 1970s.

Table A3: Summary of economic prospects(1)

Percentage changes on a year earlier unless otherwise stated

			Forecast(2)			
	1996	1997	1998	1999	2000	Average errors from past forecasts(3)
Output at constant prices						
Gross domestic product (GDP)	2 ½	3 ½	2 ¼ to 2 ¾	1 ½ to 2	2 ¼ to 2 ¾	1 ½
Non-North Sea GDP	2 ½	3 ½	2 ¼ to 2 ½	1 ¼ to 1 ¾	2 ¼ to 2 ¾	1 ½
Manufacturing output	¼	1 ¾	1 ½ to 1 ¾	1 ¼ to 1 ¾	2 to 2 ¼	2 ¼
Expenditure components of GDP at constant prices						
Domestic demand	2 ¾	3 ¾	3 ¼ to 3 ½	1 ½ to 2	2 ¼ to 2 ½	1 ½
Consumers' expenditure	3 ½	4 ½	3 ½ to 3 ¾	1 ½ to 2	2 ¼ to 2 ½	1 ½
General government consumption	2 ½	¼	-1 ¼	1	1 ¼	1 ¼
Fixed investment	1 ¾	3 ¾	6 to 6 ¼	2 ¼ to 2 ¾	3 to 3 ¼	4 ¼
Change in stockbuilding(4)	- ¼	¼	1 ¼	0 to ¼	0 to ¼	2 ¼
Exports of goods and services	7	7 ½	5 to 5 ¼	5 ¼ to 5 ¾	6 ½ to 7	1 ¾
Imports of goods and services	8 ½	8	7 ¾ to 8	5 ½ to 6	6 ¼ to 6 ½	2 ¾
Balance of payments current account						
£ billion	- ½	2 ¼	-7 ¼	-7 ¾	-7	8 ¼
per cent of GDP	0	¼	-1	-1	- ¾	1
Inflation						
RPI excluding mortgage interest payments (Q4)	3 ¼	2 ¾	3	2 ½	2 ½	1
Producer output prices (Q4)(5)	¾	¾	1 ½	2 ¼	2 ¼	1 ¼
GDP deflator at market prices (financial year)	2 ¾	2 ¾	2 ¾	2 ½	2 ½	1 ¼
Money GDP at market prices (financial year)						
£ billion	752	800	837 to 840	873 to 881	915 to 926	16 1
percentage change	5 ½	6 ¼	4 ½ to 5	4 ¼ to 4 ¾	4 ¾ to 5 ¼	2

1 Data in this appendix are consistent with the output, income and expenditure estimates and other series for the period to the third quarter of 1997 released by the Office for National Statistics on 20 November 1997.

2 Despite the assumption that ratios of variables to GDP are largely invariant within forecast ranges, the growth ranges for GDP components do not necessarily round to the ½ percentage point ranges for GDP growth. This reflects the GDP growth ranges themselves being rounded, and assumed invariance of the of public spending and counterparts within the forecast ranges.

3 Average absolute errors in autumn forecasts over past ten years; they apply to forecasts for 1998 unless otherwise indicated. The average errors for the current account are calculated as a percent of GDP. The £ billion figures are calculated by scaling the errors as a percent of GDP by money GDP.

4 Per cent of GDP.

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

The world economy

Summary

A.67 World economic growth is robust. The G7 economies are expected to grow slightly faster than trend on average this year and to expand at a healthy rate next year. Having slowed in 1996, world trade in manufactures is expected to accelerate sharply this year, and continue growing at a rapid rate in 1998. Despite some economies being at a relatively advanced stage in the cycle, global inflationary pressures are expected to remain weak overall. The recent turbulence in global financial markets is not expected to have a major impact on the world economy, but the possibility of the Asian financial crisis escalating and affecting emerging market economies elsewhere represents an important risk to the otherwise benign global outlook.

Table A4: The world economy

	Percentage changes on a year earlier				
			Forecast		
	1996	1997	1998	1999	2000
Major seven countries(1)					
Real GDP	2 ½	2 ¾	2 ½	2 ¼	2 ¼
Consumer price inflation(2)	2 ½	2 ¼	2 ¼	2 ¼	2 ¼
World trade in manufactures	7	9 ¾	9	7 ¾	7 ¾
UK export markets(3)	6	8 ¾	8 ½	7 ½	7 ½

1 G7: US, Japan, Germany, France, Italy, UK and Canada.
2 Final quarter of each period. For UK, RPI excluding mortgage interest payments.
3 Other countries' imports of manufactures weighted according to their importance in UK exports.

Output

A.68 The outlook for growth in the major European countries has brightened a little in recent months, with activity stronger than expected in the second quarter of 1997. Net exports have been the main driver of recovery to date, benefiting from strong demand growth in the US and the smaller European economies, and improvements in competitiveness. Growth is expected to become more broadly based next year, although the impact of high unemployment on confidence continues to represent a risk to consumption growth.

A.69 Japan's recovery has suffered a setback from April's fiscal tightening, which now looks to have had a bigger impact on demand than most expected. But although confidence has been harmed, a modest underlying recovery in private demand still looks to be on track. Net export growth should continue to benefit from the yen's sharp depreciation over the past year, although lower growth and weaker exchange rates in East Asia following the recent financial crisis may offset this to some extent from next year. There is, however, a downside risk of widespread financial problems in Japan, which could be triggered by weakness in the stockmarket affected by further regional turbulence. Following a pick up at the end of 1996, the US economy continued to grow faster than expected through the first three quarters of 1997, but with no evidence of rising inflationary pressures. Growth is expected to slow towards trend early next year as the recent rise in the dollar feeds through to net trade and consumption growth returns to a steadier path.

World trade

A.70 Growth in world trade in manufactures slowed sharply last year, partly related to a downturn in the global electronics sector. However, recent indicators suggest that world trade has accelerated sharply this year, reflecting a pick up in trade within the OECD area, and within the NAFTA countries in particular. At nearly 10 per cent this year, trade growth is expected to be very high by historical standards. Trade is expected to continue growing rapidly next year and in 1999, at rates well in excess of the average over the 1970s and 1980s. UK export markets are expected to grow by 8 ¾ per cent in 1997 and 8 ½ per cent in 1998, helped by the recovery in Europe and strong demand growth in the US.

CHART A13: G7 GDP and world trade

Inflation and commodity prices

A.71 G7 consumer price inflation has been steady at around 2 ¼ per cent since 1994 and has even edged down slightly over the course of this year. Despite some recent strengthening, the sharp falls in oil prices early this year have been broadly sustained. Oil prices are expected to remain close to recent levels over the coming year and flat in real terms thereafter. Non-oil commodity prices have been subdued in the last few months although, with robust world growth, they may pick up slightly next year. The effects of the El Ni·o weather phenomenon have also raised uncertainties over this outlook. However, with some spare capacity remaining in Japan and Europe, and little sign of rising pressures in the US, overall G7 inflation is expected to remain low.

The Asian crisis and financial markets

A.72 The financial crisis in Asia and the volatility seen in global equity markets since the end of October have raised fears about the sustainability of global expansion. However, outside Japan, equity prices across the G7 remain well above their level of a year ago, and the direct impact on the world economy should be relatively minor. Nevertheless, the possibility of the crisis spreading to larger economies in Asia and elsewhere in the developing world presents a risk to the outlook for world growth and trade.

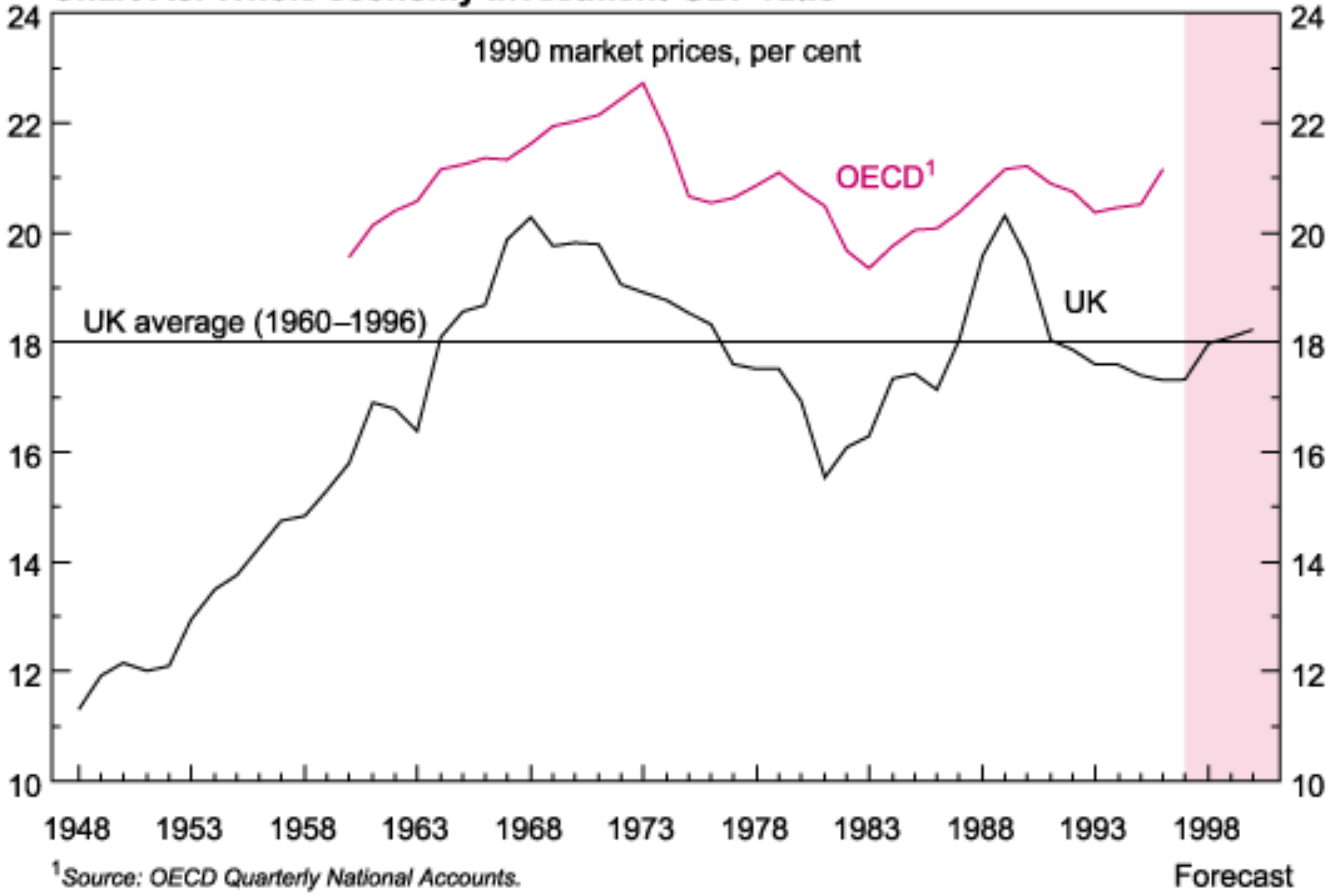
Interest rates

A.73 Short-term interest rates have increased slightly in core Europe. The Bundesbank increased the repo rate from 3.0 to 3.3 per cent in early October, thefirst tightening since mid-1992. France, and four other European countries have also raised rates. In the US, rates have been left unchanged since the ¼ percentage point tightening in March, as inflationary pressures have remained absent despite stronger than expected growth. The Bank of Japan has also left interest rates unchanged as growth has weakened. Long-term interest rates have fallen since the spring in the US, as market expectations of further monetary tightening diminish. Long rates have been fairly stable in Germany over the last six months, while in Japan, bond yields have recently fallen to record lows of below 2 per cent, as confidence in recovery has weakened.

Unemployment

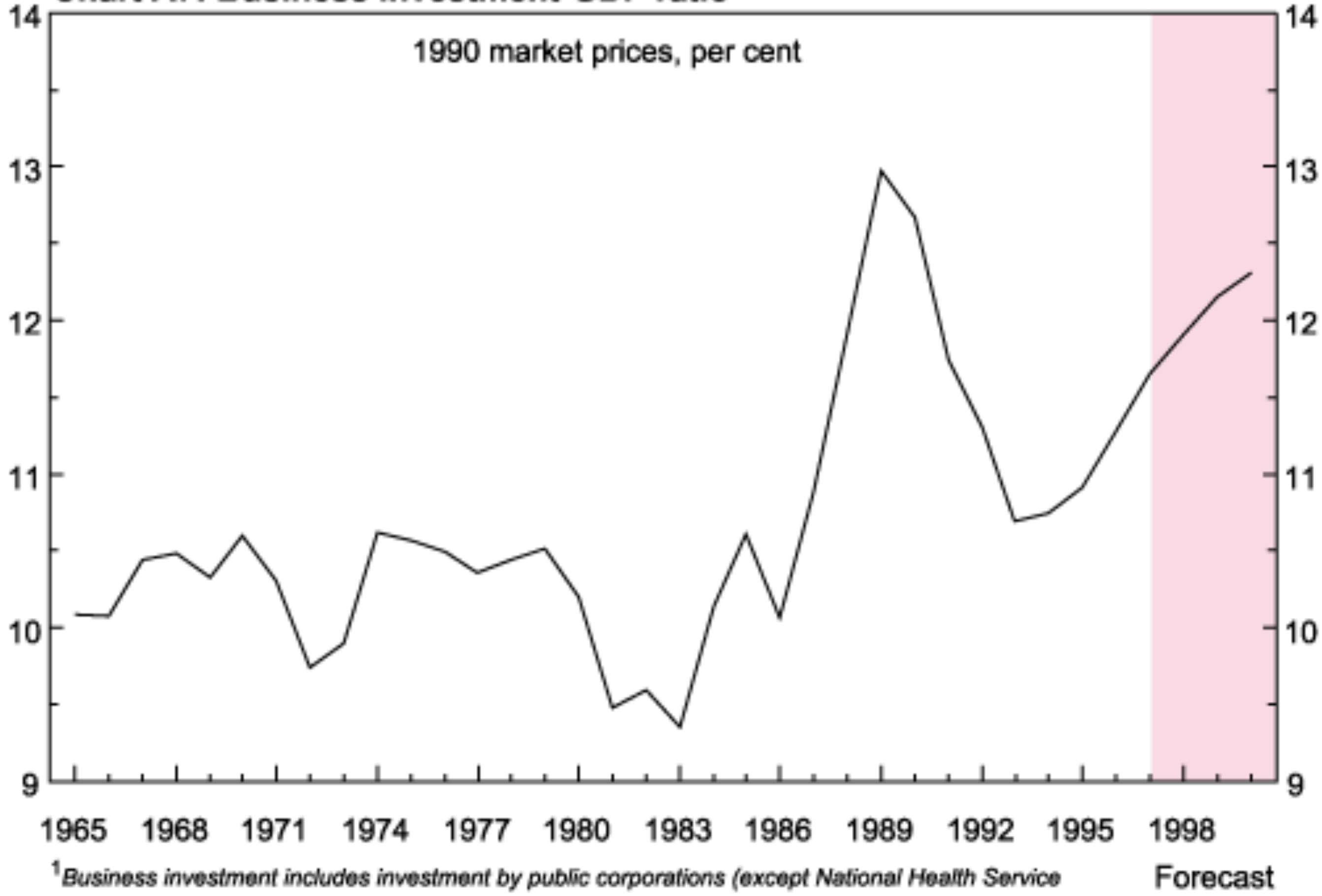
A.74 Unemployment remains low in the US, standing at 5 per cent or below since April (standardised ILO definitions). However, high unemployment persists in Europe: it has remained around 12 ½ per cent for over a year in France, and close to 10 per cent in Germany.

Chart A6: Whole economy investment-GDP ratio



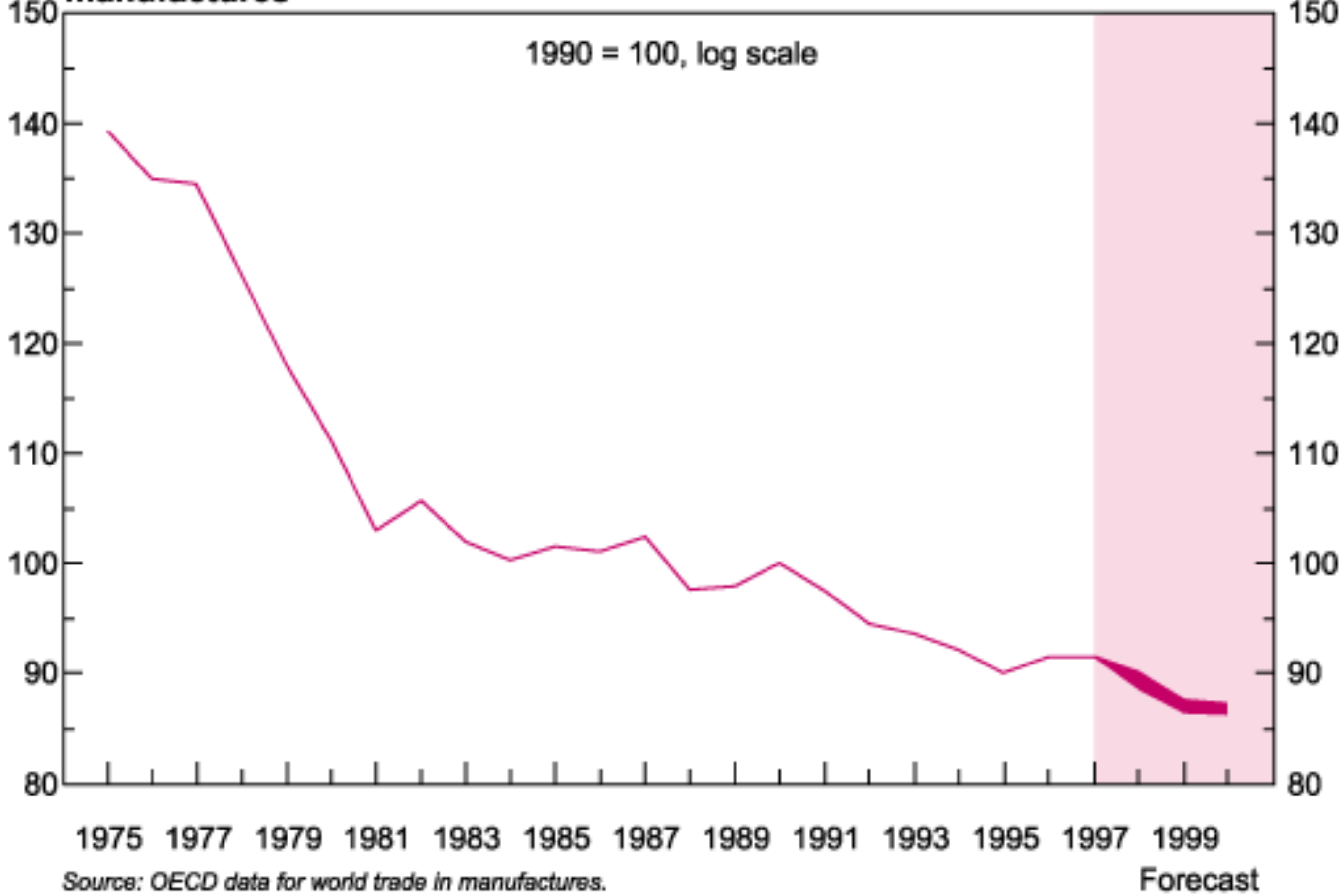
[1] *Source: OECD Quarterly National Accounts.*

Chart A7: Business investment-GDP ratio[1]



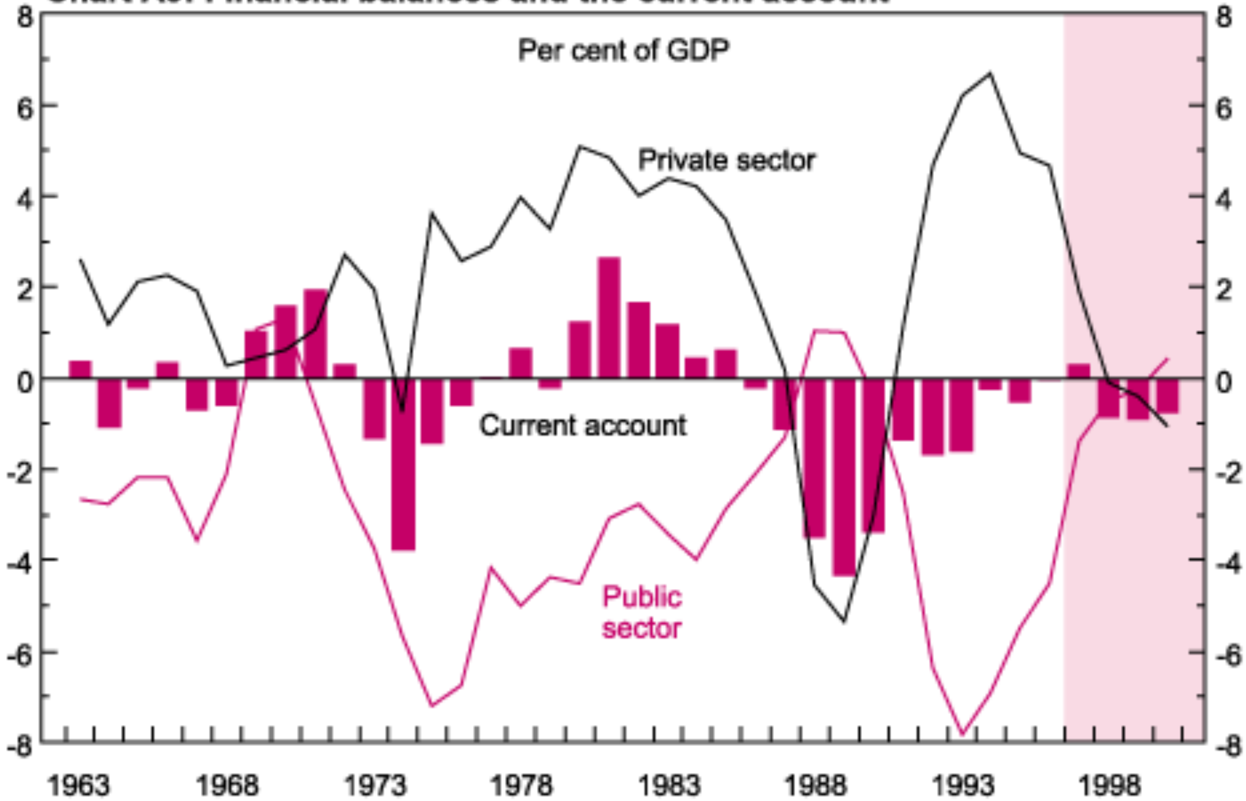
[1]*Business investment includes investment by public corporations (except National Health Service Trusts) and investment under the Private Finance Initiative.*

Chart A8: Ratio of UK manufactured export volumes to world trade in manufactures



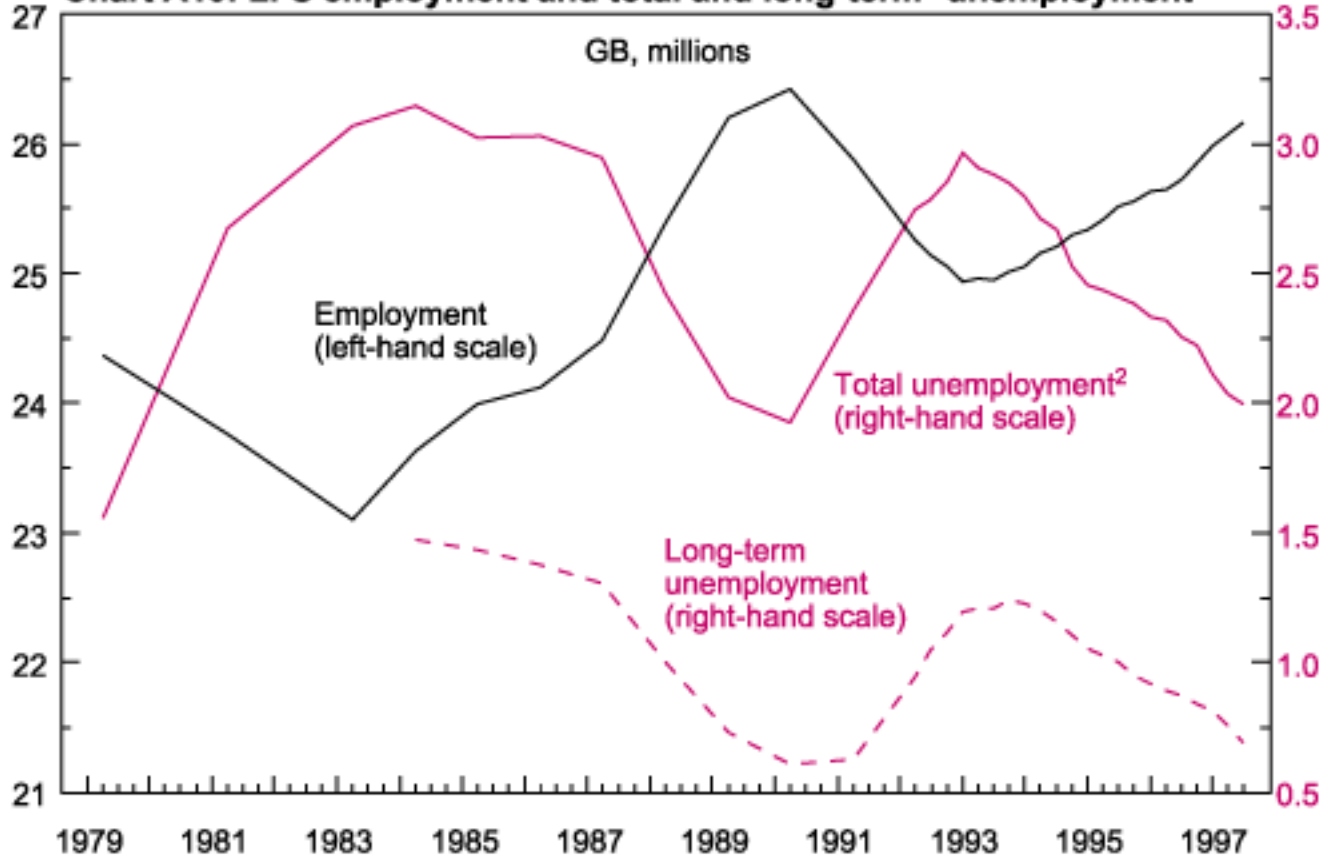
Source: OECD data for world trade in manufactures.

Chart A9: Financial balances and the current account[1]



[1] *The projected public sector financial balance (and hence its private sector counterpart) shown here is based on the assumption of 2¼ per cent trend output growth that applies generally for the projections of the public finances. It is also based on the centre of the range of the illustrative projections for public expenditure from 1999–2000.*

Chart A10: LFS employment and total and long-term[1] unemployment



[1] *12 months or more.*

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

Chart A11: Whole economy underlying average earnings

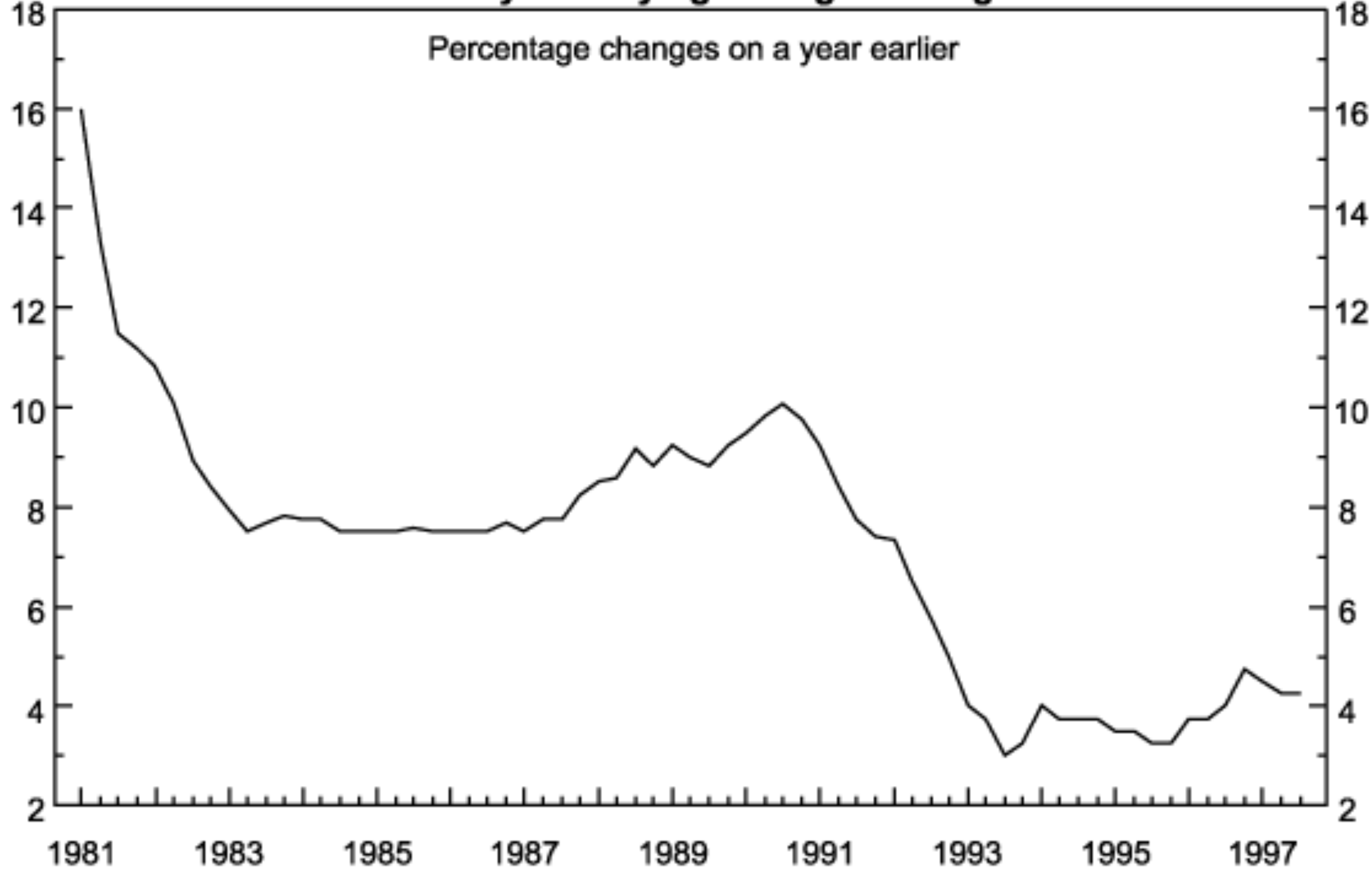
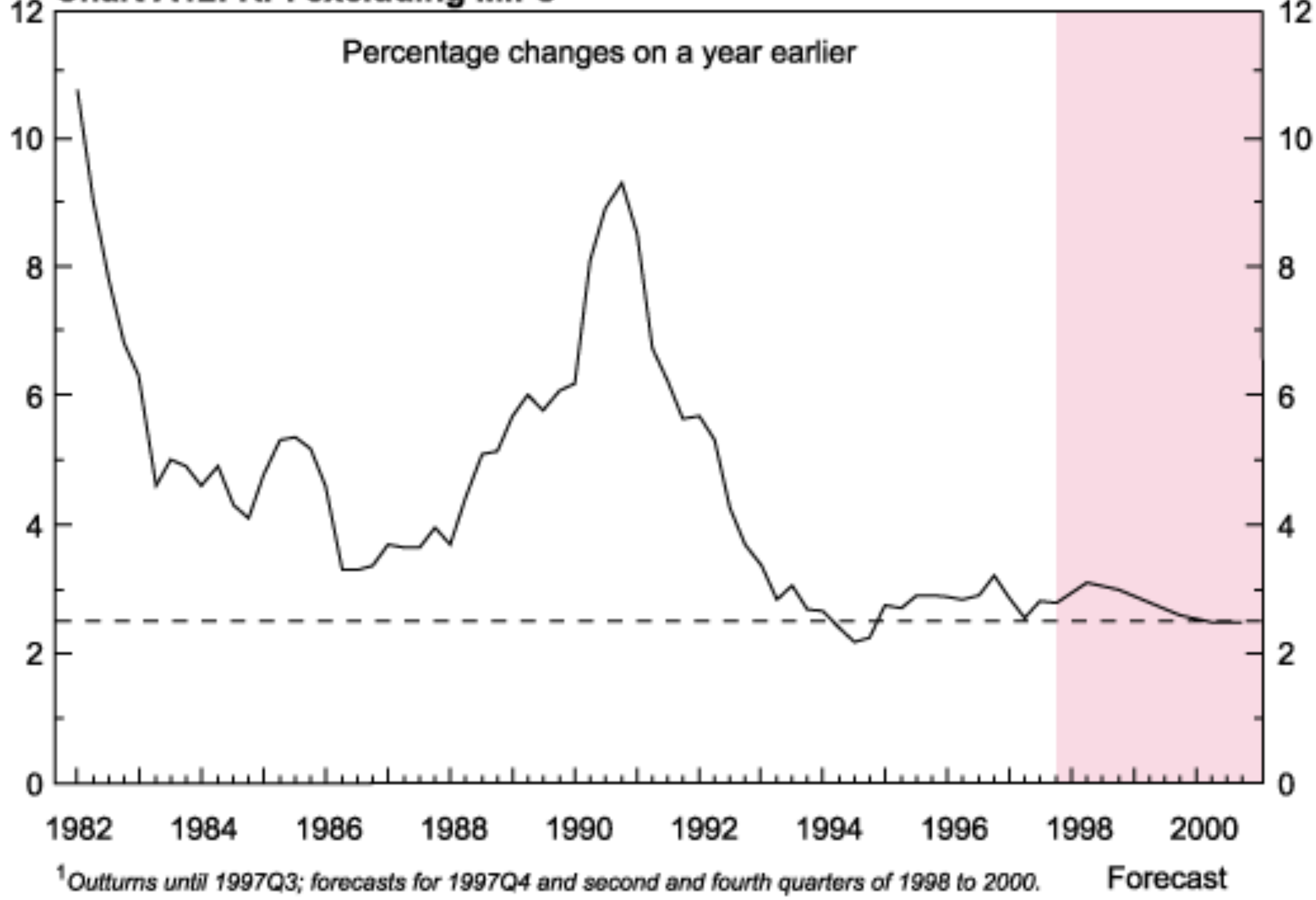
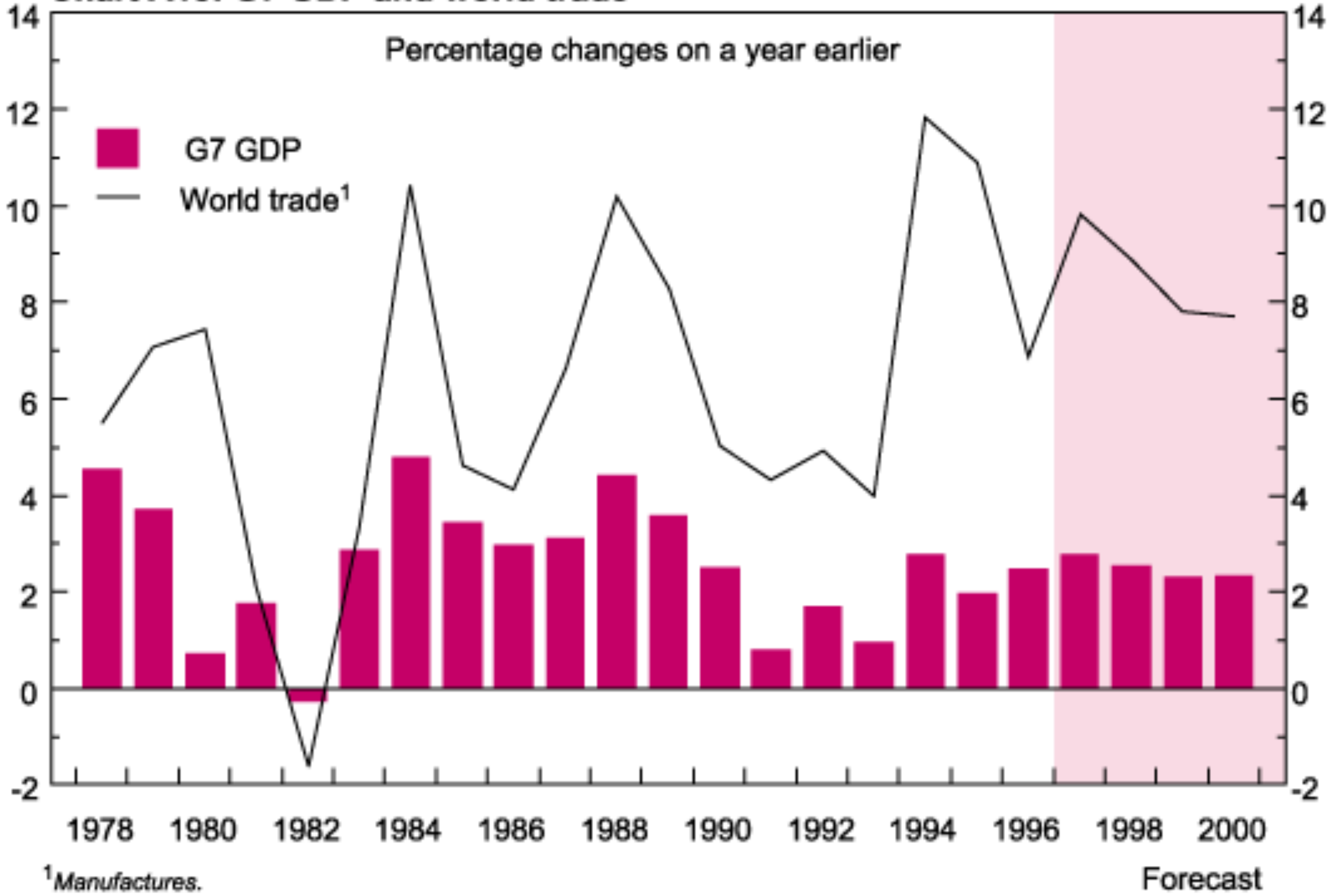


Chart A12: RPI excluding MIPs[1]



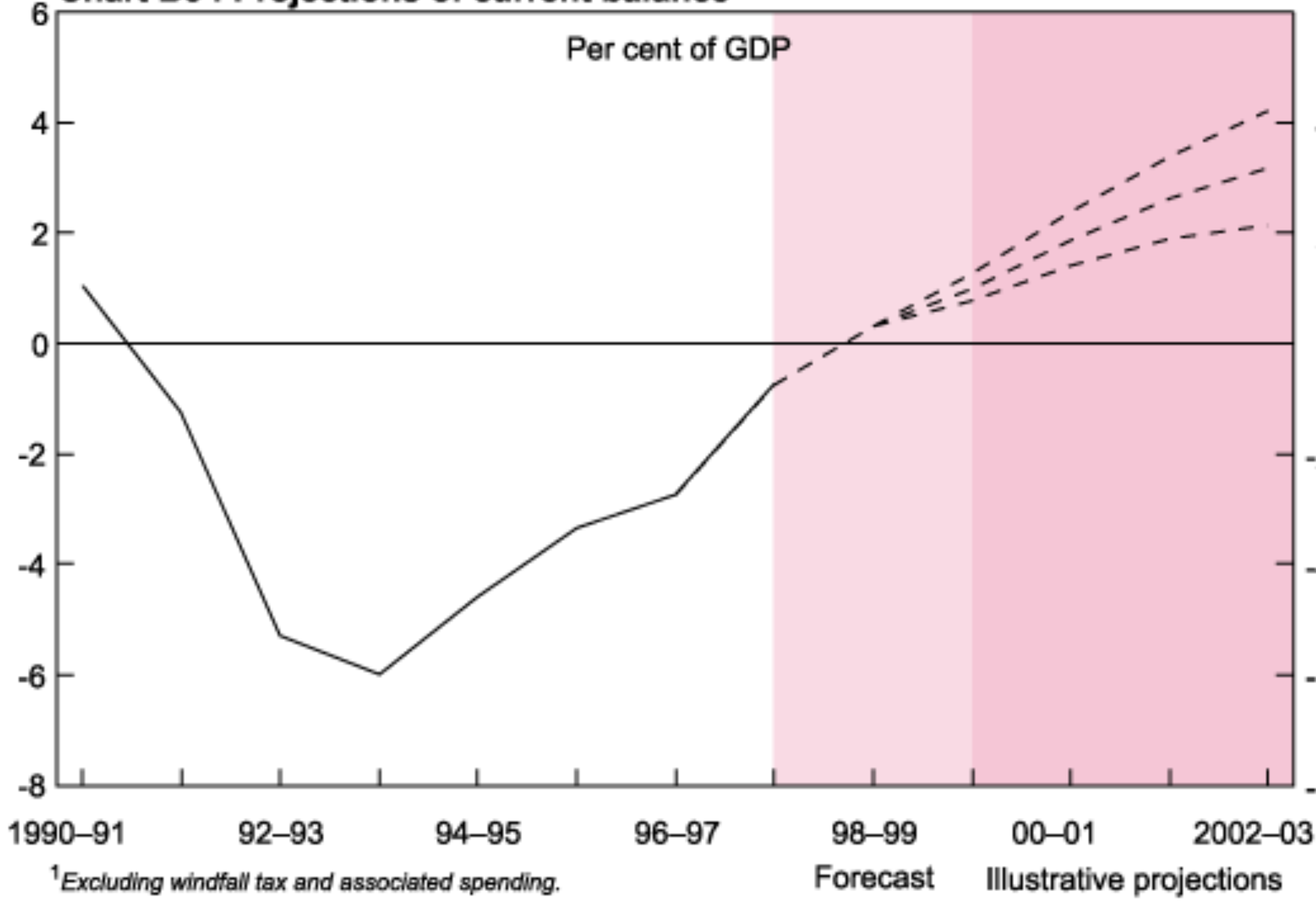
[1] *Outturns until 1997Q3; forecasts for 1997Q4 and second and fourth quarters of 1998 to 2000.*

Chart A13: G7 GDP and world trade



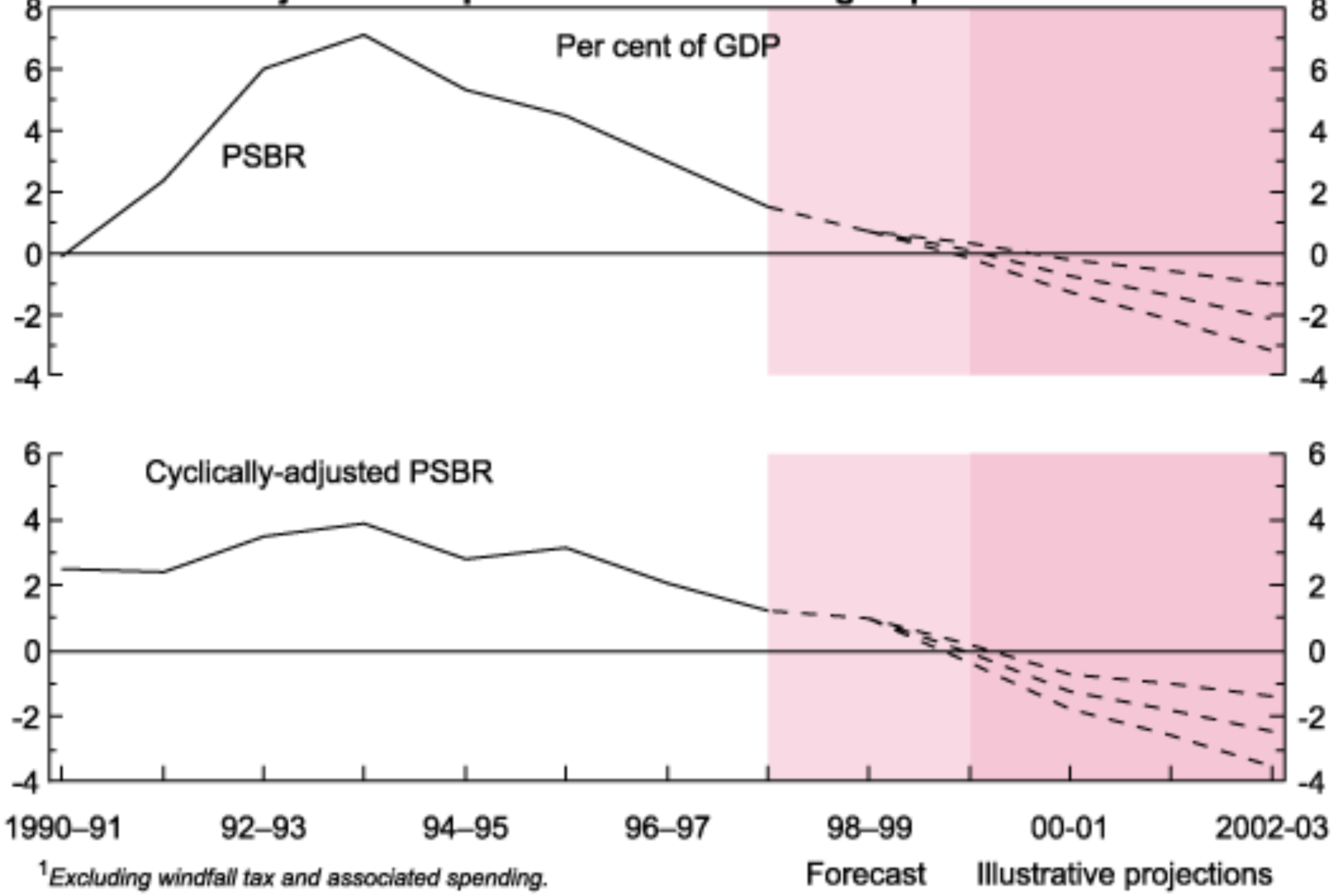
[1] *Manufactures.*

Chart B6 : Projections of current balance[1]



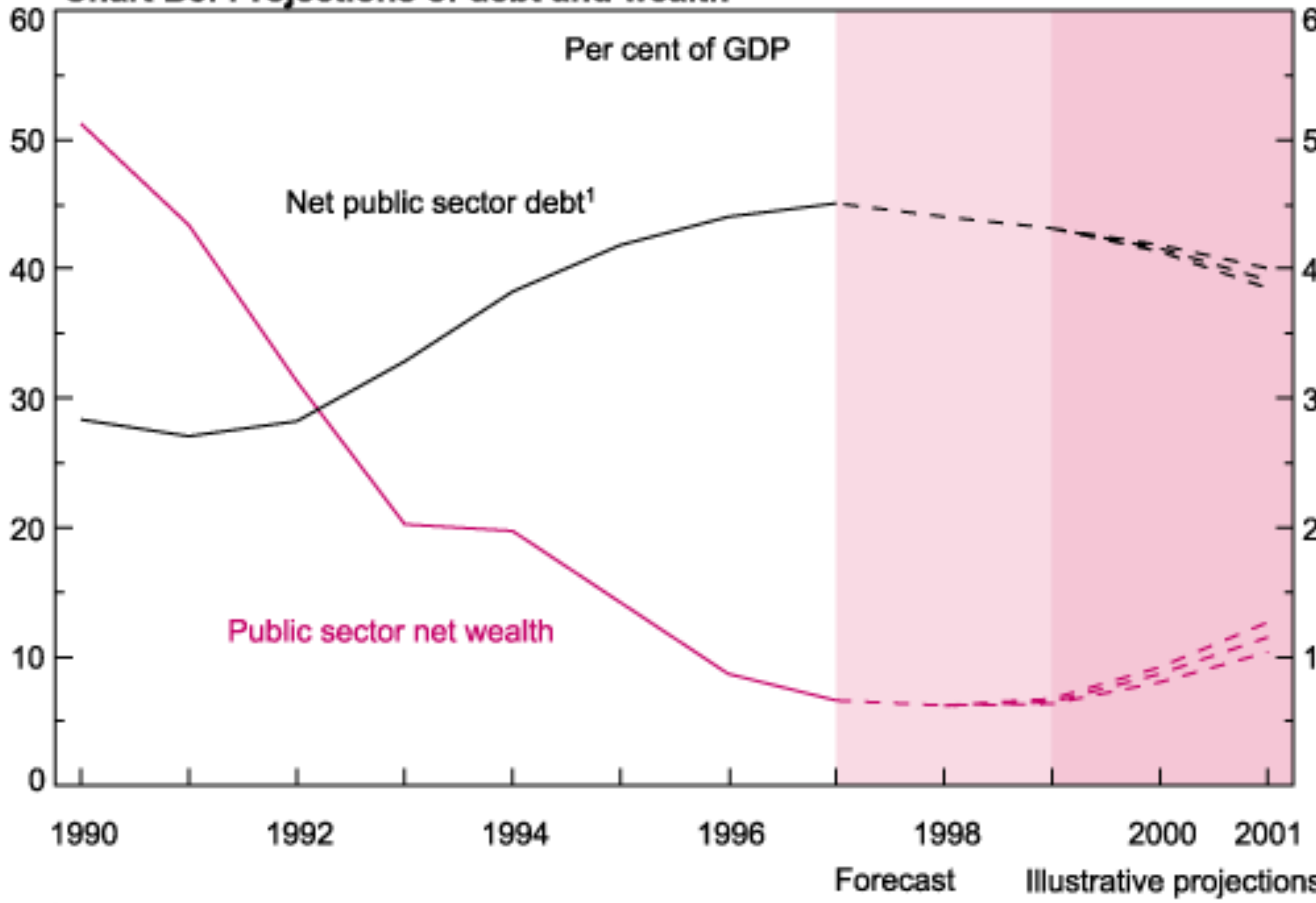
[1] *Excluding windfall tax and associated spending.*

Chart B7 : Projections of public sector borrowing requirement[1]



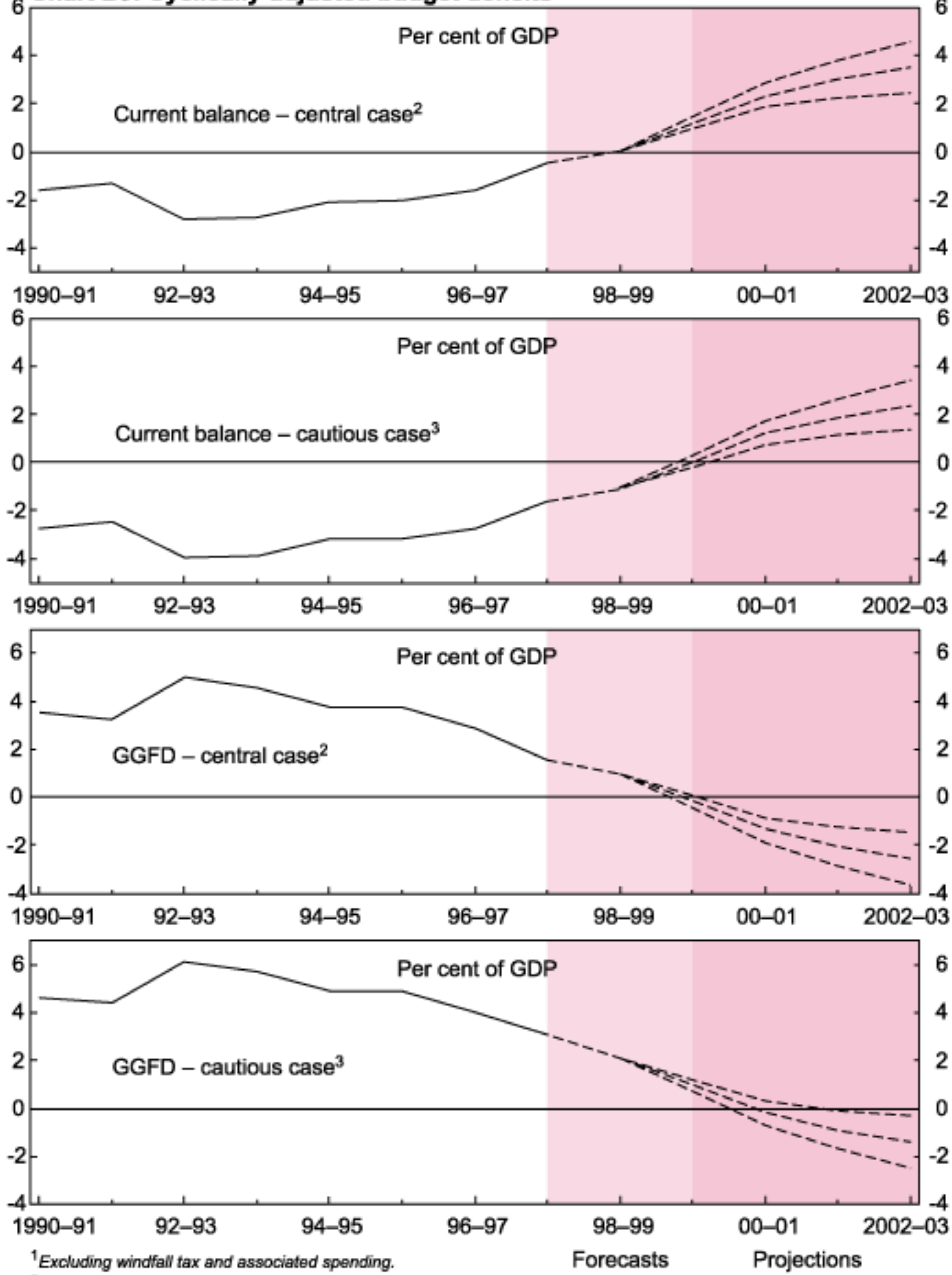
[1] *Excluding windfall tax and associated spending.*

Chart B8: Projections of debt and wealth



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

Chart B9: Cyclically-adjusted budget deficits[1]

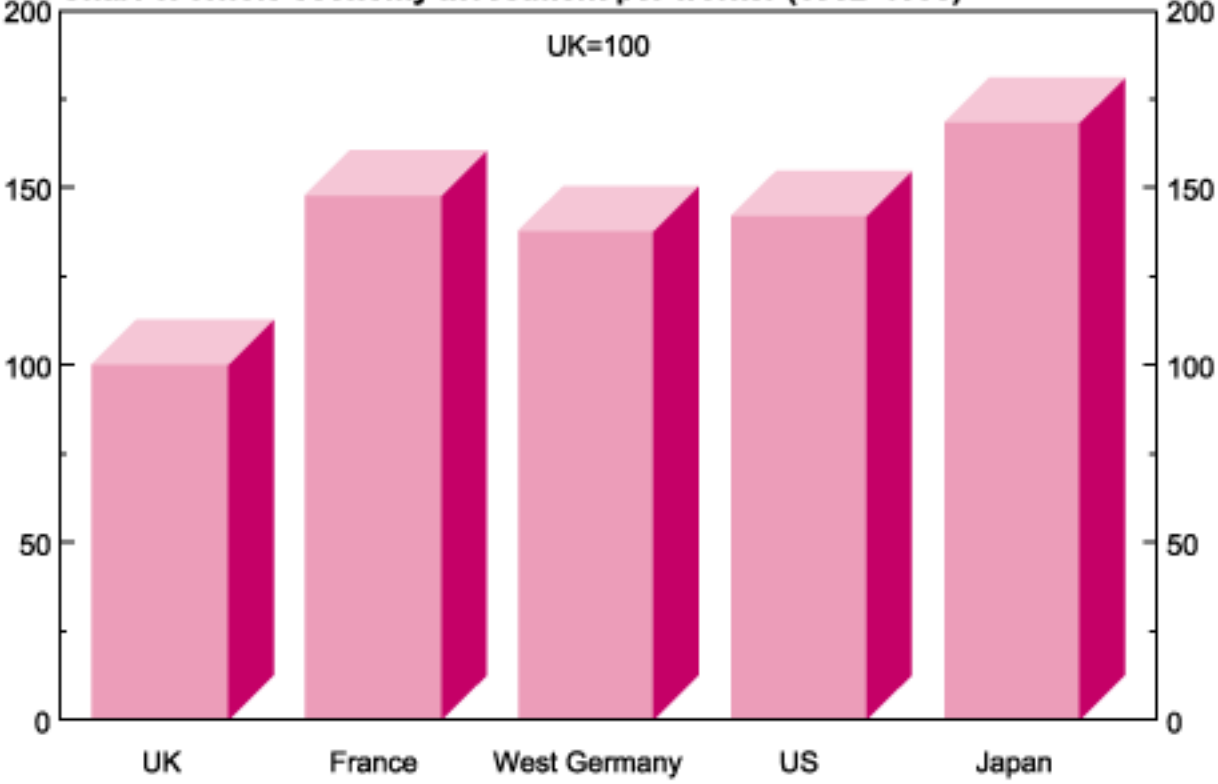


[1]*Excluding windfall tax and associated spending.*

[2]*Assuming an output gap of zero in the first half of 1997.*

[3]*Assuming the output gap is 1½ per cent higher than the central case.*

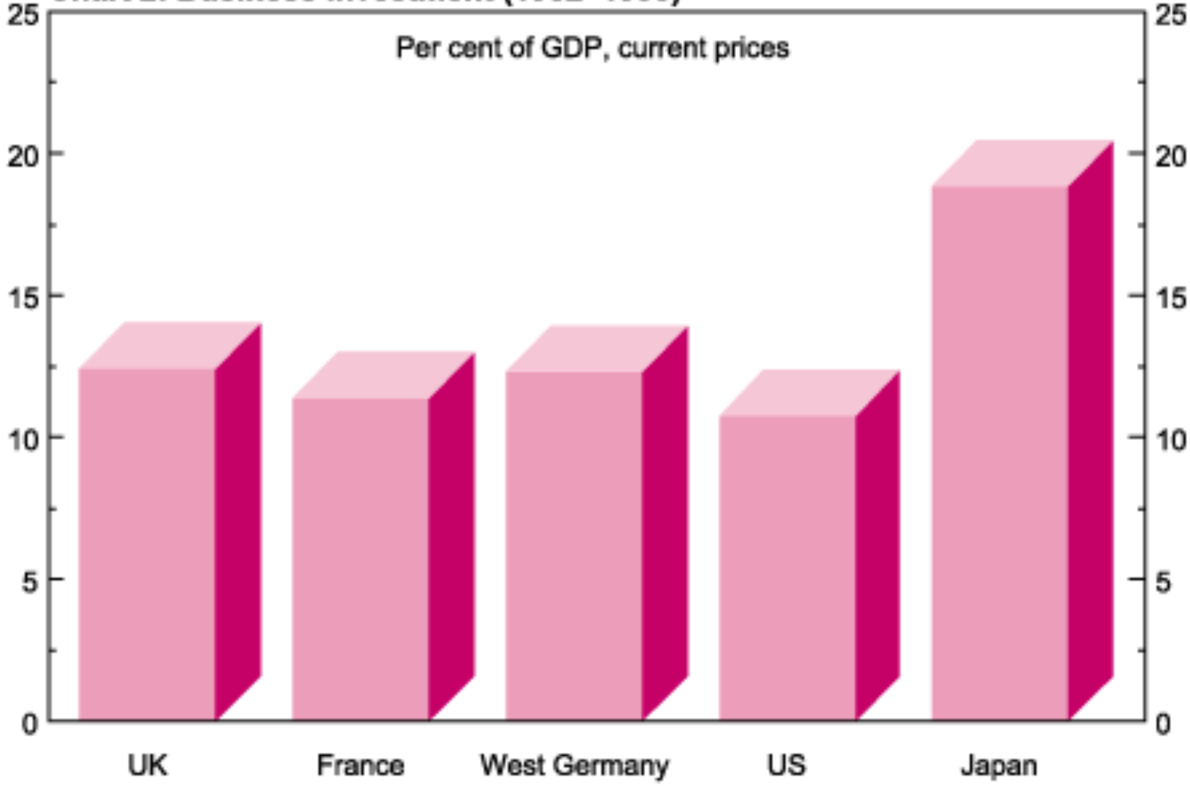
Chart 1: Whole economy investment per worker (1982–1993)[1]



[1]*Converted to current US$ using PPP exchange rates. Then rebased relative to UK=100 in each year and averaged over the period.*

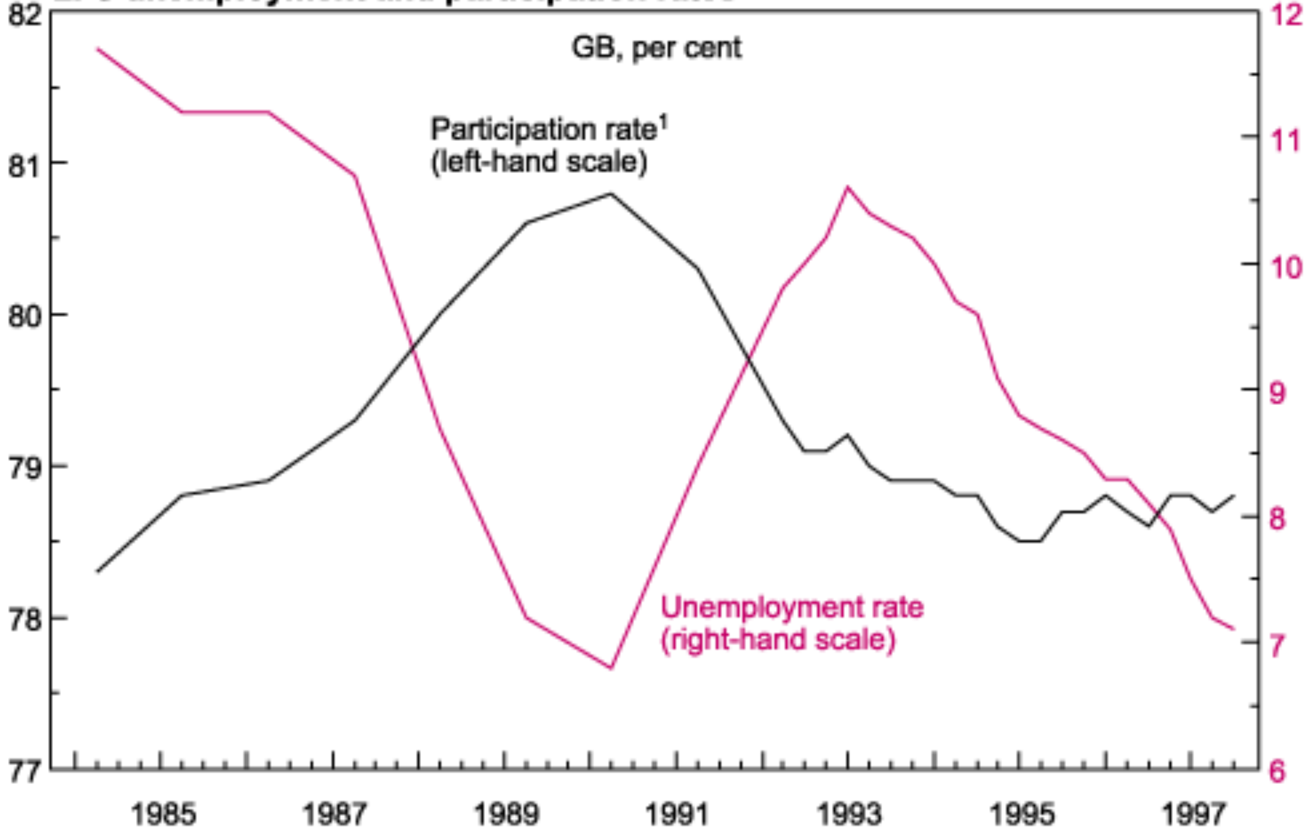
Source: OECD

Chart 2: Business investment (1982–1993)



Source: OECD

LFS unemployment and participation rates



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