Stability and Steady Growth For Britain

Pre-Budget Report

November 1999

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by Command of Her Majesty
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Overview

This Pre-Budget Report, '*Stability and Steady Growth for Britain*', describes the Government's strategy to raise Britain's national economic potential and deliver the objective of high and stable levels of growth and employment. It:

- **provides a progress report on what the Government has achieved so far;**
- **sets out updated forecasts for the economy and the public finances; and**
- **details the next stage of reforms that the Government is considering in the run up to the spring 2000 Budget, and on which it will be consulting in the months ahead.**

1.1 The Government is pursuing a comprehensive and coordinated strategy to meet its central economic objective of high and stable levels of growth and employment. Its aim is to raise Britain's national economic potential and achieve sustainable growth in economic prosperity, through creating economic and employment opportunities for all. The Government is seeking to build an economy and a society in which everyone has the opportunity to participate and share in the benefits of economic success, providing a better quality of life for everyone now and for generations to come.

1.2 The key elements of the Government's strategy, as set out in this report, are:

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

1.3 Since May 1997, the Government has been pursuing a wide-ranging agenda to address each of these areas. The benefits of delivering a platform of economic stability are already becoming apparent. The challenge in the period ahead is to maintain this stability, and use the opportunity which it provides to create a high productivity, high employment and high growth economy which will provide rising living standards for all.

1.4 The following section sets out the key elements of the Government's economic strategy. Full details of each are given in the subsequent chapters of this report, with an overview in the second part of this chapter.

A COMPREHENSIVE ECONOMIC STRATEGY

1.5 The Government's economic objective is to deliver high and stable levels of growth and employment, while ensuring that the benefits of that economic growth can be shared by everyone and so deliver a better quality of life. It therefore means taking a long-term view and looking at ways in which economic growth can go hand in hand with ensuring a fairer society and protecting the environment achieving sustainable growth in economic prosperity.

Delivering macroeconomic stability

1.6 The Government's first priority has been to secure economic stability and avoid a return to the boom and bust cycles that have been a feature of the British economy for the past 30 years. Such economic instability as characterised by sharp volatility in output, inflation and interest rates has significant costs, making it difficult for individuals and firms to plan, save and invest and thereby damaging Britain's long-term growth potential.

1.7 The Government has therefore introduced new frameworks for both monetary and fiscal policy, based on clear objectives, well-understood procedural rules and a greater degree of openness and transparency than seen in the past. Through early and decisive action the Government was able to steer a stable course through the global turbulence of last year and is now delivering economic stability. Inflation is close to target, the public finances are under control and the economy is continuing to grow and create jobs.

1.8 Having achieved this essential platform of stability, it is vital to ensure that it is maintained. This will require continued tough discipline, avoiding the mistakes of the past when governments relaxed the moment the economy started to grow. Any short-term dash for growth would simply result in a return to the instability and stop-go of previous decades. The challenge now is to lock in stability and seize the opportunity which that offers to set long-term economic ambitions and raise Britain's growth potential.

1.9 This will require four key conditions to be met:

- **stability** continuing with a pro-active monetary policy and prudent fiscal policy;
- **responsibility** avoiding short termism in pay and wage bargaining across the economy;
- **productivity** promoting competition, encouraging innovation and an enterprise culture open to all, building a modern skills base and increasing investment; and
- **employability** increasing employment opportunities, including a strengthening of the programme to move the unemployed from welfare to work.

Raising Britain's growth potential

1.10 All four of these conditions must be met. While maintaining a stable macroeconomic environment, with responsible wage bargaining, is an essential precondition to economic success and can in itself be expected to help promote the economy's growth potential by itself it is not enough. It needs to be complemented by the long-term strategy which the Government is pursuing to raise the productive capacity, or the 'trend' rate of growth, of the British economy. The Government's objective is to increase the rate at which the economy is able to grow over time without running into capacity constraints and stoking up inflationary pressures.

1.11 The Government's growth forecasts are presented as ranges, based on alternative assumptions about the growth potential of the economy. The mid-point of the ranges is based on a trend growth assumption of 21/2 per cent a year, which is the Government's neutral assessment of the economy's growth potential over the medium term. As always, the projections of the public finances are based on the deliberately cautious trend growth assumption of 21/4 per cent underlying the low ends of the ranges. The upper ends meanwhile illustrate the clear potential for stronger growth, consistent with meeting the inflation target. By combining economic stability with long-term economic reform and the modernisation of the economy, the Government is aiming to achieve growth at or indeed beyond the upper ends of the forecast ranges.

Meeting the productivity challenge

1.12 Productivity is the largest single component of economic growth. So raising the productivity performance of the British economy and making progress towards closing the productivity gap with our international partners is vital to the aim of increasing the country's growth potential. The Government has therefore set out a clear strategy designed to tackle the causes of Britain's poor productivity and promote competition, enterprise and innovation, skills and high quality, long-term investment. Chapter 3 describes this strategy and further measures under consideration in the run up to the spring 2000 Budget.

Increasing employment opportunity

1.13 Achieving high levels of participation in the labour market, through the promotion of employment opportunities for all the modern definition of full employment is also central to raising the economy's long-term growth capacity. But equally, increasing employment opportunities across the economy will help to ensure that the benefits of that economic growth are shared throughout society. Employment provides the best route out of poverty and social exclusion. The Government is therefore pursuing policies designed to help people move from welfare to work, to give people the confidence to take that step, and to ensure that work pays. Chapter 4 sets out the Government's strategy to increase employment opportunity for all.

Ensuring a better quality of life

1.14 A strong and productive economy, with a high and stable rate of economic growth, is vital for a better quality of life and rising economic prosperity. It means that people can afford to buy more and better goods and services and it provides the foundation for high quality public services and the resources to help those most in need.

1.15 But too often in the past, economic success has been judged by economic growth Gross Domestic Product (GDP) - alone. The overall level of economic growth in the economy is just one, albeit essential, component of a nation's prosperity and standard of living. Such an approach fails to take account of the interaction of the economy, the environment and society, and how delivering the best possible quality of life means taking account of factors other than the level of GDP. Economic growth should be achieved while protecting and, where possible, enhancing the environment and making sure that the benefits are available to all the Government's definition of sustainable development.

Fairness for families and communities

1.16 Building a fairer and more inclusive society, tackling poverty, delivering high quality public services such as health and education, reducing crime, improving housing and strengthening community life are just some of the factors which are also important in improving a nation's standard of living. Chapter 5 discusses how the Government is delivering fairness for families and communities. In particular, it sets out the extensive programme which the Government is pursuing to tackle the causes of poverty. The Government's ambition for the next decade is to reduce child poverty by half, as it moves towards its aim to abolish child poverty within the next 20 years.

Protecting the environment

1.17 The physical environment is also important. Economic growth needs to take place in a way which ensures the effective protection of the environment and the prudent use of natural resources. Global threats such as climate change must be limited, hazards such as poor air quality must be reduced and things that people value, such as wildlife and the landscape, should be protected. Natural resources need to be used efficiently and renewable resources, such as water, should not be used in ways that could endanger those resources. Chapter 6 describes the Government's strategy for protecting the environment, for both the current and future generations.

Conclusion

1.18 Britain must now lift its sights and set long-term economic ambitions for the next decade. The challenge is to lock in the economic stability which is now being achieved and take the opportunity which that offers to deliver steady growth, with work and enterprise open to all.

DELIVERING MACROECONOMIC STABILITY

1.19 Chapter 2 describes the Government's framework for macroeconomic policy and summarises the updated projections for the UK economy and the public finances (which are set out in full in Annexes A and B).

The new framework

1.20 On coming into office, the Government set about putting in place a new open and transparent macroeconomic policy framework to secure the economic stability which had proved so elusive in the past:

- a new **monetary framework** to deliver low and stable inflation, giving the Bank of England responsibility for setting interest rates to meet the Government's inflation target;
- a new **fiscal framework** to deliver sound public finances, underpinned by two strict fiscal rules - the golden rule and the sustainable investment rule; and
- a new **public spending framework**, integrated into the fiscal framework, to deliver greater certainty for long-term planning and remove the previous bias against investment.

1.21 With these frameworks in place, and a pro-active monetary policy operating alongside prudent fiscal policy, the economy was well placed to respond to the deterioration in global conditions in autumn 1998. Interest rates were reduced from a relatively low peak of 71/2 per cent in June 1998 to 5 per cent a year later. As expected at the time of the Budget, the pause in UK growth was short lived and damaging falls in output were avoided. Employment has continued to rise to a record level.

The economic forecast

1.22 Together the new policy frameworks are providing a platform of economic stability with low inflation and sound public finances, while at the same time delivering additional investment in key public services and infrastructure. The Pre-Budget Report forecast shows that:

- **RPIX inflation** is expected to remain close to the $2^1/_2$ per cent target over the forecast period; and
- **GDP growth** has been stronger than expected at the time of the Budget, and is forecast to rise from $1^3/_4$ per cent in 1999 to $2^1/_2$ to 3 per cent in 2000. Growth of $2^1/4$ to $2^3/4$ per cent is forecast for both 2001 and 2002.

Fiscal prospects

1.23 The public finance projections contained in the Pre-Budget Report, and summarised in Table 2.3, provide an interim forecast update. They do not necessarily represent the fiscal outcome the Government is seeking and therefore have quite a different status from those contained in the EFSR and FSBR at Budget time since those include the effects of all Budget policy decisions.

1.24 The public finances projections continue to be based on the deliberately prudent and cautious assumption of $2^1/4$ per cent a year trend growth, audited by the National Audit Office (NAO). The projections are also based on a new oil price assumption which has been endorsed by the NAO.

1.25 In addition, the fiscal projections take account of the Government's decision to move decisions about fuel and tobacco duties onto a discretionary basis. The Government is committed to meeting its environmental targets, but the future yields will depend on Budget decisions. In line with the *Code for Fiscal Stability*, the effects of real increases in duty have therefore been removed from the public finance projections, in keeping with the approach taken to the scoring of other tax revenues.

1.26 A higher current surplus last year than anticipated at the time of Budget 99, growth above the upper end of the Budget forecast range this year and a composition of growth more favourable to the public finances have all served to raise the level of the current surplus and further reduce the ratio of net debt to GDP in 19992000 and beyond. The projections show that the underlying position for the public finances remains sound and on track to meet the fiscal rules over the economic cycle.

1.27 A repayment equivalent to 0.4 per cent of GDP is now expected for public sector net borrowing (PSNB) in the current year. Cyclically-adjusted, a small surplus of 0.2 per cent of GDP is projected, compared with cyclically-adjusted balance in Budget 99. In following years, changes in PSNB are small and very similar to those set out in Budget 99, while the path for cyclically-adjusted PSNB is almost identical. Over the period, the projections imply a shift from repayment of debt to modest borrowing as net investment more than doubles to 1.5 per cent of GDP. The implication of these figures is that the fiscal stance is broadly unchanged from Budget 99, with the fiscal tightening achieved since 199697 continuing to be locked in.

MEETING THE PRODUCTIVITY CHALLENGE

1.28 Britain's productivity performance lags behind that of other major economies. Chapter 3 describes the Government's strategy to close this productivity gap which, on any measure, is substantial - up to a third. The Government's long-term economic ambition for the next decade is that Britain will have a faster rise in productivity than its main competitors, as it closes the productivity gap.

Measures already announced

1.29 Based around the five key drivers of productivity performance, the Government has already introduced an extensive range of measures to meet the productivity challenge:

- **competition:** strengthening the UK's competition framework through the new Competition Act which will come into force in March 2000;
- **enterprise and innovation:** Budget 99 consulted on a new Research and Development (R&D) tax credit to encourage small business investment in R&D, a new Employee Share Ownership Scheme to encourage employees to take a stake in the success of their companies, and announced a £20 million venture capital challenge to finance early stage high technology businesses;
- **skills:** in addition to the extra £19 billion which the Government is investing in education over the next three years, Budget 99 announced new Individual Learning Accounts to enable the low-skilled to obtain the qualifications they

need. As a long-term economic amibition for the next decade, school and college leavers will gain the highest possible qualifications they can, with the majority going on to higher education for the first time;
- **investment:** corporation tax has been reduced to its lowest ever level, and Budget 99 introduced a new 10p corporation tax rate for the smallest companies and an extension of 40 per cent capital allowances for small and medium-sized enterprises; and
- **public sector productivity:** a greater focus on improvements and service delivery, including setting over 600 output and efficiency targets through Public Service Agreements.

New measures

1.30 Building on the steps already taken, this Pre-Budget Report sets out further productivity measures, including:

- consideration of reforms to **capital gains tax** in the run up to Budget 2000, to strengthen the incentives for entrepreneurial investment. This will include, subject to detailed consultation, shortening the length of the current business asset taper;
- a £10 million package starting in April 2000 to boost **enterprise skills in primary and secondary schools**; and
- a £30 million package of measures to promote **enterprise among disadvantaged groups and in deprived areas.**

1.31 As last year, the Government will be consulting on the productivity measures set out in this Pre-Budget Report in the months ahead, including through a series of roadshows.

INCREASING EMPLOYMENT OPPORTUNITY FOR ALL

1.32 Chapter 4 describes the Government's strategy for increasing employment opportunity for all - the modern definition of full employment. It describes how policies to bring people closer to the labour market and increase participation will not only help to raise the long-term growth potential of the economy, but are also central to tackling the underlying causes of deprivation and reducing poverty. The Government's long-term economic ambition is that over the next decade there will be a higher percentage of people in employment than ever before.

Measures already announced

1.33 The Government's strategy comprises three key elements: helping people move from welfare to work; making work pay; and easing the transition to work and allowing people to work their way up once in work. The Government has already introduced major reforms to increase employment opportunity for all:

- **welfare to work**: through the New Deal programmes which have already benefited around 350,000 young people and over 170,000 long-term unemployed people; and
- **making work pay**: through reform of the tax and benefit system, including the new Working Families' Tax Credit, reform of NICs, the new 10p rate of income tax from April 1999 and the cut in the basic rate to 22p from April 2000. This is underpinned by the National Minimum Wage which was introduced in April 1999.

New measures

1.34 The Pre-Budget Report sets out further measures to promote work opportunities for all:

- **a more intensive and extended New Deal 25 plus** from April 2001, building on the principles of the New Deal for 18-24s and bringing the rights and responsibilities for the over 25s closer into line with those for young people. There will be more help with jobsearch, programmes to prepare people for the world of work, and specialist help for people with basic skills needs, or alcohol, drug or homelessness problems;
- harnessing new technology to match the people without jobs to the jobs without people and reinforce jobseekers' responsibilities. This includes a **national network of job-broking call centres** to provide a single national number for employers to call with details of vacancies and for jobseekers to contact for up-to-date information on the jobs that are available;
- setting up a **new £5 million Intermediaries Fund** to support the work of private and voluntary sector organisations in the inner cities, helping people into work within the framework of welfare to work policies;
- nationwide extension of the **Intensive Gateway** approach within the New Deal for 18-24 year olds to provide short

structured programmes to prepare young people more effectively for work;

- enhancements to the **New Deal for Lone Parents**, including inviting those on Income Support with children from the age of three to participate and improving the opportunities for lone parents to study by providing extra help with childcare through further education access funds; and
- consideration of the case for extending the principle of the Working Families' Tax Credit to working households without children through an **Employment Tax Credit.**

FAIRNESS FOR FAMILIES AND COMMUNITIES

1.35 The Government is committed to building a fairer and more inclusive society in which everyone can contribute to and benefit from economic prosperity. In particular, it is pursuing an extensive programme to tackle the causes of poverty, especially child poverty. The Government's long-term economic ambition is to halve child poverty by the end of the next decade, as it moves towards its aim to abolish child poverty within 20 years.

Measures already announced

1.36 The key elements of the Government's strategy to meet these aims, and the measures which the Government has already introduced to help do so, include:

- **support for families and children:** through the largest ever increase in universal Child Benefit, increases in Income Support, targeted support through the Working Families' Tax Credit and, from April 2001, the new Children's Tax Credit, replacing the married couple's allowance and its related allowances;
- **fairness for pensioners:** with a minimum income guarantee, a minimum guarantee on tax allowances, and the five-fold increase in the winter fuel payment to £100 for every pensioner household from this winter; and
- **delivering high quality public services:** with an additional £40 billion for health and education over the three years from April 1999, and a £2.5 billion Capital Modernisation Fund to support innovative capital projects to improve the quality of public service delivery.

1.37 The Government is also pursuing measures to support saving and pensions, promote the role of the voluntary and community sector, and ensure a fair tax system.

New measures

1.38 In addition, the Pre-Budget Report announces a series of further measures to ensure fairness for families and communities, and provide support for those who need it most. These include:

- consulting on a new **Children's Fund,** to be established in the 2000 Spending Review, to support pioneering work by voluntary and community organisations in their work with children in poverty;
- **extending the 10p rate of income tax to savings income** with effect from April 1999. As a result, over 2.5 million people the majority of them pensioners will see their tax bills decline by up to £150 (£30 on average). Corresponding changes will be made next April to capital gains tax to keep it in line with the tax rates for savings;
- **free TV licences** for people aged 75 and over from autumn 2000. Over three million households nearly half of which are in the bottom three income deciles will benefit from this measure; and
- a new tax package to encourage more individuals and businesses to **give more to charities.**

1.39 In addition, the Pre-Budget Report describes a range of measures to crack down on **tobacco smuggling**, including a national network of container x-ray scanners and compulsory pack marks to counter tax evasion and forestalling.

1.40 There is a strong ongoing health case for year-on-year real terms increases in the price of cigarettes and tobacco to complement such measures. The Chancellor will in future form his Budget judgements on the appropriate level and timing of increases taking into account a wide range of factors, including the Government's health objectives. Any additional revenue raised from real increases in tobacco duties would be spent on improved health care. For example, the extra revenues from a 5 per cent real terms rise in tobacco duty next spring would raise £300 million that would go to a further additional investment in the National Health Service from next April.

PROTECTING THE ENVIRONMENT

1.41 Growth must take place in a way which ensures the effective protection of the environment. The Government will deliver on its environmental commitments as it meets its economic goals. The Government has set out a clear framework for considering its environmental objectives and introduced a range of measures designed to meet these objectives, including those in Budget 1999. These include:

- **climate change:** introducing a climate change levy to encourage energy efficiency in business and help reduce greenhouse gas emissions;
- **supporting integrated transport:** through reform of company car tax, reduced vehicle excise duty rates for cars with the smallest engines, improvements to the transport system and tax measures to promote environmentally-friendly commuting;
- **land use:** promoting urban regeneration and ensuring sustainable waste management through increases in the rate of landfill tax; and
- **water and pesticides:** improving the quality of both river and drinking water and minimising pesticide use consistent with adequate crop protection.

New measures

1.42 The Pre-Budget Report includes:

- further details of the **climate change levy** on the business use of energy, with all the revenue raised being fully recycled back to business through a cut in employers' NICs and additional support for energy efficiency measures;
- details of how the Government is discussing with industry how best to reduce the environmental problems associated with **pesticide use and aggregates extraction;** and
- an environmental assessment of those measures whose primary aim is environmental, or which have a significant impact on the environment is given in Table 6.1.

1.43 In addition, the Government has decided that the time has come to review the way that any increases in fuel duties are determined. In future, the appropriate level of fuel duties will be decided on a Budget by Budget basis, taking account of the Government's economic and social objectives as well as the UK's environmental commitments. The revenues from any real terms increases in fuel duties will, in future, go straight into a ring-fenced fund for improving public transport and modernising the road network.

2

Delivering macroeconomic stability

Economic instability has significant costs, making it difficult for individuals and firms to plan, save and invest. The sharp volatility in output, inflation and interest rates seen in the UK over the past 30 years damaged Britain's long-term growth potential. Economic stability is therefore the first condition which must be achieved for the Government to meet its objective of high and stable levels of growth and employment.

The Government has therefore put in place a new macroeconomic framework to deliver and sustain long-term economic stability, based on clear objectives, well-understood procedural rules and a greater degree of openness and transparency than seen in the past. This comprises:

- **a new monetary policy framework giving the Bank of England responsibility for setting interest rates in the best long-term interests of the economy to meet the Government's symmetric inflation target;**
- **a new fiscal policy framework based on five central principles and underpinned by two strict fiscal rules; and**
- **a new public spending framework, integrated into the fiscal framework, which provides greater certainty for long-term planning, removes the previous bias against investment and focuses more clearly on efficiency and outputs.**

Together these frameworks are delivering a platform of economic stability with historically low inflation and sound public finances, while at the same time allowing additional investment in key public services and infrastructure. The Government is determined not to make the mistakes of the past, when policy was relaxed the moment the economy started to grow. A continuation of a pro-active monetary policy and prudent fiscal policy, combined with responsibility in wage bargaining across the economy, is essential if the full benefits of economic stability are to be realised.

THE NEED FOR STABILITY

2.1 A platform of stability is the first condition for high and stable levels of growth and employment. Without the assurance of a stable economic outlook, individuals and businesses find it difficult to plan ahead. Instability damages investment and long-term growth, wastes valuable resources and has significant social and economic costs.

2.2 Britain's economic performance has for many years been poor relative to other G7 countries, characterised by below-average growth, above-average inflation, and high volatility of both output and inflation. An important contributory factor to this poor past performance has been errors in policy making. For example, one such error occurred towards the end of the 1980s when policy came to be based on unrealistic assumptions about the economy's growth potential. This contributed to the unsustainable cyclical boom which eventually ended in the one of the deepest recessions since the War.

2.3 The consequences of macroeconomic policy errors can be profound, leading to instability and uncertainty and, ultimately, a below par growth performance that results in living standards lower than they might otherwise be.

2.4 No economy can be immune from shocks, including from external events. But their consequences will depend on the resilience of the macroeconomic framework that is in place. In particular, in today's global and fast-moving markets, a high price may be paid if policy makers do not maintain the trust and confidence of markets and the public. For that reason, a comprehensive, robust and credible macroeconomic framework is vital.

CREATING A FRAMEWORK FOR STABILITY

2.5 Since 1997, the Government has introduced a new framework for the operation of macroeconomic policy. This has been based on the lessons learned from the experiences of past years. Both monetary and fiscal policy are now highly transparent, forward-looking, based on clear rules and targets, and underpinned by legislation. This will help to promote Britain's long-term economic interests by making it more difficult to set macroeconomic policy on the basis of short-term political considerations. The new framework is delivering low inflation and sound public finances.

A new monetary policy framework

2.6 A broad consensus now exists that price stability is an essential pre-condition for achieving the Government's central economic objective of high and stable levels of growth and employment. It is clear that tolerating higher rates of inflation does not lead to higher employment or output over the long term. Indeed, high average rates of inflation which, more often than not, are accompanied by more variable rates of inflation discourage the long-term planning and investment vital to sustaining high rates of economic growth.

2.7 Yet, for most of the past 30 years, the UK's inflation record has been poor. During the 1970s, inflation averaged 13 per cent, peaking at almost 27 per cent in August 1975. Inflation averaged 7 per cent during the 1980s and reached over 9 per cent in the early 1990s. From 1980 to 1997, among the G7 countries, the UK had the second highest average inflation rate, and the UK had greater variability in inflation than all countries but France and Italy.

2.8 This performance reflected numerous shortcomings in the design and conduct of monetary policy. Objectives were often inappropriate or unclear, while monetary decisions were often poorly coordinated with fiscal policy or were made too late to prevent inflationary pressures from building. Roles and responsibilities of key players were also ill-defined, creating the impression that policy decisions could be based on short-term political considerations. A lack of transparency hindered accountability and meant that policy makers were unable to achieve maximum credibility.

2.9 On entering office, the Government moved quickly to reform the framework for monetary policy around a coherent set of principles[1]:

- a platform of stability, including low and stable inflation, is necessary for high and stable levels of growth and employment;
- the goal of monetary policy, price stability, should be defined in terms of an inflation target which is clear and stable over time;
- a symmetric inflation target - where deviations below target are treated equally seriously as those above - is vital so that monetary policy is forward-looking and can support the Government's objectives for growth and employment;
- there should be a clear separation of roles and responsibilities with respect to the setting of the framework, including the inflation target, and the implementation of monetary policy to meet that target;
- an independent committee of experts, unencumbered by short-term political pressures, and backed up by specific procedures, should have responsibility for implementing monetary policy to achieve the Government's inflation target;
- monetary policy should be characterised by high levels of openness, transparency and accountability;
- the framework must allow monetary policy to respond sensibly in the face of certain specific types of economic shocks; and
- monetary and fiscal policy should support each other in promoting stability.

2.10 Applying these principles, the Government fundamentally redesigned the framework for monetary policy. This framework is formalised in the *Bank of England Act 1998* and in the Chancellor's remit to the Monetary Policy Committee (MPC). Key elements of the reform were:

- a symmetric inflation target - $2^1/_2$ per cent annual growth in the Retail Prices Index excluding mortgage interest payments (RPIX), and a requirement that monetary policy also support the Government's wider economic policy objectives;
- the establishment of a Monetary Policy Committee at the Bank of England, composed of highly respected independent experts, and charged with, and held accountable for, setting interest rates to meet the Government's

inflation target;
- a series of mechanisms to promote openness, transparency and accountability in the MPC's operations, such as: the publication of voting records, minutes of the monthly MPC meetings and the quarterly Inflation Report; a requirement that MPC members appear before parliamentary committees; and direct accountability to the Government for their performance against their remit; and
- the introduction of an 'open letter' system. A transparent approach to deviations of inflation of more than 1 per cent in either direction from its target level gives the MPC an opportunity to respond sensibly to particular economic shocks. The letter must explain the reasons why inflation has diverged from the target, the action being taken to deal with it, when inflation is expected to return to target, and how any actions taken will be consistent with the Bank of England's responsibility to support growth and employment.

The performance of the new monetary policy framework

2.11 Since the introduction of the new framework two and a half years ago, a number of improvements in performance have been seen:

- RPIX inflation has averaged 2.6 per cent, only slightly above the target;
- inflation has not only been low, it has also been very stable. RPIX inflation has moved between 2.1 per cent and 3.2 per cent, with no breach of the 'open letter' thresholds that require the Governor of the Bank of England to write to the Chancellor;
- interest rates peaked at $7^1/_2$ per cent for four months in 1998 compared with a peak of 15 per cent for a year in the previous economic cycle, and currently stand at $5^1/_2$ per cent. Combined with the improved fiscal position, this means that the Government's debt interest payments are projected to fall by over £$3^1/_2$ billion this year compared with last;
- monetary policy decisions have been forward-looking. Prompt and decisive action by the MPC - in both raising and lowering interest rates where necessary - has enabled price stability to be maintained, avoiding the damaging boom and bust cycles seen so often in the past;
- output has remained close to trend, in contrast to previous cycles; and
- monetary and fiscal policy have been much better coordinated than in the past.

Chart 2.1: Inflation performance against target

2.12 Looking ahead, survey and financial market data suggest that inflation is expected to remain close to target:

- as shown in Chart 2.2, implied 10-year ahead inflation expectations of financial market participants have fallen from over 4 per cent in April 1997 to just under $2^1/_2$ per cent in October 1999, consistent with the inflation target; and
- long-term interest rates have fallen to very low levels and the differential between UK and German bond yields is also at historically low levels.

Chart 2.2: Inflation expectations 10 years ahead

2.13 Recent reports by both the House of Commons Treasury Committee and the House of Lords Select Committee on the Monetary Policy Committee of the Bank of England, and by international organisations such as the IMF and the OECD, have acknowledged the success of the new framework to date.

2.14 While this success has been encouraging, the MPC must continue to perform well if inflation is to remain on target. It is important not to be complacent. A forward-looking and vigilant approach will continue to be needed to maintain this track record.

2.15 The new monetary policy framework requires that the Bank of England meets the inflation target. Unsustainable wage rises would therefore not result in higher inflation, but in higher interest rates, with adverse implications for economic growth and unemployment. Wage and price setters must therefore act responsibly so that real increases in wages and profits are consistent with improvements in economy-wide productivity.

2.16 In addition, communicating the aims and rationale of monetary policy to those sectors of society - such as households - whose inflation expectations, while lower than in the past, remain above the inflation target, will continue to be important.

A new fiscal policy framework

2.17 Reforms to the monetary policy framework have been accompanied by a parallel set of reforms to fiscal policy, ensuring that the same high standards of transparency, responsibility and accountability apply to fiscal policy decisions. The two arms of policy work together in a co-ordinated way to deliver economic stability, with the objectives of both monetary and fiscal policy set by the Government. The process is aided by the presence of a Treasury (non-voting) representative on the MPC.

2.18 On arrival in office in 1997 the Government was faced with a large structural fiscal deficit, low net investment, rising public debt and falling public sector net worth. Urgent action was needed. This situation had come about, in part, as a result of a lack of clear and transparent fiscal objectives, together with fiscal reporting that did not permit full and effective public and parliamentary scrutiny.

2.19 The Government therefore implemented a new framework for fiscal policy based around a set of five central principles - transparency, stability, responsibility, fairness (including between generations) and efficiency.

2.20 These principles were enshrined in the *Finance Act 1998* and repeated in the *Code for Fiscal Stability*, approved by the House of Commons in December 1998. The Code explains how these principles are to be reflected in the formulation and implementation of fiscal policy in practice. As set out in Budget 99, in order to ensure that the public is fully informed about Budget decisions, the Government will propose an amendment to the *Code for Fiscal Stability*, requiring that, in future, a leaflet be sent to every household informing them of tax and spending decisions.

2.21 Given the central role of economic stability, the key objectives of the Government's fiscal policy are:

- over the medium term, ensuring sound public finances and that spending and taxation impact fairly, both within and across generations. In practice, this requires that:
  - the Government meets its key taxation and spending priorities while avoiding an unsustainable and damaging rise in the burden of public debt; and
  - those generations who benefit from public spending also meet, as far as possible, the costs of the services they consume.

- over the short term, supporting monetary policy, where possible, by:
  - allowing the automatic stabilisers to play their role in smoothing the path of the economy in the face of variations in demand; and
  - where prudent and sensible, providing further support to monetary policy through changes in the fiscal stance[3].

2.22 The medium and shorter-term objectives are linked. For example, the scope for, and success of, using fiscal policy to support monetary policy during a downswing in the economic cycle is likely to depend on the soundness of the medium-term fiscal position. Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended.

2.23 The Government has specified two key fiscal rules that accord with these fiscal principles. These are:

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

2.24 The fiscal rules provide benchmarks against which the performance of fiscal policy can be judged. The Government will meet the golden rule if, on average over a complete economic cycle, the current budget is in balance or surplus. The Government also believes that, other things equal, a modest reduction in net public sector debt to below 40 per cent of GDP over the economic cycle is desirable.

2.25 The Government is well on track to meet these fiscal rules. A fuller assessment is made later in this chapter and in Annex B.

A new public spending framework

2.26 To support the new fiscal framework, the Government has implemented a new regime for planning and controlling public spending. The previous framework had encouraged short-term planning and discriminated against spending on investment. Its primary focus was on controlling the *quantity* of spending, with insufficient emphasis given to controlling the *quality and effectiveness* of current and capital spending.

2.27 The new regime addresses these issues. Under the new framework, three-year plans have been set for all the main government departments through Departmental Expenditure Limits (DEL). These limits provide departments with a solid basis for planning and a strong incentive to manage their own costs effectively. Where expenditure cannot reasonably be subject to multi-year limits, it is subject to tough annual scrutiny as part of the Budget process and is contained under the heading of Annually Managed Expenditure (AME).

2.28 Within DEL and AME - which together equate to Total Managed Expenditure (TME) - current and capital expenditures are planned and managed separately, consistent with the distinction in the fiscal rules. This removes the bias against investment inherent under the previous planning regime.

2.29 Each department is also committed, through new Public Service Agreements (PSAs), to testing performance and efficiency targets for the modernisation of public services. PSAs, which were first published in December 1998[2], set out the key results the public can expect in return for the investment it is making in public services. The Government has promised to give progress reports against the targets annually.

2.30 New mechanisms are being put in place to deliver these targets and existing ones are being strengthened. Performance overall is being monitored closely by a Cabinet Committee, PSX. The Government has also appointed an advisory group of outside experts, the Public Services Productivity Panel, which is working with departments to help improve performance. Good business management is essential, with PSAs backed up at all levels by clear ownership and accountability, rigorous performance review and incentives. Where performance varies within and between services, the Government is also keen to find ways of raising standards to those of the best.

2.31 Sound strategic planning of both new capital spending and the utilisation of existing assets are essential to delivery of the Government's objectives. Departments have therefore drawn up Departmental Investment Strategies (DIS), first published in March 1999, to show how they manage capital effectively and how investment decisions are taken on a robust basis so the benefits of extra investment are maximised.

Box 2.1: 2000 Spending Review

The Comprehensive Spending Review, completed in July 1998, set spending plans for the three financial years starting in 1999-2000. It was announced at the time that a further review would take place in 2000, when the plans would be rolled forward for a further two years. It is intended to complete this review by July 2000. The third year of the current plans (2001-02) will become the first year of the new three-year planning period.

The aim of the Review will be to determine how best departments' programmes can contribute to the achievement of the Government's objectives, including in particular its aims of:

- **opportunity for everyone to fulfil their potential through education and employment;**
- **a fair and inclusive society in which communities are healthy and secure; and**
- **higher productivity, sustainable economic growth and effective cooperation with our European and international partners.**

The Review will entail a rigorous scrutiny of departments' performance in delivering effective and responsive services, improving efficiency, and managing assets and other resources. It will also consider a range of issues which cross departmental boundaries.

The Review will also look closely at the effectiveness with which departments are delivering their current PSA targets and will consider carefully the additional service outputs which can be delivered with any change to resource inputs. New PSA targets will be agreed as part of the Spending Review.

It is intended that the Spending Review should, for the first time, take account of the full resource costs of providing services, including the cost of assets employed, as part of the move to Resource Accounting and Budgeting (see Box 2.2).

Box 2.2: Resource Accounting and Budgeting

Resource Accounting and Budgeting (RAB) is part of the modernising government agenda and builds on the current

fiscal regime by planning, controlling and accounting for departmental spending on a full accruals basis. It will provide a better basis for the allocation and use of resources, enhancing the distinction between capital and current spending by recognising the capital costs (ie depreciation and interest) of public investments and assets as they occur, consistent with and alongside other current spending.

RAB is now in its final phase and it is the Government's intention to bring forward the necessary legislation to allow full implementation. Departments' first set of published audited resource accounts will be for the current financial year (1999-2000), with 'dry-run' resource accounts having been produced for 1998-99. The 2000 Spending Review (see Box 2.1) will incorporate resource budgeting and the use of resource accounting information.

Progress on the development of RAB has been reported regularly to Parliament and, subject to Parliament's agreement, Estimates for the year 2001-02, the first year of the new public spending plans, will be presented on a resource basis.

2.32 In sum, the new monetary, fiscal and, within that, spending frameworks are based on clear and firm principles designed to create a lasting platform of stability.

SUMMARY OF THE ECONOMIC FORECAST

2.33 With low inflation, sound public finances and a relatively secure private sector financial position, the economy was well placed to deal with the impact of last year's global financial instability. This followed a timely, and co-ordinated, policy tightening during the period to summer 1998. In the Budget 99 forecast, therefore, the slowing in UK growth was expected to be relatively short lived.

2.34 Subsequent developments have been broadly in line with Budget expectations. The economy is now estimated to have grown just below its trend rate from late 1997, with only a temporary pause in late 1998. In sharp contrast with previous economic cycles, damaging falls in output have been avoided. The temporary dip in growth last year largely reflected falling export volumes, particularly in Asian markets.

2.35 Monetary policy responded pro-actively to events, with base rates falling from a relatively low peak of $7^1/_2$ per cent in May 1998 to 5 per cent in June this year. This prompt policy reaction has contributed to a stronger than expected economic expansion in 1999, with preliminary figures for quarterly GDP growth of 0.9 per cent in the third quarter. Service sector output has grown healthily throughout and manufacturing output has picked up, outstripping earlier independent forecasts.

2.36 Buoyant final domestic demand has been the main driving force, partly reflecting continued labour market improvements. The Labour Force Survey (LFS) employment rate is now close to its previous record high of 75 per cent. The economic forecast presented in Annex A concludes that this has been associated with a decline in the sustainable rate of unemployment (or NAIRU) over recent years. Independent forecasters now expect the recent falls in unemployment to be sustained, and growth in earnings has eased over the past year and a half. Continued responsibility in wage bargaining will be critical in preserving lower unemployment.

2.37 Evidence is now emerging that adjustment to sterling's earlier appreciation may be nearing completion. Together with the pick-up in global growth, this has led to a recent rebound in UK exports. In particular, UK exporters are now recovering the ground lost last year in the crisis-hit Asian economies. The improving balance in G7 GDP growth is providing further support.

2.38 At the time the Government entered office, the economic outlook was highly uncertain, not least because of significant emerging macroeconomic imbalances. However, two and a half years on, the Government now believes that - on the basis of a careful and balanced assessment of past and future trends - it is possible to give a firmer indication of the outlook for trend growth. This assessment does not fall into the trap of assuming productivity improvements as a result of new policies before clear evidence emerges.

2.39 The Government believes that a neutral estimate of the UK's annual trend growth rate over the coming period is $2^1/_2$ per cent[4]. Following significant reforms to the macroeconomic framework and a number of important structural measures, the UK economy has shown clear signs of improved stability and a decline in the sustainable rate of unemployment. This evidence suggests strongly that the contribution of growth in the employment rate to overall trend growth will be greater than during the 1990s.

2.40 There is also good reason to believe that productivity growth - promoted by the Government's policies which are described fully in Chapters 3 and 4 - may also turn out somewhat higher than in the 1990s. But it is too early to conclude that the economy's underlying productivity performance has improved. So the underlying rate of productivity growth over the period ahead is assumed to be identical to that experienced during the 1990s. In this sense, the Government's neutral estimate of trend growth is subject to upside risk. The Government is determined to take a prudent approach by erring on the side of caution when uncertainties exist.

2.41 Household consumption and business investment are growing rapidly and, with inventories having already fallen significantly, this is likely to be more fully reflected in GDP growth from now on. Overall, GDP is forecast to grow by $1^3/_4$ per cent in 1999, higher than the 1 to $1^1/_2$ per cent Budget 99 range, and mirrored in sharp upward revisions to independent forecasts. Business survey indicators have also recovered rapidly, with last autumn's lows probably reflecting an over-reaction to external events (see Box A1). GDP growth of $2^1/_2$ to 3 per cent is forecast for 2000.

2.42 With stronger growth in the near term, and an improving world outlook, output is expected to be just above its trend level during the course of 2000. This suggests some slowing in the pace of domestic expansion will be required. By holding the economy close to its stable path over the next few years, a platform for sustained growth can be delivered. GDP is forecast to grow at its estimated trend rate of $2^1/_4$ to $2^3/_4$ per cent in both 2001 and 2002, in line with the Government's considered assessment of trend growth.

Table 2.1: Summary of the economic forecast

			Forecast		
	1998	**1999**	**2000**	**2001**	**2002**
GDP growth (per cent)	$2^1/_4$	$1^3/_4$	$2^1/_2$ to 3	$2^1/_4$ to $2^3/_4$	$2^1/_4$ to $2^3/_4$
RPIX inflation (per cent, Q4)	$2^1/_2$	2	$2^1/_2$	$2^1/_2$	$2^1/_2$

Box 2.3: EMU and EMU preparations

The UK has a strong interest in ensuring economic stability in Europe. Around half of UK trade and 40 per cent of overseas investment is with the euro area. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest, and whether the economic case for joining is clear and unambiguous. This requires that the Government's five economic tests are met and that the UK economy can demonstrate a settled period of sustainable convergence with the euro area.

The Government is committed to ensuring that the British people face a genuine option to join a successful single currency. Achieving greater economic stability than in the past should provide an essential platform for closer convergence of the economic performance of the UK and other Member States. Further progress on economic reform in Europe (see Box 3.1) will help provide the flexibility required to live with a single interest rate and ensure that any divergences in economic cycles are kept to a minimum.

Over the past two years, the Government has worked intensively with the business community, wider public sector and voluntary groups both to ensure that the necessary preparations were in place to deal with the euro from 1 January 1999, and to take forward detailed planning work for possible UK entry, if that is what Parliament and the people decide.

The Government has provided a range of practical help for UK businesses now having to deal in the euro. It has produced factsheets, case studies, electronic tools and progress reports. It has carried out surveys, a national communications campaign and set up 12 regional fora to help preparations at the local level. It also prepares regular progress reports on euro preparations, the third of which was published earlier this month. Businesses are now able to pay taxes and receive certain grants and other services in euros.

The first outline National Changeover Plan for possible entry to the single currency was published by the Treasury in February 1999. The plan is a consultative document which sets out the practical steps which would needed for the UK to join the euro. Introducing the plan, the Prime Minister explained that preparations need to be made now so that, should the economic tests be met, a decision to join a successful single currency could be made early in the next Parliament. The public sector has given a clear signal of its commitment to prepare, involving some spending to give

Britain the flexibility it would need to make the changeover as quickly and cost-effectively as possible.

2.43 RPIX inflation is expected to edge up gradually to the $2^1/_2$ per cent target during the course of 2000, as the benefit of falling import prices unwinds. Growth in domestic unit costs has been strong in 1999 but, allowing for the cycle and the temporary impact from significant falls in long-term unemployment, there is no evidence of any deterioration in underlying productivity performance in recent years. Growth in domestic costs is expected to return to its sustainable path as the economy continues to expand into 2000 and beyond.

2.44 Excess strength in household consumption, supported by rapid growth in house prices, poses the clearest upside risk to the economic outlook. With buoyant real incomes and low interest rates, the potential for continued strong housing and consumer demand does exist. Nevertheless, fundamental indicators of housing market balance, such as the ratio of house prices to earnings, signal a greater degree of stability compared to the past. The new monetary framework will act to damp such cycles by providing a credible anchor for household expectations - for example, of expected house price gains. The Government has taken further action to promote housing market stability by recent increases in stamp duty and the abolition of mortgage interest relief at source (MIRAS) from April 2000.

DELIVERING STABILITY: A SMOOTHER ECONOMIC CYCLE

2.45 The reforms to the monetary and fiscal frameworks are delivering important results. Over the past year, the macroeconomic framework has helped deliver economic stability and avoid unnecessarily large fluctuations in output, even in the face of the large external shock in 1998. The latest economic projections indicate that output is expected to continue to remain close to trend.

2.46 In comparing the behaviour of the present economic cycle with the previous one, a number of key observations can be made:

- during the last economic cycle, interest rates were raised too late, almost two years after the economy is now estimated to have passed through trend. During the current cycle, interest rates were raised as the economy moved through trend. This allowed rates to peak at $7^1/_2$ per cent, half the level seen during the last cycle;
- the MPC took account of the downside risks to the economy from the global financial turbulence last year, cutting interest rates sharply through the second half of 1998 and into 1999. This timely action helped to offset the risks to confidence and output while ensuring that inflation remained on track to meet the target; and
- fiscal policy has supported monetary policy through the cycle. The substantial fiscal tightening during 1997-98 supported monetary policy when the economy was above trend. Having restored the public finances to health, Budget 99 continued to lock in that tightening but also allowed fiscal policy to support monetary policy as the economy was expected to move further below trend.

2.47 A high degree of economic stability will also help to provide the foundations for the necessary convergence should the UK decide to join EMU in the next Parliament (see Box 2.3).

MEETING THE FISCAL RULES: FISCAL POSITION AND PROSPECTS

2.48 A key role of the PBR is to present an update on the outlook for the economy and the public finances, taking into account economic and other developments since the Budget. The projections here, and in more detail in Annex B, update those in Budget 99 based on the latest information. They allow an assessment of progress against the Government's two fiscal rules. It is important to note, however, that the public finance projections in the PBR present an interim forecast update and do not necessarily represent the outcome the Government is seeking. The projections have a quite different status from those contained in the EFSR and FSBR at Budget time since those include the effects of all Budget policy decisions.

2.49 A separate Treasury paper, *Analysing UK Fiscal Policy,* published on 9 November, provides a guide to fiscal policy under the new framework. In line with that paper, the presentation of the fiscal numbers in this chapter is based around five key themes of fairness and prudence, sustainability, economic impact, financing and European commitments.

2.50 While the economic forecast is based on a neutral estimate of $2^1/_2$ per cent a year trend growth over the projection period, the public finances projections continue to be based on the deliberately prudent and cautious trend growth assumption of $2^1/_4$ per cent, audited by the National Audit Office (NAO). In the Spring 2000 Budget and next year's Spending Review this will remain the assumption for the purposes of projecting the public finances.

2.51 The trend growth assumption is just one of a number of cautious assumptions underlying the fiscal projections which have been audited by the NAO. A full set of the NAO audited assumptions is listed in Table B1. It includes a new oil price assumption used for projecting North Sea revenues. This approach has been endorsed by the NAO[4].

2.52 The fiscal projections in the PBR take account of the Government's decision to move decisions about fuel and tobacco duties onto a discretionary basis. The Government is committed to meeting its environmental targets, but the future yields will depend on Budget decisions. In line with the *Code for Fiscal Stability*, the effects of real increases in duty have therefore been removed from the public finance projections, in keeping with the approach taken to the scoring of other tax revenues. This is consistent with a cautious approach to the public finance projections.

Ensuring sound public finances into the medium term

2.53 A higher surplus on the current budget last year than anticipated at the time of Budget 99, growth above the upper end of the Budget forecast range this year and a composition of growth more favourable to the public finances have all served to raise the level of the current surplus and further reduce the net debt ratio in 1999-2000 and beyond. The projections show that the underlying position for the public finances remains sound and on track to meet the fiscal rules over the economic cycle.

2.54 The Government is determined not to repeat the mistakes of the past, where fiscal policy was relaxed the moment the economy started to grow and when the position of the public finances improved. It would be irresponsible to make promises about public spending and taxation now, before there is hard evidence as to the permanence and sustainability of the improved outlook for the public finances. It would put in jeopardy the platform of stability which has been created through tough discipline both in fiscal and monetary policy.

2.55 Maintaining sound public finances, by meeting its strict fiscal rules, is the primary objective of fiscal policy. But, where consistent with meeting the rules, fiscal policy also has a role to play in supporting monetary policy through the cycle. At the time of the Budget, the Government will review all of the available evidence before making judgements about its desired path for fiscal policy. In doing so it will maintain the cautious approach undertaken since 1997 to ensure that the rules are met and, consistent with that, to allow fiscal policy to continue to support monetary policy.

Recent fiscal trends and short-term outlook

2.56 Table 2.2 compares the latest fiscal projections with those in Budget 99. A current budget surplus of £9.5 billion is now estimated for 1999-2000, compared with the Budget projection of £2 billion. A similar improvement is seen for public sector net borrowing (PSNB). A repayment of £3.5 billion is now expected in 1999-2000, compared with a projected deficit of £3 billion in Budget 99.

2.57 The stronger estimated position for 1999-2000 than anticipated at the time of Budget 99 reflects three main factors on the revenue side:

- **higher outturn figures for both the current balance and PSNB** in 1998-99 than expected at the time of the Budget 99. This has had the effect of raising the forecast base, and hence the profile into future years;
- **a stronger than expected cyclical path for output and employment.** GDP growth so far during 1999-2000 has been stronger than expected at the time of the Budget; and
- **a more favourable composition of GDP growth than expected.** Not only has GDP growth been stronger than anticipated, but its composition has been more favourable to the public finances, increasing the tax base relative to that expected at Budget time. In particular, the share of wages and salaries is estimated to be a little higher this year than forecast at Budget time, and the consumption share of national expenditure is higher by about 1 percentage point. This increase in the tax base for given GDP has raised receipts of income tax and social security contributions, non-North Sea corporation tax, North Sea revenues and VAT.

Table 2.2: Fiscal balances comparison with Budget 99[1]

	Outturn[2]		Estimate	Projections		
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Fiscal balances (£ billion)						
Surplus on current budget - PBR	7.2	9.5	11	13	13	12
Surplus on current budget - Budget 99	4.1	2	4	8	9	11
Net borrowing - PBR	-2.5	-3.5	-3	-3	1	4
Net borrowing - Budget 99	-1.0	3	3	1	3	4
Cyclically-adjusted budget fiscal (per cent of GDP)						
Surplus on current budget - PBR	0.6	0.9	1.0	1.2	1.2	1.1
Surplus on current budget - Budget 99	0.2	0.6	1.0	1.1	0.9	1.0
Net borrowing - PBR	0.0	-0.2	-0.2	-0.2	0.1	0.4
Net borrowing - Budget 99	0.1	0.0	-0.2	-0.1	0.3	0.4

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

[2] *The 1998-99 figures were estimates in Budget 99*.

2.58 On the spending side, with the exception of 1999-2000, DEL is unchanged from Budget 99. The current year DEL total has been increased by the carry-forward from 1998-99 of a £0.7 billion underspend on DEL programmes in that year, in line with the procedure announced in the 1998-99 Public Expenditure Outturn White Paper (Cm 4416). The forecasts of individual AME programmes have been updated since the March Budget. Total AME remains unchanged from the Budget and, in line with the convention adopted in last year's PBR, changes to AME programmes have been offset in the margin. The figures will be reviewed again at the time of the next Budget.

2.59 The projections for 1999-2000 represent only an interim forecast update and are subject to change in the period before the Budget. Forecast errors, even in the near term, can be significant, reflecting a variety of factors - both relating to revenue projections for the year as a whole and the position of the economy in the economic cycle.

2.60 At the time of the next Budget, the Government will have further information about fiscal trends in the current year and, as such, will be able to take a more informed view of the position of the public finances. It is at Budget time that the Government takes decisions on the fiscal stance to meet its fiscal rules and, where possible, to support monetary policy.

Table 2.3: Summary of public sector finances[1]

	Per cent of GDP						
	Outturn[3]	Estimate	Projections				
	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Fairness and prudence							
Surplus on current budget	0.8	1.1	1.2	1.3	1.2	1.1	1.0
Cyclically-adjusted surplus on current budget	0.6	0.9	1.0	1.2	1.2	1.1	1.0
Average surplus since 1997-98	0.1	0.4	0.6	0.8	0.8	0.9	0.9
Long-term sustainability							
Public sector net debt[2]	40.3	38.2	36.9	35.3	34.1	33.2	32.5
Net worth[2]	13.7	15.6	16.6	17.8	18.3	18.9	19.2
Primary balance	3.2	2.9	2.9	2.8	2.3	1.9	1.5
Economic impact							
Net investment	0.6	0.7	0.9	1.1	1.3	1.5	1.5
Public sector net borrowing (PSNB)	-0.3	-0.4	-0.3	-0.3	0.1	0.4	0.5
Cyclically-adjusted PSNB	0.0	-0.2	-0.2	-0.2	0.1	0.4	0.5
Financing							
Central government net cash requirement[2]	-0.5	0.1	0.0	-0.1	0.1	0.6	0.7
European commitments							
Maastricht deficit[4]	-0.5	-0.3	-0.2	-0.2	0.1	0.4	0.5
Maastricht debt ratio[5]	47.0	44.9	43.1	41.3	39.9	38.8	38.0
Memo: output gap	*0.3*	*0.2*	*0.2*	*0.1*	*0.0*	*0.0*	*0.0*

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

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

[3] *The 1998-99 figures were estimates in Budget 99.*

[4] *General government net borrowing on an ESA 95 basis. The Maastricht definition includes the windfall tax and associated spending.*

[5] *General government gross debt on an ESA 95 basis.*

Fairness and prudence

2.61 Underlying the *Code for Fiscal Stability* is the requirement for fiscal policy to be undertaken in a responsible and fair manner, including between generations. The surplus on the current budget represents the difference between current receipts and current expenditure including depreciation. It measures the extent to which current taxpayers are meeting the costs of the public goods and services they consume. The golden rule not only ensures fairness between generations, but also contributes to a prudent approach to the public finances. Current spending and revenue are the most significant drivers of trends in PSNB. Thus, achieving the golden rule plays a major part in keeping borrowing to levels consistent with a prudent and sustainable net debt ratio. In this way, the golden rule and the sustainable investment rule work together to deliver sound public finances.

2.62 The surplus on the current budget has improved markedly since 1996-97 when there was a large deficit of 3 per cent of GDP. By 1998-99, this deficit had been transformed into a surplus of 0.8 per cent of GDP.

2.63 In 1999-2000 and beyond, the surplus on the current budget is projected to remain broadly unchanged, at around 1 per cent of GDP. Current expenditure is assumed to rise in line with the cautious assumption of GDP growth, while receipts rise slightly faster as a result of real fiscal drag and the impact of past Budget measures. With public net investment increasing as a share of GDP, PSNB is projected to increase slightly over the projection period.

2.64 The average surplus on the current budget from 1997-98, when the economy was last judged to be on trend, is projected to increase towards 1 per cent of GDP, thus remaining on track to meet the golden rule.

2.65 Looking at the surplus on the current budget can be misleading when trying to assess the underlying position of the public finances. The economic cycle can have an important short-term impact on the public finances through the operation of the automatic stabilisers. For instance, in the late 1980s large surpluses were recorded on the current budget, but these (unadjusted) surpluses turned out to be misleading. On a cyclically-adjusted basis, the current budget remained in deficit - the surpluses were largely due to cyclical factors. It is therefore important to look at cyclically-adjusted, or structural, fiscal balances. It is for this reason that the *Code for Fiscal Stability* requires the Government to publish cyclically-adjusted estimates of the key public finance indicators.

2.66 There has been a significant structural improvement in the public finances between 1996-97 and 1998-99. The projections show, for 1999-2000 and thereafter, that this structural improvement is set to be locked-in. However, as noted earlier, large uncertainties surround these projections, both relating to revenues and the cyclical position of the economy.

Long-term sustainability

2.67 Substantial progress has been made in reducing net debt since 1996-97, with net debt projected to fall below 40 per cent in 1999-2000. This is consistent with meeting the sustainable investment rule. Net debt is projected to continue falling steadily thereafter, reflecting the sustained improvement in the position of the public finances.

2.68 Public sector net debt is just one measure of the sustainability of the public finances. Another is net worth[5], the difference between the total assets and liabilities of the Government. Net worth is projected to rise gradually to around 19 per cent of GDP by the end of the period. The primary balance (PSNB excluding debt interest payments) also helps assess the sustainability of the fiscal position. The primary balance is projected to be in surplus over this period, consistent with a sustained fall in the net debt ratio.

Economic impact

2.69 As discussed earlier, the fiscal projections presented in the PBR do not necessarily represent the outcomes the Government is seeking. Rather, they represent an interim update of the projections in the Budget, incorporating new data and other information on the state of the economy. Decisions on the stance of fiscal policy are taken once a year, at the time of the Budget.

2.70 The overall impact of fiscal policy on the economy can be assessed by examining changes in PSNB. One of the factors contributing to PSNB is net investment which has an impact on economic activity (both in the short and long term) and needs to be taken into account when assessing the overall economic impact of fiscal developments.

2.71 Setting the fiscal rules over the economic cycle provides an inbuilt capacity for fiscal policy to respond to changing economic circumstances by allowing scope for the automatic stabilisers to operate. But it is not only through the operation of the automatic stabilisers that the fiscal position can impact on economic activity. Changes in cyclically-adjusted (or structural) PSNB also have an effect. A reduction in cyclically-adjusted PSNB will dampen aggregate demand over and above the operation of the automatic stabilisers, while an increase in cyclically-adjusted PSNB will have the opposite effect.

2.72 A repayment equivalent to 0.4 per cent of GDP is now expected for PSNB in the current year. Cyclically-adjusted, a small surplus of 0.2 per cent of GDP is projected, compared with cyclically-adjusted balance in Budget 99.

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

2.73 In following years, changes in PSNB are small and very similar to those set out in Budget 99, while the path for cyclically-adjusted PSNB is almost identical. Over the period, the projections imply a shift from repayment of debt to modest borrowing as net investment more than doubles to 1.5 per cent of GDP. The implication of these figures is that the fiscal stance is broadly unchanged from Budget 99, with the fiscal tightening achieved since 1996-97 continuing to be locked in.

Financing

2.74 The forecast of the central government net cash requirement in 1999-2000 has been revised down from £6.2 billion to £1.1 billion. This, together with the effect from the central government net cash requirement outturn from 1998-99, has reduced the 1999-2000 financing requirement by £6.8 billion, from £21 billion to £14.2 billion. Gilts sales so far in 1999-

2000 total £11 billion out of the Budget plans of £17.3 billion, and a further £2.8 billion to £3.6 billion of sales are planned. The rest of the financing requirement is accounted for by net financing from National Savings, and an increase in short-term debt, in preparation for the start of the DMO's cash management operations.

European commitments

2.75 The Government remains on track to meet the Maastricht Treaty and Stability and Growth Pact commitments. These provide reference values for general government net borrowing (below 3 per cent of GDP) and general government gross debt (below 60 per cent of GDP). The PBR projections show general government net borrowing broadly close to balance, and debt on a declining trend. Both measures meet the reference values comfortably.

Dealing with uncertainty

2.76 Forecasting the public finances involves a high degree of uncertainty. It is for this reason that the medium-term projections presented here are based on cautious assumptions audited by the NAO. In addition, the projections imply a surplus on the current budget over the economic cycle, providing a safety margin over what would be strictly necessary to meet the golden rule.

2.77 One particular source of uncertainty surrounds the position of the economy in relation to its sustainable long-term trend. Chart 2.4 illustrates a more cautious case in which trend output is assumed to be 1 per cent lower than in the projection used for the medium-term public finance projections set out in Table 2.3. This scenario would imply that a greater proportion of the projected surplus on the current budget is due to the cyclical strength of the economy. Even on this more cautious assumption, surpluses on the current budget are still projected over the medium term.

Chart 2.4: Cyclically-adjusted current budget

CONCLUSION

2.78 The new monetary policy framework and tough discipline in fiscal policy has created a platform of stability over the past two years. The Government is determined not to repeat the mistakes of the past when large structural fiscal deficits were allowed to accumulate, adding to the stock of government debt and pushing up debt interest payments. It is therefore continuing to pursue a prudent approach to managing the public finances, in particular by basing its projections of the public finances on a deliberately cautious assumption of trend growth of 21/4 per cent a year, below its neutral estimate of trend growth of 21/2 per cent a year.

2.79 The potential for still stronger non-inflationary growth therefore is clear, illustrated by the upper ends of the GDP growth forecast ranges presented in this chapter and Annex A. Raising the economy's long-run growth potential to deliver high and stable levels of employment requires four key conditions to be met, as discussed below. If these conditions are met the upper end of its growth ranges can be achieved.

2.80 This chapter has outlined the importance of two of these conditions:

- stability - a pro-active monetary policy and prudent fiscal policy. The new frameworks for monetary and fiscal policy have so far proved effective in reducing fluctuations in output and generating the stability necessary for high and stable levels of growth. But complacency would be dangerous. The MPC must continue to be vigilant and forward-looking, while fiscal policy needs to be set both prudently and appropriately so as to support monetary policy; and
- responsibility - avoiding short-termism in pay and wage bargaining across the public and private sectors. Inappropriate pay and wage demands would threaten the platform of low inflation built up over the last few years.

2.81 The following two chapters describe the remaining two conditions which Britain must put in place to raise its economic potential and increase national prosperity:

- productivity - Chapter 3 sets out how the Government is meeting the challenge of raising productivity to the levels recorded in other major economies; and
- employability - Chapter 4 sets out the Government's strategy to increase employment opportunity, including a strengthening of the programme to move the unemployed from welfare to work.

2.82 Together, Chapters 2 to 4 describe the Government's approach to achieving high and stable levels of growth and employment. The remaining two chapters describe how the Government is ensuring that this goes hand in hand with building a fairer society and protecting the environment, consistent with the Government's strategy for sustainable development (see Box 2.4).

Box 2.4: Sustainable development

The Government's strategy for sustainable development for the UK, *A better quality of life,* was published in May 1999. It sets out four objectives that underlie the Government's approach to sustainable development:

- **social progress which recognises the needs of everyone;**
- **effective protection of the environment;**
- **prudent use of natural resources; and**
- **maintenance of high and stable levels of growth and employment.**

It is not enough to meet one of these objectives alone. The challenge of sustainable development is to move forward together on economic, social and environmental performance. This Pre-Budget Report demonstrates that the Government's policies are consistent with the promotion of sustainable development.

A set of key headline indicators of sustainable development has been developed to focus attention on what sustainable development means, and to give a broad overview of the pattern of economic, social and environmental progress. These are part of a much larger set of sustainable development indicators, which will be published in due course. This approach complements the work of the Office for National Statistics on developing environmental and household accounts for the UK.

Achieving sustainable development does not just depend on Government action alone. Everyone can play a part in reducing their own impact on the environment. Action at local levels is vital too. All local authorities have a target to prepare local sustainable development - "Local Agenda 21" - strategies by 2000. The Government hopes to have sustainable development frameworks for each English region in place by then end of 2000.

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[1] The new monetary policy framework and an assessment of its performance to date are discussed further in *The New Monetary Policy Framework,* HM Treasury, October 1999.[Back]

[2] *Public Services for the Future: Modernisation, Reform, Accountability* (Cm 4181).[Back]

[3] Approximated by changes in cyclically-adjusted public sector net borrowing.[Back]

[4] See *Trend Growth - Prospects and Implications for Policy*, HM Treasury, November 1999.[Back]

[4] *Audit of the Future Oil Price Convention for the November 1999 PBR*, HC873.[Back]

[5] Net worth was previously referred to as net wealth. However, under the changes to the presentation of the national accounts as a result of ESA 95, it is now called net worth.[Back]

3

Meeting the productivity challenge

Britain faces a clear productivity challenge, with performance lagging behind that of other major economies. The UK's productivity gap with countries such as the US, France and Germany is substantial up to a third. This reflects long-standing problems and weaknesses, not just in one but in many areas. For example:

- **past macroeconomic instability: repeated cycles of boom and bust have damaged investment and long-term growth;**
- **a low capital stock: the capital stock per hour worked is 30 per cent higher in the US and 70 per cent higher in Germany;**
- **poor skills: seven million UK adults lack basic skills in literacy and numeracy;**
- **a weak R&D record: UK companies invest a lower proportion of national income in R&D than the US, Germany or France.**
- **a lack of entrepreneurship: the level of entrepreneurship in the UK is about half that of the most entrepreneurial country the US although it compares well with other parts of Europe.**

In order to address these weaknesses and help close the gap with other major countries, the Government has set out a clear strategy to meet the productivity challenge, focusing on:

- **promoting competition in the economy: by strengthening the framework for competition policy through the new Competition Act;**
- **encouraging enterprise and innovation: by taking steps to enhance the UK's enterprise culture and maximise the incentives for innovation;**
- **raising the skills base: increasing resources and standards in education and improving the opportunities for life-long learning;**
- **creating the right conditions for investment: by delivering both macroeconomic stability and microeconomic reforms to promote incentives to invest; and**
- **improving public sector productivity: by setting clear targets for improving efficiency in public service delivery.**

THE PRODUCTIVITY CHALLENGE

3.1 Raising productivity is one of the key conditions for meeting the Government's objective of high and stable levels of growth and employment and delivering sustained increases in living standards. This chapter describes the challenges Britain faces to raise its productivity performance, how the Government is contributing towards meeting those challenges, and the environment it is creating for businesses and individuals to raise their performance. It is becoming increasingly important that the UK quickly addresses these issues and meets the challenges associated with the rapid pace of technological change and the evolving nature of business. The Government's long-term economic ambition for the next decade is that Britain will have a faster rise in productivity than its main competitors, as it closes the productivity gap.

3.2 The UK's productivity performance has been poor. There are various ways of measuring productivity, but they all point to a sizeable gap compared with other major economies:

- on the frequently used measure of **output per worker** or labour productivity, the UK has a gap of 35 per cent with the US, around 25 per cent with France and almost 15 per cent with Germany. Matching the US performance would raise the level of UK income by £5,000 per person;
- **output per hour worked** is 25 per cent higher in France and Germany and 15 to 20 per cent higher in the US; and

- **total factor productivity,** a measure of the efficiency of both capital and labour, is almost 20 per cent higher in France and around 10 per cent higher in the US and Germany.

Chart 3.1: The productivity gap

Identifying the problem

3.3 Economic growth can result from:

- greater inputs of labour and capital into the economy; and/or
- better use of these inputs through technical progress or other efficiency gains.

There are important interrelationships between the different factors influencing growth. Strengthening one may also act to strengthen others. For example, increasing investment may help technological progress.

3.4 Comparative studies of the UK against other economies illustrate why the UK's growth performance has fallen short in the past and indicate the areas that must be tackled to generate a world class performance. A number of factors can be clearly identified as having an impact on the UK's poor productivity performance:

- lack of physical investment;
- lack of skills; and
- inefficient use of capital and labour.

Physical investment

3.5 Physical capital increases inputs into the economy and, as it embodies the latest technology, helps diffuse innovation throughout the economy. One of the UK's weaknesses in the past has been low levels of investment. The UK has invested a smaller share of GDP than the OECD average since 1960, leaving the UK with a lower capital stock than its major competitors. The weakness of UK investment in the past reflects:

- macroeconomic instability, making it hard for firms to plan ahead;
- microeconomic difficulties, such as the tax system encouraging firms to pay out profits in dividends rather than reinvesting them; and
- low public sector investment dragging down the capital stock for the country as a whole.

Skills

3.6 Skills directly influence how much each person can produce. Also, access to a skilled workforce will encourage firms to invest, and invest in the latest technology. In the past the UK has been held back by inadequate investment in education. Seven million adults lack literacy skills and even more struggle with basic arithmetic. A lower proportion of the UK workforce has higher skills (degree or above) than the US and a lower proportion have intermediate skills than Germany[1].

Total Factor Productivity

3.7 Growth does not just come from greater labour and capital inputs into the economy, but also from more productive use of these inputs through technological progress or other efficiency gains. This has been a major source of growth in the UK and many other countries, but here again the UK lags.

The productivity challenge

Chart 3.2: The investment gap
Chart 3.3: The skills gap
Chart 3.4: Private sector total factor productivity
Chart 3.5: The R&D gap

3.8 One problem has been a failure to invest in technological development. At both the level of the firm and for the country as a whole, research and development (R&D) expenditure tends to boost growth. But the UK's business expenditure on R&D is lower than in the US, Germany and France. Moreover, the UK has not gained the full economic benefit from its inventions. To do so, inventions need to be diffused throughout the economy. The process of innovation is much broader than invention.

3.9 Firms need to turn new inventions into wealth creating businesses, products and services. The desire of existing businesses to grow and the creation of new businesses, entrepreneurship, creates the incentives to innovate. Entrepreneurial activity in the UK compares reasonably well with most parts of Europe, but on some measures it is only around half that of the most entrepreneurial country, the US.

3.10 Competition forces firms to become more efficient to avoid falling behind. It also forces firms to innovate as they have to introduce newer and better products to survive, and to invest in both physical and human capital to keep up with their rivals. Entrepreneurship is important in part because it increases competition. Similarly trade increases competition in an economy and helps innovation.

Tackling the problem: the five key drivers

3.11 Therefore the best economic environment for encouraging productivity is one:

- which is strongly **competitive,** so that markets are opened up for new entrants and existing businesses have to be dynamic and entrepreneurial to stay ahead;
- which is supported by a culture of **enterprise** with incentives for individuals and businesses to be more entrepreneurial, and where new ideas and inventions are exploited successfully through **innovation** to become new products, services and processes;
- where individuals have the **skills** and abilities to make the best use of the new technologies that arise;
- where the incentives and environment therefore exist for more, and more productive, **investment;** and
- that is underpinned by improved **public sector productivity** delivered through better quality services and increased investment in infrastructure.

3.12 Similar themes also emerged from the consultations the Government held through seminars and roadshows after last year's Pre-Budget Report on how to address the productivity gap. Therefore, in devising policies to improve the UK's productivity, the Government has identified and worked with the five key drivers of a productive economy mentioned above. The Government will also be holding roadshows to consult on the measures in this chapter over the coming months.

3.13 As discussed in Box 3.1, these are not just issues for the UK. All European Member States are committed to structural reforms to increase employability and productivity.

Box 3.1: Economic reform in Europe

Raising employment and productivity are major challenges currently facing all EU Member States. For the EU to match US levels requires a commitment to developing an innovative, flexible, knowledge-driven economy with competitive markets and better opportunities for small firms to expand. Member States endorsed the idea of structural reform at the Cardiff European Council in 1998 and reaffirmed this at subsequent European Councils. Comprehensive structural reform - such as recent UK reforms - will allow Europe to increase social cohesion and social justice through the rewards of more efficient and dynamic economies.

The chart plots non-employment against productivity in the Member States and compares this with the US. The US appears out on its own with relatively low non-employment and high productivity. The relative positions of Spain, Greece and Portugal on the chart reflect the fact that they are still catching up with the rest of the EU. It is nonetheless apparent that, despite clear leads in Europe in some areas (e.g. investment in skills), there is plenty of scope for all Member States to make progress in raising either employment or productivity, or both, before they match US levels. Convergence on US levels of employment and productivity would imply considerably higher output for all Member States.

Non-employment rates and productivity levels in EU countries, 1997

All Member States have introduced, or are in the process of introducing, structural reforms designed to boost employment and productivity. Each Member State is committed to economic reforms that will increase employability, support entrepreneurship, increase adaptability and promote equal opportunities at work.

Member State reforms designed to increase productivity include:

- **introducing more competition to make product markets more efficient and deliver a better deal for consumers in terms of lower prices and more choice, for example by liberalising utilities or introducing tougher competition policies;**

- **better regulation such as removing restrictions on shop opening hours and reducing taxes on profits; and**

- **making capital markets work better by increasing competition and thus availability of capital, helping small firms expand, while protecting investors. A number of Member States have introduced measures to boost investment and innovation such as tax incentives to promote greater provision of risk capital.**

COMPETITION

The impact of competition on productivity

3.14 A competitive economy will drive up productivity. In competitive markets, firms face a direct, sharp, ongoing incentive to improve continuously the efficiency with which they produce goods and services, keeping prices down and quality up. They know that if they do not, they will lose business to competitors or new entrants.

3.15 Competition also provides the environment which best encourages enterprise and innovation. New and existing market participants are incentivised to develop new products and new ways of delivering existing products. This in turn means that companies and individuals invest in human and physical capital to stay ahead of the competition and to obtain the rewards from doing so. Conversely, firms in a competitive economy that do not invest in their staff and their capital will fall behind, lose market share and ultimately see their profits eroded.

3.16 The importance of competition and openness has been highlighted in a number of studies, including recent work by the OECD[2] which emphasises the positive impact on productivity growth that the entry of new, often innovative, firms can have.

The strength of competition in the UK economy

3.17 Competition is a difficult concept to measure, and no single indicator can readily be used to judge how competitive the UK economy currently is. However, the vigour of competition depends broadly on two factors: the openness of markets to overseas firms; and the extent to which there is robust domestically generated competition.

3.18 The level of international trade and foreign direct investment are the principal indicators of openness. Trade and foreign direct investment add directly to the intensity of competition and have positive effects. They stimulate increased product development among indigenous firms in response to increased competition, as well as becoming vehicles for technology transfer, including through the supply chain.

3.19 The UK is relatively open to international trade and has a good track record in attracting foreign direct investment. The Government therefore believes that it should focus on further action to improve the level of domestically generated competition.

The Competition Act

3.20 The new Competition Act 1998 will come into force in March 2000. The Act revolutionises the enforcement of competition policy by enhancing the powers available to the Office of Fair Trading (OFT) to tackle anti-competitive practices and abuses of a dominant position. It also introduces strong penalties for transgressors and ensures that the OFT is able to identify and pursue cases of anti-competitive behaviour entirely independently of Ministers. The key priority for the coming year will be to ensure that the Act is implemented effectively (see Box 3.2).

3.21 The Government also intends to reform the process for controlling mergers. The DTI published a consultation document in August which proposes giving the competition authorities rather than Ministers the responsibility for taking decisions in the vast majority of cases. And it proposes focusing the criteria against which mergers are assessed much more clearly on competition and the interests of consumers, so that most cases are decided solely on these grounds. The Government will be announcing how it intends to take forward these proposals next year.

Box 3.2: Changes in the OFT to meet the demands of the new Competition Act

The new regime established by the Competition Act will give the OFT greatly strengthened powers to prevent anti-competitive behaviour. In recognition of this the OFT was provided with an extra £15.4 million of resources over three years in the Comprehensive Spending Review to equip it to ensure that companies comply with the new regime.

The OFT has been preparing for implementation of the Act, informed by extensive discussions with the authorities in Europe, North America and Australia. It has already consulted on the penalties regime that will apply to firms which breach the prohibitions in the Act and on a leniency policy to encourage whistleblowing amongst cartel members. The intention is that companies should face a maximum penalty of 10 per cent of their UK turnover for each year of the infringement, up to a maximum of three years. In particular the OFT:

- **is undertaking an extensive programme of educating businesses about the implications of the Act, designed to ensure that companies are aware of the sorts of behaviour which will be illegal in the future and the penalties for non-compliance. The programme includes:**
    - **developing a comprehensive set of guidelines to ensure that business is aware of how the new Act will be interpreted;**
    - **publishing a series of simple booklets that explain the new Act, targeted in particular at SMEs;**
    - **providing talks and business advice open days throughout the country; and**
    - **making available a video of a "dawn raid" showing the consequences of an OFT investigation;**
- **has taken steps to reinforce the quality and capacity of its professional expertise. It has recruited additional economists, lawyers and investigation experts; and**
- **is organising a programme of training for its investigation officers, run by HM Customs and Excise, and is purchasing specialist equipment to ensure that it can extract relevant information from the IT systems of firms under investigation.**

US experience suggests that cartels cost consumers at least 20 per cent of their expenditure on the goods and services concerned. The US authorities are now unearthing an average of two cartels a month with the aid of whistleblowers. The new UK Competition Act and OFT's plans for its implementation will ensure that UK consumers benefit from an equally robust approach to 'cartel busting'.

3.22 The Government is concerned that prices in some sectors in the UK may be too high relative to those in some other countries. It has therefore commissioned an extensive study of the prices of 100 goods and services in the UK, US, France, and Germany which will be published in January 2000. This study will be updated each year, and will be used as a means of focusing attention on areas where prices might need to be investigated. In addition, the Competition Commission is separately investigating competition in the car industry and in food retailing and will be reporting to the Government in due course on the results of its investigations and any recommendations for action it feels are appropriate.

Keeping pace with future developments

3.23 Competition policy needs to adapt to the fast-changing economy. The growth of the service sector has been rapid in recent years and it now accounts for around two-thirds of the UK economy. At the same time, rates of price and wage inflation in the service sector have tended to be higher than in manufacturing. In part, this reflects the movement in relative prices necessary to ensure that resources shift towards higher-growth sectors. But it may also reflect the fact that services face less competition and will resort more readily to price increases when demand is strong. If competition can be increased, not only will this improve productivity but it will also contribute to a better inflation performance and to macroeconomic stability.

3.24 The competition authorities are already responding to the changes in the economic structure of the UK. For example, around 80 per cent of recent reports by the Competition Commission have related to the service sector while the OFT and Oftel have recently announced a study into barriers to competition in e-commerce. The Government is also taking a number of specific steps to ensure that there is effective competition throughout the service sector:

- the November 1998 Pre-Budget Report announced that Don Cruickshank would lead a review of banking, one of the largest sectors within the service economy. The Government announced today that it would be making important improvements to the competition regime in the Financial Services and Markets Bill to take account of recommendations in the Banking Review's interim report. The review's final report will be published next year;
- a Utilities Reform Bill will confer on the energy, water and telecommunications regulators a primary duty to advance the consumer interest through competition wherever possible and appropriate;
- the Government is carrying out a comprehensive review of competition in the water industry and aims to publish a

consultation document on options for reform early in the new year. It is also reviewing competition in airports and is currently looking at a wide range of issues with a view to publishing proposals for consultation next year;

- in the light of advice from the Director General of Fair Trading the Government will consider how best to ensure that the current exemptions from the Competition Act for the rules of professional bodies do not unnecessarily restrict or distort competition;
- the Government is working in the EU to develop the single market in financial services. Following a call from the Cardiff Council under the UK Presidency, the Commission's action plan provides a good basis for progress. Deeper, more liquid EU capital markets will help companies, large and small, raise capital for investment; and
- the next World Trade Organisation trade round will commence in Seattle at the end of November. One of the Government's key priorities for this round will be to liberalise trade in the service sector, so increasing both the opportunities for successful UK companies overseas and competition at home.

The role of the consumer

3.25 The best guarantee that individuals will benefit from the development of effective competition is for them to be vigilant, empowered consumers. They must have access to the information they need to make comparisons between rival suppliers. This was the message of the Government's Consumer White Paper, 'Modern markets: confident consumers' (Cm 4410), published in July 1999. It recognised that consumers can help generate a virtuous circle by promoting innovation in companies and stimulating better value, in return obtaining better products at lower prices.

3.26 The Government has added the teaching of consumer awareness and rights and financial education to the new national curriculum (see paragraph 3.94 below). At the same time, the Government is improving the information available to consumers to improve their ability to make informed choices on what are often complex products. For example, the Financial Services Authority has set out proposals for publishing clear and helpful information on products such as personal pensions, endowment policies, Unit Trusts and ISAs.

Regulation and competition

3.27 As Don Cruickshank noted in the interim report of the Banking Review, the Government must also ensure that its own actions, particularly in the field of regulation, do not unnecessarily restrict or distort competition not just in the financial services sector but throughout the economy. So in assessing the impact of regulation, the Government needs to look not only at potential burdens on business but also at whether regulation inhibits the supply of goods and services in new and innovative ways or acts as a constraint on, or deterrent to, new entrants coming into a market. Over the coming months, the Government will be considering how to ensure that this test is applied to all significant new and existing regulations as part of its wider programme to promote better regulation and to remove unnecessary red tape.

ENTERPRISE AND INNOVATION

Enterprise

Creating an enterprise culture

3.28 Vibrant competition spurs enterprise by forcing established firms to respond to change and giving new opportunities for entrepreneurial businesses to challenge incumbents. In such an environment, only those businesses able to embrace and exploit change will survive and flourish. This applies not just to new businesses, which have become the strongest consistent source of net job creation in the economy, but also to established firms. Enterprising attitudes are necessary in both, and will be assisted by an entrepreneurial culture which reflects the attitudes across society to risk, reward, failure, and wealth generation.

3.29 The UK has traditionally seen itself as an enterprising economy in comparison with many other European countries. Recent evidence3 suggests that the UK does compare well with much of Europe, but lags behind some of its other leading competitors in providing the right environment and culture to support entrepreneurial activity:

- entrepreneurial activity in the UK (starting up businesses and investing directly in such enterprises) is around half that of the most entrepreneurial country the US. Increasing Britain's level of entrepreneurial activity towards that in the US would be expected to have a significantly positive effect on productivity growth;
- the UK has a risk-averse culture, with respect for entrepreneurs in the UK lower than in any other G7 country except Japan. Moreover, only 16 per cent of people in the UK think that good entrepreneurial opportunities exist,

compared to 57 per cent in the US; and

- Britain has low levels of entrepreneurial activity among women 2 per cent of women are trying to start a business, compared to 5 per cent of men. In the US, the proportion of women trying to start a business is around 7 per cent, compared to nearly 10 per cent for men.

3.30 As well as increased individual entrepreneurship, the UK economy would benefit if more firms were more ambitious. Currently less than one quarter of SMEs in the UK have an objective to grow substantially over the next three years.[4] Lower ambitions translate into lower performance, which can diminish the key role played by small firms in the economy, both as net job-creators and as the source of new ideas and stronger competition.

3.31 The Government is determined to address the UK's enterprise deficit. It is working with partners across business and education to foster a shift in understanding of, and support for, a more entrepreneurial culture. The Government also has an important role in helping ensure that incentives attract people and capital towards entrepreneurial activity. Finally, there needs to be a rigorous appraisal of the barriers to enterprise and how the Government can reduce them and support businesses in overcoming them.

Lord Trotman's review of small business

3.32 It is vital that the importance of small firms is recognised and that they are given the best possible chance of maximising their potential for growth. **The Chancellor has asked Lord Trotman to review the policy environment that the Government has put in place for small business in areas such as tax and business support.** Lord Trotman will be reporting in time for his recommendations to be considered in the run up to Budget 2000.

The National Campaign for Enterprise

3.33 Strengthening the UK's enterprise culture is a long-term challenge, requiring partnership between Government, business and educators. The Government is currently working with the British Chambers of Commerce on developing the **National Campaign for Enterprise,** due to be launched in Spring 2000 (more details are set out in 3.96 below).

Incentives to enterprise

3.34 Enterprise is a scarce resource in the economy. If the UK is to develop a successful enterprise culture, it is important that the financial and cultural incentives are strong enough to encourage those with entrepreneurial talent to use it.

Capital Gains Tax

3.35 In April 1998, the Government introduced Capital Gains Tax (CGT) taper relief in order to create incentives for investment in assets generating sustained growth, with particular support for entrepreneurial investment. Capital markets are evolving rapidly, and the competitive imperative to achieve substantial growth is intensifying (particularly for smaller enterprises in the e-commerce field). This in turn is making it more important for smaller enterprises to access the risk capital they need to deliver their growth potential. Equity investment from "business angels" and other individuals is typically the first level of venture capital for such companies. So the supply and price of such finance can be affected directly by the CGT regime, as can the incentives for reinvestment of entrepreneurial gains in subsequent ventures.

3.36 To ensure that it is doing the most it can in this area, the Government will consider the impact of the current design of the CGT business assets taper, with decisions announced in Budget 2000. **In particular, and subject to detailed consultation, the Government will shorten the business assets taper from 10 years to 5 years in order to bring the timing of CGT incentives more into line with entrepreneurial investment patterns.** It will also assess the case for widening the scope of CGT incentives towards entrepreneurial investment by reducing substantially the percentage thresholds for qualifying business asset shareholdings (from their current levels of 5 per cent for full time employees and 25 per cent for others).

Enterprise Fund

3.37 Stronger incentives for entrepreneurial venture capital investment are also being created through the establishment of DTI's Enterprise Fund that was announced in the
DTI's 1998 Competitiveness White Paper, 'Our competitive future: building the knowledge driven economy' (Cm 4176). This will combine public support and private finance in two innovative new channels for equity investment:

- **a national high-tech venture capital fund**, combining a £20 million government investment with private finance to raise a total of up to £100 million for investment in venture funds specialising in backing early-stage, high-tech companies; and

- **a network of regional venture capital funds** of at least £10 million each across the English regions aimed at small scale, equity gap investment, again using Government finance to bring in private finance, while maintaining a strong commercial incentive on the funds to achieve long-term returns.

3.38 The Secretary of State for Trade and Industry will also be announcing details of the new Enterprise Grant shortly. This grant scheme for small firms will, alongside the assistance provided by the Enterprise Fund, ensure a coherent package of financial support for small business.

Corporate Venturing Tax Incentive

3.39 Corporate venturing offers advantages to both new and established firms. Developing technology businesses need to have both the finance and the know-how to make the leap from being promising start-ups to being successful world class companies. Corporate venturing allows smaller companies to access the finance, management, technical and marketing skills of larger firms. For large companies it enables them to access the technologies they themselves cannot always create.

3.40 Following consultation after Budget 1999 **the Government will be introducing a tax incentive in next year's Finance Bill to provide incentives for UK companies to undertake corporate venturing**. Companies that undertake corporate venturing will receive an up-front corporation tax relief at 20 per cent on investments in small higher risk trading companies as well as a deferral relief where companies sell shares and reinvest the gain in corporate venturing. Further details and enhancements of the corporate venturing tax relief will be announced by the Secretary of State for Trade and Industry tomorrow.

Employee Share Ownership

3.41 Aligning more closely the incentives of employees, managers and investors will help to deliver a stronger entrepreneurial performance. The Government recognises that employee share ownership can contribute to this. Research has shown that over time employees with a stake in the business in which they work will tend to contribute more actively to its development. As more employees have such an incentive, the effects are reinforced.

3.42 As announced in Budget 1999 **the Government is introducing a comprehensive all-employee share ownership scheme** from April 2000 to support companies own efforts to foster a more productive relationship with their employees. This will be the most tax-advantaged all-employee share scheme ever introduced in the UK. It will also provide greater flexibility than in the current scheme to meet the needs of companies and employees. The Secretary of State for Trade and Industry will announce further details tomorrow.

Box 3.3: Electronic commerce

The Government's aim is to make the UK the best place to carry out electronic trading by 2002. It will create competitive markets, transform education, widen access to computers, and modernise its own use of technology.

The Government is reviewing every barrier to competition in emerging e-commerce markets and the Government's Competition Act (see paragraph 3.20 above) puts in place a tough new competition regime.

Transforming education and widening access will ensure that the opportunities of new technologies are shared by everyone. The Government aims to give everybody in Britain the chance to gain the skills and access to make the best use of the Internet. It is:

- **providing £1.7 billion for the national IT strategy;**
- **enabling employees to borrow computers from their companies as a tax-free benefit. Over 300,000 people are expected to borrow computers in this way;**
- **developing a system under which poorer individuals sometimes through local partnerships - will be able to lease computers. 100,000 computers should be on loan by the end of 2001;**
- **linking all schools, libraries, colleges and universities via the Internet through the National Grid for Learning; and**
- **establishing up to 1000 ICT learning centres across the UK to improve access to ICT for all.**

Modernising Government, especially its use of technology will refocus activities on the customer. The Government:

- **intends to offer a discount on tax returns filed over the internet as announced in Budget 1999. Further details will be announced in Budget 2000;**
- **is providing £1.1 million from the Capital Modernisation Fund to develop electronic procurement systems across government, which could save over £10 million a year; and**
- **is using £230 million from the Invest to Save Budget to fund new innovative ways of delivering government services many exploiting the potential of the Internet.**

Enterprise Management Incentives

3.43 Smaller, higher-risk companies face particular challenges in remunerating the high calibre managers and other key employees they need to realise the company's growth potential. Strengthening of a company's skill base in this way is often a pre-condition for obtaining external risk capital. So it is important to ensure that there are sufficient incentives to encourage talented individuals to take a risk and invest their energy in growing smaller enterprises. **The Government is therefore introducing a new Enterprise Management Incentives (EMI) scheme in the next Finance Bill**. EMIs will encourage key employees to join small higher-risk companies, by offering access to tax-advantaged share options. Under this scheme, such companies will be able to offer up to 10 key employees options over shares worth up to £100,000 (at time of option grant). Further details will be set out by the Secretary of State for Trade and Industry tomorrow.

Review of Corporate Insolvency regime

3.44 Incentives to enterprise are affected not only by the rewards to successful management and investment, but also by the penalties for not succeeding. Business failures are inevitable in a vibrant enterprise economy, but it is important to ensure that the process of failure does not unnecessarily deter the creation of enterprises, nor hinder their access to finance. **The Treasury is undertaking a joint review with the DTI into the corporate insolvency regime**. The aim is to create a culture in the UK more favourable towards corporate rescue which avoids unnecessary losses in economic value.

3.45 At the personal level, bankruptcy can also stigmatise those individuals whose businesses have failed despite their honest endeavours. The DTI is undertaking a parallel review of the legislation in this area. One of the measures being considered is a reduction in time, from three years to six months, before which some bankrupts are discharged from bankruptcy. Other measures are also being considered to reduce the fear of failure.

Enterprise open to all

3.46 It is important to set incentives for people to be entrepreneurial, but enterprise should not be confined to narrow sections of society. Businesses need to make opportunities open to all; and the Government must also ensure that incentives are available to everyone in the country. This will allow Britain to benefit fully from the entrepreneurial potential of people and businesses whatever their background and wherever they are.

3.47 Established businesses have an important role to play in helping deprived areas and disadvantaged groups reach their full potential. Modern companies are increasingly aware that corporate social responsibility is a key component of a successful business strategy. Hence many companies are actively supporting local communities. The Government is keen to see this practice become more widespread.

3.48 The Policy Action Team (PAT14) that has been looking at access to financial services, concluded that banks in particular have a major task ahead of them in extending services to low-income households and developing delivery channels accessible to people in deprived neighbourhoods. Part of the answer may well involve e-commerce. The Government believes banks and other providers of financial services should be transparent about their involvement with community development and ensure that opportunities that are profitable for them as well as beneficial for the community are not overlooked. It will monitor progress carefully.

Stimulating enterprise in deprived areas

3.49 It is clear that many enterprises in deprived areas currently face acute problems in obtaining access to suitable support, advice, and finance from mainstream commercial providers and through traditional delivery channels. Groups such as women, ethnic minorities and disabled people have not been given enough opportunity to start businesses. **To help stimulate better delivery of such services, particularly through locally-rooted partnerships between the public and private**

sectors, the Government will be taking forward a £30 million programme to promote better access to finance and business support, including:

- **a new development fund** to promote innovative ways of supporting enterprise in deprived areas, such as business incubator units;
- **a new challenge fund to help resource Community Finance Initiatives**, local intermediaries serving locally-based SMEs;
- **Loan Guarantees to help co-finance commercial lending to Community Finance Initiatives**; and
- **a national network of mentors to business start-ups**, through a new Business Volunteer Mentoring Association.

3.50 These measures address many of the issues raised in the report of the Treasury-led Policy Action Team 3 (PAT3) on enterprise and social exclusion in deprived areas, published on 2 November. The report sets an agenda for the Government (especially the SBS), Regional Development Agencies (RDAs) and local authorities to follow through. It also identifies potentially profitable opportunities for banks and other major businesses to contribute to economic regeneration through enterprise creation and growth. The programme includes £20 million of additional funding from the windfall tax.

3.51 Anyone with a good idea and ambition should have the opportunity to turn this into a successful business. Uncertainty over future levels of income, in particular during the start-up phase of the business, can be a significant disincentive to an unemployed person moving into self-employment. The Government is considering the case for a start-up grant, to act as an income bridge between benefits and business, as recommended by PAT3.

3.52 The Government will also consider creating scholarships specifically targeted at entrepreneurs from deprived areas. These scholarships will give individuals the skills they need to turn their ideas into thriving businesses by offering them access to advanced management and business training.

Reducing the barriers to enterprise

3.53 To give small firms greater recognition, the Government is setting up a new Small Business Service (SBS). Ministers will be announcing the outcome of the DTI's recent consultation shortly, and recruitment of the Chief Executive is underway. The new SBS will have three main tasks:

- to help small firms deal with regulation and ensure small firms' interests are properly considered in future regulation. This will involve working with regulators and other Departments to minimise burdens on small business and ensure that clear guidance is available;
- to simplify and improve the quality and coherence of Government support for small businesses. This will include an early review of all Government support available to small business; and
- to act as a strong voice for small business at the heart of Government. The Chief Executive of the Small Business Service will have direct access to Ministers.

3.54 To enhance a competitive and entrepreneurial economy, a careful balance needs to be struck with regulation. It is important that regulations with good intentions do not frustrate competition and enterprise, and that unnecessary regulations are investigated and removed. The Regulatory Impact Unit in the Cabinet Office and the Better Regulation Taskforce led by Lord Haskins are tasked with ensuring that new legislation is devised only following a regulatory impact assessment, and that unnecessary regulations are removed. Last month they announced they were reviewing payroll regulations against their principles of good regulation.

3.55 The Government recognises that small firms have problems dealing with payroll regulations. In response to this the Inland Revenue will significantly expand the amount of support it offers to new employers. More details will be announced shortly by the DTI and the Inland Revenue. The Inland Revenue will also publish a new national standard for payroll software early next year.

3.56 Employers often suggest that the differences in the detailed rules for pay-as-you-earn (PAYE) income tax and national insurance contributions (NICs) and their application cause difficulties when dealing with payroll. By bringing policy responsibility for tax and NICs together in the Inland Revenue the Government has now provided a single focus for employers' representatives to discuss improvements in legislation and processes across both PAYE and national insurance. The Inland Revenue will work with employers' representatives and others on options to reduce technical differences, while having due regard to individuals' benefit entitlement.

Planning

3.57 The planning system has a key role to play in promoting sustainable development and must be attuned to the needs of business and enterprise. Important changes are being made to ensure that the planning system helps promote clusters (see 3.74-77 below). In addition the Government has a comprehensive agenda to modernise the planning system so that it supports competition and innovation, does not provide a barrier to the growth of either new and existing companies, and offers certainty, efficiency and transparency in decision making.

3.58 To ensure that the planning system encourages competition and innovation and is efficient:

- regional plans will have to support **competition**, and will be subject to a **Sustainability Appraisal**, which will assess how the plans, among other objectives, have promoted competition;
- **councils which have demonstrated a track record in streamlining planning decisions for business will gain Beacon Council status**. These business-friendly councils will be offered grants to spread good practice to others and raise standards generally. The first Beacon Councils will be announced in December;
- **DETR have issued proposals to streamline decisions on major projects of national significance, such as large infrastructure projects**. The object is to reduce unnecessary and costly delays, whilst ensuring the public rights to comment on developments are respected;
- regional planning bodies are expected to work closely with the RDAs the innovative, business-led organisations to take forward regional policies and other business interests in drawing up regional plans. The notion is that successful planning must be based on an effective working partnership between all stakeholders. These principles are reflected in the planning concordat between the DETR and local government. A further concordat between local government, business and the voluntary sector is also being put in place;
- **demanding new targets have been set for the Planning Inspectorate** to speed up planning enquiries. In the years covered by the Comprehensive Spending Review there will be a 46 per cent improvement in inquiry appeal handling times, cutting the cost to business of unnecessary delays. This will complement the steps being taken to improve local authority planning performance through the introduction of Best Value and other streamlining processes; and
- a consultation on **the reform of planning obligations**, often known as Section 106 agreements, is to be launched next year. The current system has been criticised for lacking transparency, for delays and for the creation of uncertainty and burdens for business. Equally there may be scope for more flexible use of these agreements for developers and local authorities to negotiate imaginative ways to offer benefits to local residents affected by a development. The consultation document will address all these concerns.

Innovation

3.59 A dynamic enterprise culture is the key to increasing the rate of innovation in the economy. It ensures that people have both the incentives and the skills to turn new ideas and inventions into wealth-creating businesses, products, services. Too often in the past the UK has been strong on invention and weak on innovation, precisely because we lacked the essential pre-condition of an enterprise culture.

3.60 Innovation the successful exploitation of new ideas has always been a major source of growth in the economy. And it is becoming more important, as the rate of technological progress accelerates and global competition becomes more intense. In order to succeed, countries need to ensure not only that their knowledge base continues to expand, but also that they exploit it ever more effectively.

3.61 The Government has a key role to play in ensuring that the scope for innovation is maximised and that there are incentives for pursuing new technologies. Firstly, the Government is a major investor in R&D a key driver of innovation - through public sector research laboratories and through its funding of university research. Secondly, there can be pervasive spillover effects from innovation since unlike the consumption of goods the fact that one person is exploiting a new idea does not prevent others from exploiting it too. This means that firms may under-invest in R&D.

3.62 To encourage innovation the Government needs firstly, to ensure that the science base in the country is doing leading-edge research; secondly, to encourage technology transfer from research that is carried out; and thirdly to improve the incentives for business to conduct research.

3.63 The Comprehensive Spending Review included a £1.4 billion injection of funds to ensure that the UK continues to be world-beating at generating research. At the heart of this programme is a £700 million Joint Infrastructure Fund endowed by the Government and the Wellcome Trust, for new university equipment and buildings.

3.64 Many UK universities help to create prosperity and jobs through successful commercialisation of their research, creating new spin-out companies, licenses, or other forms of commercial or research collaboration with business. By certain measures some UK universities are even more successful than their US counterparts for example in terms of spin-outs, patents or royalty income per unit of research income. But in terms of realising the broader wealth creation potential, many universities will need to learn from the best and significantly improve the commercialisation of their research if they are to catch up with the US the world leader in this area.

3.65 In the US, more than 200 universities are engaged in technology transfer, which adds $21 billion to the US economy each year. If UK universities can improve their technology transfer efforts and foster more entrepreneurship in their staff, then the gains to the economy could be great. This is why the Government:

- set up the University Challenge fund. The £50 million fund was announced in last year's PBR and the first round winners have been selected. The Budget announced a further £15 million of funds for the scheme, which will have a second round; and
- ran the Science Enterprise Challenge. This provided £25 million for eight centres of enterprise around the country. The winners were announced on
14 September and are now implementing their plans.

3.66 To add to the national network of eight enterprise centres at UK universities, the Chancellor announced yesterday that Massachusetts Institute of Technology (MIT) will jointly establish an Institute with Cambridge University. The Government will contribute about £14 million a year on average from the Capital Modernisation Fund for the next five years towards the costs of establishing the Institute. Funding for the Cambridge University Enterprise Centre from the Science Enterprise Challenge Fund will be released following this agreement. An announcement will be made in due course about its allocation. Among other things the Institute will:

- stimulate the development of technology based business out of the academic base;
- develop a research programme in fields likely to have a substantial impact on the future evolution of technology; and
- undertake education and research designed to improve the UK's entrepreneurship, productivity and competitiveness.

3.67 Successfully commercialising university research depends not only on the university identifying and marketing its research with commercial potential, but also on the willingness and ability of companies to recognise and take up the new technologies. The technology transfer process relies not only on "university push", but also on "industry pull". The Government needs to ensure that businesses play a role in these initiatives to promote technology transfer. But businesses also need to engage with the science base more generally. They should actively seek out research with applications relevant to their business and see it developed through a collaborative process into successful products and services. Businesses with a strategy for R&D that looks to their long-term competitiveness should see the value of engaging more actively with research establishments.

3.68 Evidence from US companies shows a clear association between a company's higher R&D intensity and their growth prospects over the next five years. However, even companies that fully recognise the benefits to themselves of R&D cannot take account of the benefits to other companies and the wider economy. This provides a rationale for the Government to intervene to improve companies' incentives to undertake R&D.

3.69 This rationale is particularly strong in relation to small firms who are less well-placed than large firms to capture the spillovers that often result from businesses' R&D programmes, and who also find it harder to raise finance for R&D than do larger firms. Small and medium-sized businesses under invest in R&D to a greater degree than large companies. Not only does the UK have the lowest ratio of industry-funded business enterprise R&D to GDP in the G5, but our smaller companies' R&D to gross value-added ratio is significantly less than for large companies.

R&D tax credit

3.70 For these reasons, the Government will introduce a R&D tax credit targeted on small and medium-sized enterprises from April 2000. As stated in Budget 1999, this tax credit will increase the 100 per cent relief for R&D to 150 per cent. So when added to the existing relief, the cost of R&D will be reduced by 30 per cent for a company benefiting from the small companies rate.

3.71 The credit will also be available to companies not yet in taxable profit, recognising the greater cash constraints that such early-stage, innovative companies face and the extra assistance they need. If these companies take the relief up-front, their cash cost of doing R&D will be reduced by 24 per cent. Following consultation, the Secretary of State for Trade and Industry will announce further details and enhancements tomorrow.

3.72 The Government has received positive responses to proposals for reforming the taxation of intellectual property rights, following the Inland Revenue's Technical Note published in March 1999. Subject to the results of further consultation with business on a number of technical issues, the Government plans to introduce legislative changes in Finance Bill 2001.

Box 3.4 The Baker report: exploiting public sector research

Government spends £2.2 billion of its £6.75 billion total research spend in its own laboratories the public sector research establishments or PSREs which have led to such diverse advances as liquid crystal display technology and Dolly the cloned sheep. More is needed to increase the generation of jobs and prosperity from these important investments.

That is why the Government asked John Baker, chairman of Medeva plc, to make recommendations for improving the exploitation of PSRE research. His report "Creating knowledge: creating wealth" was published on 27 August 1999. The Government fully endorses the principles in the report, and will:

- **ensure a much stronger drive to exploit PSRE research with more freedoms for PSREs;**
- **make changes to civil service conduct rules to allow Government scientists new incentives and rewards, subject to safeguards, for participating fully in exploitation;**
- **tackle the risk avoidance culture in PSREs; with the Government encouraging well managed risk-taking. The Government welcomes the statement issued today affirming that the National Audit Office will adopt an open-minded and supportive approach to commercialisation by PSREs, focusing on their commitment to exploitation, the quality of their risk management, and the lessons that can be learned for PSREs as a whole.**
- **address the need of PSREs for advice to help them commercialise their discoveries and inventions; the Government will consult on options, including a role for Partnerships UK the new public private partnership which the Government is creating to assist the public sector in being a better client of privately-financed services.**

The Government welcomes the Baker report and the broad thrust of its recommendations. Many of these will need to be taken forward by the departments and Research Councils that sponsor PSREs and the Government will announce how this will be done in the new year.

3.73 The aim of the reforms is to replace the current separate and often out-dated tax rules with a new and simpler treatment of intellectual property rights (IPR) transactions, based more closely on accounting practice. There may also be scope to simplify the rules for deducting income tax at source when royalties are paid to owners of IPR (eg payments for use of patent or copyright). These reforms should help reduce compliance costs, and thereby remove one of the barriers to innovation.

Clusters

3.74 In an era of globalisation and the growth of the Internet, a firm's location still matters. There is strong empirical support that the returns to R&D, and the spillover of knowledge between firms and research institutes are enhanced by co-location. The networking and interaction between firms and research institutes, and the clustering of specialist service providers of legal and financial advice and venture capital, provide a powerful stimulus to productivity growth.

3.75 Lord Sainsbury's report into Biotechnology Clusters, published in August 1999, represented an important step in developing understanding of clusters and the appropriate policy response.

3.76 One element of the Government's clusters strategy is to reform the planning system. **The Deputy Prime Minister will today be announcing further changes to the planning system to strengthen the support for the growth and development of clusters of firms**. Building on changes that have already been announced, these will mean:

- regional plans should proactively identify cluster areas and plan for their expansion;
- regional plans will identify innovative cluster areas and recognise the importance of business to business links for cluster development as well as links between business and the science and research base;
- guidance from DETR on the importance of clusters in Planning Guidance on regional plans (PPG11), will also be put into planning guidance on local plans (PPG12); and
- DETR will produce a detailed explanatory guide on how to implement a clusters planning policy.

3.77 Planning reform is not the only issue. Following discussion of clusters in EA(PC) the Cabinet Committee on Productivity and Competitiveness chaired by the Chancellor the next steps in the Government's strategy will be announced by Lord Sainsbury on the 18 November. He will announce a cross-departmental Ministerial group to drive forward work on clusters. One of the tasks of this group will be to consider in greater detail the issues raised by the RDA economic strategies published on 26 October. These included business incubators, networking activity among firms and links between firms and universities in course design and research.

3.78 Lord Sainsbury's report into clusters also highlighted the importance for growing firms of the availability of high quality premises on flexible terms. Once research into the impact of its 1992 Code of Practice on the commercial property market has been completed, the Government will be considering if anything further is required to accelerate recent trends towards greater flexibility and transparency in the operation of the market.

3.79 The Government can also support innovative and firms creating high value added products and services in the way it uses its own funds to promote investment in assisted areas. The Government's Regional Selective Assistance (RSA) is worth £120 million per annum in England. Following consideration by EA(PC), this flagship scheme for promoting investment in assisted areas will be refocused on high-value projects making the maximum contribution to the country's long-term competitiveness. The Secretary of State for Trade and Industry will announce details shortly.

SKILLS

3.80 The enterprise economy that the Government is seeking to create requires a workforce with a high standard of basic skills and the ability to adapt continuously to new technologies and changing working environments. The Government needs to ensure that those in work or seeking work of all ages, abilities and backgrounds have good opportunities to improve their employability.

3.81 Although standards are rising in primary and secondary schools, the education service has further to go to deliver high levels of general educational attainment and people with sufficiently adaptable skills. Britain's under-performance in skills reduces the capacity for innovation and enterprise, and constrains productivity as the less skilled cannot make the best use of the technologies and opportunities available.

3.82 In the UK, fewer young adults stay on in education compared to other countries; some seven million adults lack literacy skills, and even more struggle with basic arithmetic. These failings inhibit a large proportion of the workforce from keeping pace with the changes in working practices at a time when it is ever less likely that people will be able to hold just one job throughout their career.

3.83 As a long-term economic ambition for the next decade, school and college leavers will gain the highest possible qualifications they can, with the majority going on to higher education for the first time.

3.84 The Government's response to the numbers of people without basic skills includes:

- the implementation of literacy and numeracy strategies in primary schools: those aged 11 who meet the required standard in English and mathematics rose five and ten percentage points respectively in 1999 compared to 1998;
- the introduction of more classroom assistants and the National Grid for Learning in primary and secondary schools;
- proposals for strengthening school leadership and rewarding teachers for high performance, as set out in 'teachers: meeting the challenge of change' (Cm 4164).

3.85 As well as increasing the basic skills of those in school, the UK needs to provide training to people who are already in the workforce. Life-long learning is vital to improving the skills of the workforce to help them move with the changing technologies and continue to fulfil their potential.

3.86 Since April this year people have been able to open individual learning accounts at their local TECs in England and Wales by paying £25 to receive £150 towards the cost of appropriate learning. There are also pilot projects in Scotland. From next year the Government will be putting in place a national framework under which people who open individual learning accounts will be eligible for:

- 80 per cent discounts on computer literacy courses and some other specific types of learning; or 20 per cent discounts on a wide range of other eligible learning activities. (Scotland and Northern Ireland will decide their own priorities for what will be eligible for receipt of the discounts).

3.87 On current plans the discounts will first become available from next September and, accordingly, as announced in Budget 1999, Vocational Training Relief is to be withdrawn at the end of August 2000. In making the proposals work to their best effect, the Government sees a role for trades unions in encouraging their members to open learning accounts and in exploring with employers the scope for them jointly investing in their employees' accounts. Employers will be encouraged to contribute towards the learning of all their employees free of tax and NICs.

3.88 The University for Industry (UfI) will offer on-line and supported learning to individuals and business, with a particular focus on SMEs. It is soon to announce its first development centres. Up to 70 of these centres will test UfI services and learning materials in the run up to launch next autumn. The centres will be in easily accessible locations such as shopping centres, community centres and churches. Learners will be able to choose from a range of test course materials including information technology and business and management skills. This is an important step in the establishment of the UfI, which is a key element in the Government's commitment to life-long learning.

3.89 A productive workforce requires not only high levels of basic skills such as literacy and numeracy, but also a large pool of people with good management skills. All businesses rely heavily on the expertise and judgement of their management teams. And poor management can have a damaging effect on a company: last year's report by the Society of Practitioners of Insolvency found that 22 per cent of business failures were directly attributable to poor management.

3.90 Recent years have seen a significant rise in the number of UK business schools offering MBA-based training. However, despite this rise in numbers, the UK only has three schools ranked amongst the world's top 505. Equally, the majority of business schools do not provide training directly tailored for SME managers and entrepreneurs.

Management Education

3.91 The Government's strategy for tackling these issues includes:

- ensuring that the Department for Education and Employment, the SBS and the University for Industry work together to develop a coherent approach for SME management development;
- working with Investors in People (IiP) UK to review the IiP standard to ensure that it is SME friendly. A new SME standard has been produced and is currently being piloted. This new standard will be fully implemented in April 2000; and
- launching, with the National Federation for Enterprise Agencies, an initiative to increase the number of business mentors by 1,000 in the next two years.

3.92 In addition, the Government is:

- **setting up the Council for Excellence in Management and Leadership, a small group of industrialists and entrepreneurs, under the leadership of Sir Anthony Cleaver, Chairman of AEA Technology plc, to develop a strategy for improving the levels of leadership and management competence in the UK; and**
- **creating the Business School Small Firms Advisory Group to identify best practice in relation to business school provision of management training specifically designed for SMEs and entrepreneurs**. This group will report to the Council for Excellence in Management and Leadership by March 2000.

3.93 The workforce also needs the right attitudes and the mind-set to have a successful career in a more enterprising economy. It is important that young people receive positive messages about enterprise throughout their education, and acquire more entrepreneurial skills. For example, young people need to understand the viability of self-employment as a career option, and the skills needed to succeed in working lives that are more likely to involve a broader range of different jobs than before. The curriculum and primary and secondary education in the past have not paid enough attention to ensuring that people leave school with such skills and outlooks.

National Curriculum

3.94 To address this, the Government has revised the National Curriculum to include a new focus on enterprise skills at both primary and secondary level. **From September 2000, the National Curriculum will make more explicit the links between education, employment and enterprise; and it will also include financial literacy and consumer education**. Guidance, schemes of work and materials for schools are now being developed in time for September 2000.

Education Business Links

3.95 The Government wants to involve as many schools and businesses as possible in developing a new spirit of enterprise among young people. However, the current scale and quality of enterprise education is inadequate. That is why the

Government is announcing a **£10 million package to boost enterprise skills in schools, particularly those in disadvantaged areas. The money will come from within the Departmental Expenditure Limit of the DfEE. Starting in April 2000, this package will provide:**

- **£5 million to improve the quality of the existing infrastructure of school-enterprise bodies**;
- **£3 million to enhance teachers' professional development and improve the quality of work experience for students; and**
- **£2 million to help double the scale of enterprise programmes with a proven track-record of success**, such as those provided by Understanding Industry and Young Enterprise (including Junior Achievement in primary schools).

3.96 The **National Campaign for Enterprise** (see paragraph 3.33 above) aims to create a more entrepreneurial culture in the UK by transforming attitudes, developing skills and encouraging the formation of new businesses. The Campaign, which will initially focus on young people, will be spearheaded by a network of entrepreneurial Ambassadors who will act as role models and mentors. Alan Sugar, who for the last two years has toured schools and universities speaking about the importance of enterprise to young people, will add his weight to the Campaign, as will Richard Branson, who is to launch the new Virgin Business School in the new year. Other Ambassadors will include Reuben Singh, Simon Woodroffe, Prue Leith and Dr Chris Evans.

3.97 The Campaign will help to develop the enterprise skills of young people in the UK. It will promote the existing range of enterprise programmes aimed at young people, such as Young Enterprise and Understanding Industry, helping them to raise their profile and reach a wider audience. The Campaign will launch a book in the new year showcasing successful entrepreneurs. It will be aimed at inspiring young people to go into business, and contain examples of how established and young entrepreneurs got started.

Work permits

3.98 The UK also needs to attract the most skilled and most enterprising people from abroad to add to the skills pool of resident workers. This will increase the quality of the UK's human capital and will allow greater economic activity and more employment opportunities for all in the longer term. Skilled foreign workers will help the UK address skill gaps, both where there are transient shortages in particular areas, for example amongst IT workers, or where skills shortages persist.

3.99 The Government is therefore making it easier for skilled foreign workers in key areas to come and work in the UK, where they have the skills and attitudes to help generate an enterprise economy. The Government is:

- **adding relevant categories of IT workers to the list of work permit shortage occupations as recommended by the IT, Communications and Electronics Skills Strategy Group report;**
- **undertaking a fundamental policy review of work permit arrangements.** This will aim to simplify the process for employers and provide criteria which better reflect the global labour market;
- **considering recommendations from the report into immigration following the DTI's Competitiveness White Paper to make the processes in the Immigration and Nationality Directorate more business friendly;** and
- **investigating ways to make it easier for foreign entrepreneurs and small investors to come and start businesses in the UK.**

INVESTMENT

3.100 The Government's new macro-economic framework, combined with the structural reforms designed to raise the productivity of the economy, together create the very best environment for investment.

3.101 The Government has put in place a platform of macro-economic stability for the long term, built around explicit objectives for low and stable inflation and sound public finances. This provides individuals and businesses in the UK with the confidence to invest, and it attracts internationally mobile capital flows in greater volume and at lower cost.

3.102 But against this benign backdrop, Britain needs to provide a sharper stimulus, to reverse a history of under-investment. This stimulus comes from the Government's structural reforms designed to raise productivity:

- more vigorous competition means that firms have rapidly to adopt new technologies, through physical investment, if they want to succeed;

- an enterprise culture open to all drives both the creation of new businesses and growth in existing businesses, and so raises investment;
- innovation improves the production possibilities of the economy and generates the new commercial opportunities that encourage people to invest; and
- a modern skills base ensures the most productive use is made of new physical capital, without which firms will lack the incentive to invest.

3.103 In all these ways the Government's productivity agenda will help to encourage a higher quality and quantity of investment. But the Government also influences investment through the institutional structures it creates and, very importantly, through the tax system.

Changing the tax system

3.104 The Government has cut corporation tax rates to 30, 20 and 10 per cent, their lowest ever level, and the lowest amongst our major competitors. In introducing the 10 per cent rate, the Government has enabled 270,000 small and growing companies to retain more of their profits for re-investment and growth. Moreover, it has provided added certainty for firms taking long-term investment decisions by committing not to raise corporation tax rates this Parliament.

3.105 In addition, the Government has:

- reformed the corporate tax system to modernise and simplify it, removing advance corporation tax (ACT) which acted as a major distortion. It now provides a more neutral environment for financing decisions and supports an improved climate for quality and long-term investment; and
- extended 40 per cent first year capital allowances until 1 July 2000 meaning that small and medium-sized companies have, for the past three years, enjoyed a significant reduction in the costs of investment.

3.106 There are early indications that the combination of greater macro-economic stability, and the Government's swift action to remove distortions and enhance incentives through the corporate tax system, are beginning to have a beneficial effect. Business investment as a share of GDP has increased in recent years. In 1999 it is projected to reach 14 per cent, its highest level since at least 1965. As the Government's structural reforms take effect they will help to reinforce this recovery in investment, and help to reverse the UK's poor record.

Capital markets

3.107 The UK has long benefited from deep and sophisticated equity markets, enabling a wide range of companies to raise capital in an efficient manner. But it is important to ensure that the relationships and remits throughout the investment chain - from investors, particularly institutional investors, through fund managers, to companies themselves support long-term investment decisions and engender innovation, both in the products available on the capital markets and in the companies themselves. In particular, the Government needs to ensure that smaller, higher-growth, often more innovative companies are well-served by the capital markets.

3.108 The Financial Service and Markets Bill establishes the Financial Services Authority (FSA) as a single regulator to meet the challenges of evolving markets. Its motto is regulation that has a light touch where possible, and provides protection where necessary. Under the Bill, the competent authority for listing will be transferred from the London Stock Exchange to the FSA to avoid any conflicts of interest and to facilitate competition.

3.109 The Government is keen to see an increase in the amount of funds from institutional investors directed towards venture capital. In the US it is estimated that around 5 per cent of institutional assets are invested in venture capital, whereas in the UK that figure is closer to
1 per cent. There is a concern that this important sector of the economy, with significant growth potential, could be missing out on a valuable source of funds.

3.110 Following the Prime Minister's speech to the British Venture Capital Association in July 1999, three of the leading actuaries published a statement that the time was now right for institutional investors to invest a higher allocation of their funds in unquoted securities. This was an important development and the Government will continue to take an interest in the industry's response.

3.111 Increased transparency and accountability between companies and their shareholders is also essential if the market for institutional investment is to operate as efficiently as possible. To this end the National Association of Pension Funds published a report in July suggesting ways of increasing levels of UK shareholder vote execution. The DTI is currently considering the results of its consultation on how increased transparency could be introduced into the setting of Directors' remuneration to ensure that it is both accountable and adequately linked to performance.

3.112 Positive steps have also been made on improving access to public markets for high-tech, growth companies. Techmark, the London Stock Exchange's new index for technology companies, was launched by the Chancellor of the Exchequer on 3 November. Following that launch, the US technologies market NASDAQ announced plans to launch its European operations in the UK, reinforcing London's position as the EU's financial centre. This launch will bring NASDAQ's skills and experience in supporting early stage, high-tech companies to the UK. Together with the launch of Techmark, this represents a significant step forward in helping such companies join the main market, with the access to institutional funding which that brings.

3.113 Small and growing firms seeking investment are not usually in a position to look to public equity markets and may not yet have profits to reinvest. Finance for small and growing firms comes from a wide range of other sources including: banks, other firms, and private investors. The Government is acting to improve access to finance in all these areas.

3.114 The Banking Review (see 3.24 above) is examining the levels of innovation, competition and efficiency of the banking sector and considering how it could better serve SMEs.

3.115 The measures to encourage venture capital, including the corporate venturing tax relief (set out in paragraphs 3.3940), will also improve the access to finance for small firms and help to raise investment.

3.116 The Financial Services and Markets Bill will reduce the time and cost involved in raising capital from private investors. It will exempt communications from companies to a defined class of high net worth or sophisticated individual investors from the normal financial promotion rules. This is likely to be of most benefit to smaller firms seeking to raise equity from "business angel" investors.

3.117 The Government is also encouraging saving, through ISAs, stakeholder pensions and Pooled Pension Investments (PPIs). Saving by individuals is an important source of capital formation, as well as providing security for the people concerned.

3.118 The measures above, combined with the rest of the Governments strategy to improve the microeconomic environment for enterprise in the economy, will lead to higher private sector investment. But the Government is also reversing the legacy of under-investment in the public sector.

PUBLIC SECTOR PRODUCTIVITY

3.119 The biggest contribution that Government can make towards increasing the UK's productivity is to establish macroeconomic and microeconomic policies which encourage enterprise. But it is also important to recognise that the Government is directly responsible for a significant proportion of the economy.

3.120 The Government is focusing on concrete improvements and service delivery, and has set over 600 output and efficiency targets through Public Services Agreements (PSAs). These targets are being closely monitored to ensure that public services become more modern, efficient, and responsive, bringing all areas up to the level of the best. The Government will report on progress against these targets in spring 2000.

3.121 The Government's emphasis on improving outputs from public services is demonstrated by significantly increased provision for renewal, reform and modernisation of the UK's infrastructure. The £2.5 billion Capital Modernisation Fund has been set up to support innovative capital projects which will further improve the quality of public service delivery.

3.122 The Government also believes in using both private and public sector expertise to raise public sector productivity. The Public Sector Productivity Panel consisting of private sector experts and senior business people is working with government departments to identify and tackle key areas for improvement. To encourage ideas from within public services for increasing efficiency and improving service delivery, the Invest to Save Budget allows services to bid for funds to support innovative projects.

3.123 The public sector is the largest buyer of goods and services in the country. But up to now it has had a fragmented system in which 180 departments and agencies have separate dealings, often with the same supplier. Following the report by Peter Gershon, the Managing Director of Marconi Electronic Systems Ltd, into public procurement, that was announced in last year's PBR, the Government is streamlining its procurement processes by creating the Office of Government Commerce

(OGC). The OGC should deliver over £1 billion of efficiency savings over the next three years, while also cutting project delays and overruns.

3.124 The final part of the Government's strategy to raise investment is to reverse the legacy of under-investment in the public sector. This is important not only for its direct effect on the level of investment, but because it is a necessary complement to higher private sector investment. Public investment, for example in high quality infrastructure and public services, provides the foundations for a successful private investment.

3.125 The Government's aim is to renew and improve Britain's infrastructure and public sector services. The Comprehensive Spending Review announced an almost doubling in net public investment over the period of 199899 to 200001.

3.126 The Government is using partnerships with the private sector to add to and complement this additional public sector investment, in cases where they provide better value compared to investment by the public sector. Under public private partnerships (PPPs), the public sector specifies the outputs required, but the responsibility for the underlying investment, and many of the risks associated with delivering those outputs, is transferred to the private sector partner. This will offer better services, delivered more efficiently and providing better value for money for the taxpayer than public sector investment, provided the outputs can be clearly specified from the outset, and that all parties understand the risks they are taking on.

3.127 Since May 1997, the PPP programme has developed rapidly. The Government's reforms to the private finance initiative (PFI) have led to an increase in the flow of deals. The PFI is expected to generate some £11 billion worth of new private sector investment to deliver improved public services over the period 1999-00 to 2001-02. In July 1999, and following the recommendations of the second report into PFI by Sir Malcolm Bates, Chairman of the Pearl Group, the Government announced plans to build on this success further, with the establishment of Partnerships UK (PUK) a private sector company with a public sector mission. PUK will provide the public sector with the key commercial skills to forge more and better partnerships with the private sector on equal terms, and will act as a project manager for PFI deals, providing public sector organisations with expert advisory and implementation skills.

3.128 The Government is also using PPPs in a number of state-owned industries, to introduce private sector management and ownership disciplines, so as to help these businesses fund and better manage their investment programmes and operate efficiently. This will help improve the services they provide, as well as enhancing their own chances of long-term commercial success and the value of these businesses to the taxpayer.

3.129 Similarly, PPPs are contributing to the Government's drive to use publicly-owned assets more effectively and efficiently. The National Asset Register (NAR), published in 1997, identified the assets that the Government owns. Since then, departments have been encouraged to sell off the assets that they do not require, and to make best use of irreducible assets that they do not use to full capacity, often in partnership with the private sector. To ensure that departments have made progress in these aims since 1997, the Government will be publishing an update of the NAR next year which will detail their activities in these areas.

[1]Higher skills: degree or above. Intermediate skills: vocational qualification above high school but below degree level. [Back]

[2]"Decomposition of Industry-level Productivity Growth: A micro-macro link" OECD 1997. [Back]

[3]The Global Entrepreneurship Monitor, 1999 UK Executive Report published by London Business School. [Back]

[4]Enterprise Britain 1998, Centre for Business Research, Cambridge University. [Back]

5Financial Times Survey on Business Education, 25 January 1999. [Back]

4

Increasing Employment Opportunity for all

The Government's aim is employment opportunity for all - the modern definition of full employment - based on clear rights and responsibilities. The Government wants to ensure that there is work for those who can, while providing security for those who cannot. By providing employment opportunities for all, the Government is tackling the underlying causes of deprivation so helping to break the inter-generational cycle of poverty. Moreover, expanding the effective supply of labour will allow the economy to grow more rapidly without running into skills shortages and inflationary pressures.

The Government's strategy for ensuring that work is open to all comprises three principal elements:

- **welfare to work policies as the key to delivering employment opportunities: reducing inactivity, especially concentrations in groups or areas; re-attaching unemployed and inactive people to the labour market and making them more effective at competing for jobs; and enabling a rapid return to work for the unemployed, avoiding detachment from the workforce;**
- **making work pay: by ensuring that tax and benefit policy provides the right incentives at all levels of the labour market, so that work pays more than benefits; helping to tackle the unemployment and poverty traps; and creating a tax and benefit system that reflects the modern labour market and works towards the goals of encouraging work and supporting families; and**
- **easing the return to work and allowing people to work their way up once in work: by ensuring the transition from welfare to work is secure; supporting parents in work through good quality childcare; and helping people to move up the earnings ladder by enhancing their skills once in work.**

INTRODUCTION

4.1 The Government is committed to the goal of high and stable levels of growth and employment. Its aim is employment opportunities for all, the modern definition of full employment. In the dynamic, modern labour market, this cannot be delivered through jobs for life, but rather through ensuring job opportunities for all throughout all their working lives. The Government's long-term economic ambition is that by the end of the next decade there will be a higher percentage of people in employment than ever before.

A dynamic labour force

4.2 The UK has a dynamic labour market. Every year over 8 million people move into a new job. Over the last 20 years, the labour market has seen large changes in the nature of work and the make-up of the workforce. Female employment has risen by nearly $3\frac{1}{2}$ million since the early 1970s, and alongside this there has been a significant growth in part-time employment. Since May 1997, employment in the UK has risen by 700,000. According to the Labour Force Survey, more people a total of over 27 million are now employed than ever before.

4.3 High and stable levels of employment can only be achieved against a background of macroeconomic stability. Chapter 2 set out how economic stability is being achieved through a credible monetary and fiscal policy framework, which includes discipline and responsibility in wage bargaining. However, stability alone is not sufficient to ensure employment opportunities for all. So the Government has embarked upon a radical programme of tax and benefit reform combined with active labour market policies.

Tackling the underlying causes of deprivation

4.4 By increasing employment opportunities for all, the Government is tackling one of the most important underlying causes of deprivation. Chapter 5 explains how the Government is meeting its commitment to support family and community life and to abolish child poverty within a generation. Childhood poverty is particularly damaging because early disadvantage is all too frequently compounded in later life. People who leave school with few or no qualifications are much more likely to become workless and are less likely to receive in-work training. Men in the bottom quarter of the earnings distribution are nearly three times as likely to leave work within a year as those in the top quarter. Long periods of unemployment can have longer term damaging effects, reducing people's chances of working and their earnings potential over many years.

4.5 This cycle of deprivation and poverty must be broken. The Government believes that what matters most is giving people opportunities throughout their lives. It is not acceptable to say that people have had a chance, and missed it everyone deserves a second, third or fourth chance.

4.6 Merely compensating people for poverty and a lack of opportunity, however, cannot break the cycle of deprivation. To do that requires active intervention, to help people to become more independent, rather than locking them into dependency. Getting a job is the surest route out of poverty: in 80 per cent of cases between 1991 and 1995, finding work meant moving out of the bottom fifth of the income distribution. That is why the Government is committed to giving people the opportunity to work.

Reducing worklessness, not just cutting unemployment

4.7 Unemployment, on the ILO measure, has fallen by around 385,000 since May 1997 to its lowest level since the series began in 1984. The claimant count is down by nearly 400,000 since May 1997 to 1.2 million, its lowest level since April 1980. Long-term and youth unemployment have halved. But while employment is high and the unemployment rate is now lower than in most European countries (although still higher than the USA) the UK continues to have a high proportion of workless households. Nearly 7 million people below pensionable age 4.3 million adults and 2.7 million children live in households where no-one is in work. More than one in six working age households now have no-one in work, twice the level of 20 years ago.

4.8 This combination of high employment and large numbers of households without work has come about because worklessness has become increasingly concentrated within households. In the 1970s, while the employment rate was lower, most of those not working shared a household with someone in work who could support them. In the mid-seventies there were six times as many households with a combination of people in work and others out of work as workless households. Today, the numbers are almost equal. In addition, for those in workless households, the chances of someone moving into work are much lower: a person is twice as likely to get a job if their partner is already working than if their partner is also workless.

4.9 These concentrations of worklessness are now the most important cause of poverty among working age people and their children. Two-thirds of working age households on persistently low incomes are workless, and eight out of ten have no-one in full-time employment.

Re-attaching workless people to the labour market

4.10 The economy does not contain a fixed number of jobs. One person's employment should not be seen as another's worklessness. Instead, by bringing workless people closer to the labour market and making them more effective at competing for jobs, total employment can be increased. With a more effective supply of labour, employers can fill their vacancies more easily, and the economy can grow without hitting skills shortages or running into inflationary pressures. In a dynamic labour market, that growth leads to higher employment.

4.11 This is most clearly shown by the ability of the UK economy to find work for the millions of women who have entered the labour force over the past 30 years. Since the early 1970s, the number of women wanting to work has increased by nearly $3^1/_2$ million. While, in line with wider trends, there has been an increase in female unemployment over this period, the labour market has successfully found work for the vast majority, over 90 per cent, of these women. The same pattern can be seen, for both men and women, looking across countries. Chart 4.1 shows those countries which have seen the greatest growth in employment are those which have also seen the greatest growth in the labour force the number of people wanting to work.

Change in employment relative to change in labour force

WELFARE TO WORK

4.12 Every year, there are over 3 million new claims for Jobseekers' Allowance. Most people receive Jobseekers' Allowance for only a short period, with over half leaving within the first 13 weeks. Only 10 per cent remain unemployed a year later. But for those who do become long-term unemployed, their chances of getting a job are sharply reduced. A period of long-term unemployment can also have longer lasting effects, reducing people's opportunities over many years, perhaps permanently. Men who were unemployed for a year by the time they reached 23 spent 14 times longer unemployed over the next decade as those who had no unemployment before age 23. For women, the effects were smaller, but still substantial.

ONE: forging a new culture putting work first

4.13 The Government's new ONE service combines a one-stop shop for benefits and employment advice, a personal adviser service to help people back into work, and work-focused interviews for all new benefit claimants: one place for work and benefits. It will forge an entirely new culture which puts work first, and provide a modern, integrated and flexible service for all. ONE has been running in four pilot areas since June.

4.14 This represents a fundamental shift in the way the Government supports people away from a system that asks simply "what money can we pay you?" to one that says "how can we help you become more independent?". While it is too early to draw any firm conclusions, the early signs in the ONE areas are encouraging. A further eight pilots will start later this year, making use of call-centre technology and involving the private and voluntary sectors in management. From April 2000, new claimants in ONE pilot areas will, subject to legislation, be required to take part in an interview to talk about their prospects of finding work and about the help that is available both to move into work and to ensure that work pays.

New Deal

4.15 Through the New Deal, the Government is ensuring that those who are out of work are kept in contact with the labour market and do not drift into long-term unemployment. The New Deal is about equipping workless people to compete effectively for the jobs that a dynamic labour market creates.

4.16 There are currently around 1 million vacancies in the economy. Every three months, a further half a million are notified to Job Centres alone, with many more elsewhere. Employment opportunities exist across the country. Chart 4.2 shows that even in the areas of highest unemployment, between 15 and 20 per cent of claimants move off Jobseekers' Allowance every month. For example, the unemployment rate in Swindon is a third of that in Sheffield, but the percentage of claimants leaving Jobseekers' Allowance in Swindon some 25 per cent on average every month is not that much higher than Sheffield at 18 per cent.

Average monthly off-flows from Jobseekers' Allowance

4.17 By getting people back into work quickly, the scarring effects of long-term unemployment do not have time to set in. International evidence shows clearly that employment programmes that place a strong emphasis on getting people back into work rapidly, such as the New Deal, are the most effective at doing so.

New Deal for 18-24 year olds

4.18 Youth unemployment, has fallen by half since May 1997, but tackling youth unemployment remains a high priority. The New Deal for 1824 year olds helps young unemployed people to secure jobs as the most effective way of enhancing their earnings, increasing their skills and securing their future economic independence. The New Deal for 1824 year olds includes:

- gateway provision, with help with job search, careers advice and guidance;
- for those who don't find unsubsidised employment, mandatory activity though one of four options (subsidised employment, full-time education and training, work on the environmental task force or with the voluntary sector) after four months, to help improve their employment prospects; and
- follow-through to ensure these young people are helped to build on their experience and move into employment.

4.19 Around 350,000 young people have joined the New Deal since it was launched nationally in April 1998. Some 145,000 had found jobs by the end of August 125,000, or 86 per cent, of them unsubsidised. In addition, over 92,000 young people have gained valuable work experience and training through the other New Deal options.

4.20 Budget 99 made available additional funds to provide a more intensive initial gateway period for some young people, who might gain from greater pace and purpose in their job-seeking activities. Twelve Intensive Gateway pilots were announced in August 1999. These provide a structure of short programmes to prepare young people more effectively for work. These include:

- more intensive help with job search; and
- programmes to help with "soft" skills, such as punctuality, team working and communication skills.

4.21 In parallel, from July, the fourth month of the gateway has been made more intensive so that all young people in the New Deal at this stage are clear that there is no option of continuing on benefits and have the support they need to move on to one of the four options outlined above that is right for them. **The Government intends a nationwide expansion of the intensive gateway approach currently being piloted, taking into account the lessons learnt from the evaluation of these pilots, from spring 2000, funded from the Windfall Tax**.

4.22 The Government's existing New Deal Innovation Fund is supporting 23 pilots which are testing out locally-developed proposals to improve delivery of the New Deal in a number of key policy areas: helping disadvantaged young people, increasing geographical mobility, improving retention in employment, and strengthening pre-employment collaboration with employers. A further eight innovative proposals, paid for from existing funding, are also being taken forward.

4.23 The Government intends to extend the Windfall Tax financed Innovation Fund beyond the current financial year in order to back good ideas generated at local level for improving the effectiveness of the New Deal. In particular, it is interested in exploring how best to support intermediary organisations from the private and voluntary sectors, which can add value by linking long-term unemployed people to employers with vacancies on offer. To that end, it has decided to establish an Intermediaries Fund covering eleven inner-city areas

Box 4.1: Preparing people for work

The Government is looking to support innovative solutions to help those who may need extra help moving into work. It is keen to explore ways in which intermediary organisations can help the transition from welfare to work by bridging the gap between employers and unemployed people.

As part of an extended New Deal Innovation Fund, the Government intends to support intermediary organisations working closely with employers to help groups from disadvantaged backgrounds move into and remain in employment. A fund will be established which will be used to invite proposals with this aim from intermediary organisations working in about ten inner city areas. Help will need to reflect local needs and be focused on long-term unemployed people, within the context of the New Deal. Public money would be linked to matched funding from the private sector, and employers in particular.

The Government also intends to use the innovation fund to explore the role sector-based intermediary organisations can play in supporting employers - particularly small businesses - and unemployed people to take full advantage of the opportunities offered by the New Deal. As an initial step, the Government has organised a workshop to explore how intermediaries might support disadvantaged unemployed people from East London find and keep financial-sector jobs in the City of London. The workshop will bring together business leaders, voluntary and community groups to explore the lessons to be learnt from both the US, and UK experience so far, to see how these can be taken forward. One example from the US is the very successful "Welfare to Wall Street" programme in New York, under which the Wildcat Community Organization acts as an intermediary, playing a very intensive and supportive role to jobseekers while they develop skills through an employment programme.

A similar workshop is being planned for the IT sector and the Government is exploring how this can be extended to other sectors.

at a cost of £5 million over 3 years to support private and voluntary sector organisations capable of helping people into work within the framework of welfare to work programmes. This will build on both work already underway in the UK and best practice from the USA.

Worklessness in deprived communities

4.24 Communities suffering from multiple deprivation need special help. One of the 18 fast-track Policy Action Teams (PAT) set up following the Social Exclusion Unit's Report "Bringing Britain Together" was charged specifically with developing an action plan to reduce the difference between the levels of worklessness in poor neighbourhoods and the national average; and within that to reduce the disproportionate unemployment rates for people from ethnic minorities. The PAT's report will be published shortly, and its recommendations will feed into the Government's forthcoming "National Strategy for Neighbourhood Renewal" paper. Information on the New Deal for Communities and the Government's approach to ensuring that no individual or neighbourhood is trapped in poverty or socially excluded is set out in Chapter 5.

New Deal for the long-term unemployed

4.25 The number of long-term unemployed people has, like youth unemployment, fallen by half since May 1997. The Government is determined to build upon this initial success and to continue to tackle the problem of long-term unemployment.

4.26 Since June 1998, those aged 25 and over and unemployed for two years or more have been eligible for the New Deal for the over 25s. This includes access to a Personal Adviser and, alongside a range of options for the long-term unemployed, a £75 a week wage subsidy and opportunities to undertake full-time education and training. By August 1999, around 172,000 long-term unemployed people had started on the New Deal, and 24,000 had found jobs.

4.27 The New Deal has been extended through a series of innovative pilots based on the intensive approach pioneered for 1824 year olds. These were launched at the end of November 1998. Those people unemployed for over 18 months, or 12 months in some areas, start an intensive gateway of job search activities. Those who do not find work enter a period of full-time activity for three months. This activity depends on individual need, but can include work trials with employers, training, work experience and support for self-employment. Ongoing support is available to those most at risk of remaining unemployed. There are 28 pilots in Great Britain. In Northern Ireland, as part of the Chancellor's Economic Initiative announced in May 1998, these opportunities are open to all those who have been unemployed for 18 months or more.

Enhanced provision for jobseekers over 25

4.28 The Government is making a start on modernising the Employment Service to improve radically the ways in which employers can notify their vacancies and making it easier for jobseekers to apply for jobs using the full-range of new technologies. During 2000, we will:

- **create a jobs and learning bank, which will put jobs, jobseekers' CVs and information about careers and learning opportunities on the internet;**
- **expand nationwide the network of touch-screen jobpoints in Job Centres and other locations so that jobseekers can search not only all job vacancies notified to the Employment Service but also those carried by private agencies and newspapers; and**
- **develop links with the BBC and other potential partners to harness the potential of interactive television to link employers and jobseekers.**

4.29 With almost one million vacancies in the economy the Government wants to strengthen the matching of unemployed people over 25 to jobs, ensuring that they have fast and ready access to details of vacancies that are available. **The Government will set up a national network of job-broking call-centres**. These call-centres will provide a single national telephone number for employers to register vacancies and jobseekers to call for information about the jobs on offer. In addition, call-centre will telephone jobseekers' who have been unemployed for six months or more to put them in contact with employers who have suitable vacancies. This will help ensure that the long-term unemployed have quick access to information about the jobs that are available and will reinforce jobseekers' responsibilities as they will be expected to apply for the vacancies offered to them. This package will be funded from the Capital Modernisation Fund.

4.30 The Government will also increase the intensity of Fortnightly Jobsearch Reviews for people who have been unemployed for six months or more. This will allow Job Centre staff more time to match jobseekers with vacancies and to ensure that jobseekers are applying for jobs.

A more intensive national New Deal 25+

4.31 For those unemployed for more than 24 months, the New Deal advisory stage will be strengthened to provide more support for job search and to enhance links with employers. New Deal Personal Advisers will be given more time to work with individuals to help them into work. Extra support will be available for those who do not manage to find a job to address basic skills needs, including "soft" skills, with access to careers guidance and mentors, and specialist support for those with deep-rooted problems, such as drug or alcohol dependency.

4.32 New Deal Personal Advisors will identify a number of suitable vacancies and jobseekers will be expected to apply for them. If candidates are unsuccessful, advisers will try to establish why and to use this feedback to help candidates enhance their employability.

4.33 The Government intends to itensify and extend the New Deal for the over 25s on a national basis from April 2001, building on the principles of the New Deal for 1824s and bringing the rights and responsibilities for those aged 25 and over closer into line with those for young people. This will be funded from the Windfall Tax. This will incorporate the lessons from the evaluation of the innovative New Deal for the over 25s pilots introduced in November 1998. To enable this evaluation work to continue, and to provide as much evidence as possible about what works and what does not, the pilots will be extended to run until April 2001. In some cases the pilots will continue in much the same form as they are currently operating; in others a more radical approach will be taken.

Employment Zones

4.34 In April 2000 Employment Zones will, subject to legislation, be introduced in 15 areas in England, Scotland and Wales that suffer from particularly high levels of unemployment. Employment Zones are a new and innovative approach that aim to help around 50,000 long-term unemployed people aged over 25 back into work. They will offer the opportunity of tailoring programmes specifically to people's needs, with jobseekers and their Personal Advisers being able to set up Personal Job Accounts and use funds normally available for support more flexibly. They will both empower individuals and offer strong incentives to providers to help people in the most flexible and best ways they can. They will be evaluated to discover best practice that can be shared in future Welfare to Work developments.

New Deal 50 plus

4.35 The employment rate of men aged over 50 has fallen dramatically over the past 20 years. At the same time women over 50 have not experienced the marked increases in participation that younger women have enjoyed. In Budget 99 the Chancellor announced the New Deal for the over 50s. This was launched in nine Pathfinder Areas[1] on 4 November 1999, and will be extended nationally from April 2000. This New Deal programme provides:

- personal advice including help with job search;
- an employment credit of £60 a week for full-time work and self-employment and £40 per week for part-time employment for up to one year; and
- an in-work training grant of up to £750.

4.36 The employment credit, combined with the National Minimum Wage, guarantees a minimum income of £170 a week for the over 50s returning to full-time work, and £110 a week moving back into part-time work.

4.37 This range of support will be available to people aged over 50, where they or their partner have been on benefits for more than six months. The programme is voluntary and available to people who are economically inactive as well as those registered as unemployed.

New Deal for lone parents

4.38 Fewer than half of lone parents currently work a much lower rate than most of our European partners. To help lone parents who want to move back into employment, the New Deal for lone parents (NDLP) was launched nationwide on 26 October 1998. It provides the opportunity for all lone parents to meet a personal adviser and receive help and support to improve their employment prospects. From the national roll-out of NDLP up to the end of August 1999, over 76,000 lone parents had agreed to participate in NDLP and over 20,000 had already moved into employment. Innovative pilots, being run by voluntary, public and private sector organisations, will test different approaches to help lone parents into work, including mentoring, work experience and training.

4.39 Building on the success of NDLP to date, the Government will increase the choices and opportunities available to lone parents considering work. It will:

- **provide more intensive support including outreach initially in pathfinder areas, for lone parents with children aged 14 and 15 to help them to prepare for the time when their eligibility for Income Support will cease;**
- **build on the New Deal's popularity amongst lone parents with pre-school children, by extending invitations**

to participate in NDLP to lone parents on Income Support with children from the age of three; and**

- **establish an Innovation Fund to find different ways of helping lone parents into work and improving the delivery of the New Deal**.

4.40 For those lone parents who do not feel that they currently have the right skills to work, there will be the option of improving their future employment prospects. **To help lone parents to prepare for work, NDLP will provide access to resource centres.** This provision will be specifically tailored to lone parents and their particular needs, providing help with job search and basic skills training. An in-work training grant is also being piloted to help lone parents to gain qualifications once they move into work through the New Deal. This package will be funded from the Windfall Tax.

4.41 Lone parents on Income Support are also able to take part in Further Education without losing their benefits. **To improve their opportunities for studying further, extra help with childcare will be provided through FE access funds (see later in the chapter)**.

New Deal for partners of unemployed people

4.42 Where one partner is unemployed, the chances of the other partner being in work are lower. This is particularly marked for women: where the male partner is unemployed, only 36 per cent of female partners are employed. In contrast, where the male partner is employed 75 per cent of female partners are employed. The New Deal for partners of unemployed people was launched in three pathfinder areas in February 1999 and was rolled out nationally in April 1999. This provides a personal adviser service aimed at helping partners of unemployed people to move into work. Childless partners aged 1824 are eligible for the full range of services in the New Deal for 1824s.

New Deal for disabled people

4.43 People with disabilities are only half as likely as non-disabled people to be in employment. According to the Labour Force Survey, some 1 million people with disabilities who are currently without work want a job. The gap between the labour market participation rates of disabled and non-disabled people has widened since 1984, albeit with a small narrowing since 1997. In addition, the number of people claiming Incapacity Benefit (or its predecessor) has risen threefold since 1975.

Box 4.2: Moving people out of the informal economy

The hidden economy is a significant problem. It means that people are not paying what they owe in tax, and are often defrauding the benefit system at the same time. Many of these will be turning down legitimate work because they are employed in the hidden economy. Some will be engaged in criminal activity. But others will be people working at the margins of the formal economy who do not know about the financial benefits of legitimate work or of the help that is available to move into employment or self-employment, or who are put off by the impression of red tape and bureaucracy.

The Chancellor has asked Lord Grabiner QC to conduct a review into tackling this problem. The review will look at the nature and scale of the problem; at ways in which the sanctions against those who abuse the system can be strengthened; how to reinforce the message that people are better off financially and in terms of social protection in the legitimate economy; how to encourage people to move out of the hidden economy; and the help available to get started in legitimate employment and self-employment. The review will report by the time of the Budget.

4.44 In his July 1997 Budget, the Chancellor announced that the Government would extend the New Deal to include those on long-term sickness and incapacity benefits using money from the Windfall Tax. Since then, a number of pilots have been launched to assess the best way of helping people into work, including a personal adviser service, 24 innovative schemes and experimental changes to the benefit system. The New Deal 50 plus also offers considerable financial help to recipients of long-term sickness and incapacity benefits aged over 50.

Funding Welfare to Work

4.45 The Welfare to Work programme is funded from the receipts of the one-off Windfall Tax on the excess profits of the privatised utilities. The Windfall Tax raised a total of £5.2 billion. Table 4.1 sets out the latest estimates of the allocation of the Windfall Tax receipts between programmes.

Table 4.1 Allocation of the Windfall Tax receipts

£million	199798	199899	199900	200001	200102	**199702**

Spending by programme[1]						
New Deal for 1824 year olds[2]	50	210	710	630	640	**2240**
New Deal for over 25s[3]	0	20	170	210	90	**490**
New Deal 50 plus	0	0	10	20	20	**40**
New Deal for lone parents	0	50	50	50	40	**190**
New Deal for disabled people[4]	0	10	30	90	80	**210**
New Deal for partners of unemployed people	0	0	20	20	20	**50**
New Deal for schools[5]	100	270	340	330	310	**1350**
Childcare[6]	0	30	10	0	0	**40**
University for Industry[7]	0	5	0	0	0	**5**
Enterprise development	0	0	10	10	10	**30**
Total Expenditure	**150**	**580**	**1350**	**1350**	**1210**	**4630**
Unallocated						**570**
Windfall Tax receipts	**2600**	**2600**				**5200**

[1] *Rounded to the nearest £10 million. Constituent elements may not sum to totals because of rounding. Outturns for 199798 and 199899,estimated allocations for 199900 onwards.*

[2] *Includes £10 million for 1824 year old childless partners of unemployed people, subject to legislation.*

[3] *Includes £10 million for assisted areas.*

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

[5] *Capital spending on renewal of school infrastructure, to help raise standards announced in the 1997 Budget.*

[6] *Includes £30 million for out-of-school childcare. The costs of the 1997 Budget improvements in childcare support through Family Credit are included from April 1998 until October 1999, when the measure will be incorporated within the Working Families Tax Credit.*

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

EASING THE TRANSITION TO WORK

4.46 For many people, especially those who have been out of work for long periods, the transition back into work can be a difficult period. Financial security is of particular concern for families with children. To help lone parents to make the transition from welfare to work, their out of work Income Support has been extended for two weeks since October 1999. Combined with the Extended Payments scheme for Housing Benefit, lone parents eligible for this "run on" could gain around £300400. The scheme is available to all lone parents who have been claiming Income Support for at least 26 weeks prior to finding work. The Government will consider whether there is a case for extending this run-on to other groups on the basis of evidence from lone parents.

4.47 The Government's long-term aim is, as Chapter 5 explains, an Integrated Child Credit. This would bring together the child premia in Working Families' Tax Credit and Income Support, and the Children's Tax Credit. Such an integrated approach would help provide financial security for families with children during the transition to work.

National Childcare Strategy

4.48 The lack of good quality, affordable childcare provision creates a barrier to work for many parents, particularly lone parents. The continuing labour market trend of mothers moving back into work when their children are young, as well as the increase in financial help available to low income families through the childcare element of the Working Families' Tax

Credit, means that the demand for childcare is likely to continue to rise. The Government's National Childcare Strategy is a key policy in supporting low income families. Its objective is to ensure that a lack of good quality childcare does not prevent parents from taking up employment.

4.49 Just 18 months into the strategy, the Government has delivered through the local Early Years Development and Childcare Partnerships: 66,000 new places in out of school clubs; 226,000 nursery places for 3 year olds; new proposals, following consultation, for the regulation of childcare; and a whole new funding stream to enable low and middle income parents to afford childcare through the childcare tax credit in both the Working Families' Tax Credit and the Disabled Person's Tax Credit. The Government is also increasing the number of childcare places in Further Education by 10,000 (see later in the chapter).

4.50 In setting its strategy and objectives, the Government will consider:

- measures to promote the efficiency of the childcare market;
- what gaps in provision exist, and how they should be filled;
- barriers to supply;
- the efficiency of the future regulatory regime, via the Office for Standards in Education; and
- how best the strategy can be delivered.

MAKING WORK PAY

4.51 People are reluctant to take jobs where the financial gain is small or non-existent. Often in the past, the gap between out-of-work and in-work incomes has been too small to provide sufficient incentive to move off benefits and into employment the so-called unemployment trap. People in employment have also been discouraged from working longer hours or taking a better paid job because the combined effect of losing benefit entitlement and paying more tax has made them no better off the poverty trap.

4.52 Policies to reattach people to the labour market and enable them to compete for jobs need to be underpinned by a strategy for ensuring that the financial returns to work make it worthwhile.

4.53 Creating the right incentives matters at every level of the labour market evidence confirms that the financial rewards to employment are important. The expansions to the Earned Income Tax Credit, the primary in-work welfare programme for families with children in the USA, account for over half of the increase in the single mothers' annual employment rate between 1984 and 1996 and a third of the increase between 1992 and 1996.

4.54 Different groups of people face different obstacles to work. For example, families with children and in particular lone parents may be constrained by the costs and availability of quality childcare. Policies to make work pay therefore need to look across the range of policies on tax and benefits.

National Minimum Wage

4.55 To underpin the Government's tax and benefit reforms and ensure fair minimum standards of pay, the National Minimum Wage was introduced in April 1999. The introductory rates are:

- £3.60 an hour for adult workers aged 22 and over;
- £3.20 an hour for trainees (workers aged 22 and over and in the first six months of employment and receiving training leading to a recognised qualification); and
- £3.00 an hour for workers aged 1821 inclusive, rising to £3.20 in June 2000.

4.56 The initial impact of the National Minimum Wage is currently being assessed by the Low Pay Commission, which will report to the Government shortly.

Income Tax

4.57 In Budget 99 the Government reformed the income tax system to increase the rewards to work particularly for the low paid.

- A 10p rate of income tax was introduced from 6 April this year the lowest starting rate since 196263. This has halved the marginal tax rate for 2.3 million people, of whom 1.7 million are low paid;

- **From April 2000, the basic rate of income tax will be reduced to 22p the lowest level for some 70 years**.

4.58 By 20012002, the tax burden on a family on average earnings with two children will be at its lowest level for around 30 years.

Box 4.3: The income tax personal allowance and employer NICs threshold for 2000-01

The Chancellor announced in Budget 98 that the threshold for employer NICs would be aligned with the income tax personal allowance. In line with this decision, the personal allowance for 2000-01, taking into account indexation, will be £4,385 a year, and the threshold for employer NICs will be £84 a week.

National Insurance Contributions

4.59 Budget 99 continued the implementation of the package of reforms recommended by Martin Taylor, which the Government began in Budget 98.

- In April 1999 the entry fee on employee NICs was abolished. This ended the situation where an employee could face a drop in net pay as a result of a one penny increase in gross earnings.
- **All employees will gain from increases to the starting point for NICs. This will be increased to £76 a week in April 2000, compared to £66 a week now, and will be aligned with the income tax personal allowance in April 2001**. This will particularly benefit low paid employees, who currently pay no income tax, but still find themselves liable for NICs.
- As announced in Budget 99, the tax and NICs treatment of cash and non-cash remuneration will be further aligned.

4.60 The Government will protect the benefit entitlement of some 1 million individuals whose national insurance liability falls to zero. A zero-rate band of NICs, applicable between the lower earnings limit and the new threshold for NICs, means that employees will accumulate the same entitlement to benefit that they currently have.

4.61 In April 1999, the point at which employers begin to pay NICs was aligned with the personal tax allowance an increase of £17. As part of this reform of employer NICs, the Government has introduced a single employer rate replacing the complicated array of four separate rates which will make it considerably easier for employers to administer and understand NICs. As a result of these changes the NICs burden on most employers will be significantly reduced.

4.62 Employer NICs will be reduced by 0.3 percentage points from April 2001, thereby ensuring that all the revenue raised from the climate change levy is fully recycled to business as a whole. This reduction will apply to both the standard and contracted-out rates of employer NICs. By lowering the cost to firms of hiring workers this will act to boost employment opportunities across the economy.

Working Families' Tax Credit

4.63 The Government introduced the Working Families' Tax Credit on 5 October 1999 to replace the existing Family Credit regime. The Working Families' Tax Credit will help make work pay for around 1.4 million low and middle income working families with children giving them, on average, £24 a week more than on Family Credit. As a tax credit, payable through the wage packet from April 2000, it will demonstrate more clearly the rewards of work over welfare. By 2001, around 500,000 more families will be receiving the Working Families' Tax Credit than would have received Family Credit.

4.64 Combined with the National Minimum Wage, and other tax and benefit reforms, the Working Families' Tax Credit guarantees:

- a minimum income of £200 a week (£10,400 a year) for a family with someone in full-time work £80 a week more than a couple would receive on Income Support;

- a family with one part-time (16 hours) worker a minimum income of £145 a week;

- working families with an income of less than £235 a week will not pay any net income tax; and

- a family with two young children earning £13,000 a year will be £2,500 a year (over £45 a week) better off in work.

4.65 The Working Families' Tax Credit also helps to underpin the National Minimum Wage, for example:

- a couple with two children under 11 and one partner working 35 hours a week at the National Minimum Wage of

£3.60, will have an effective hourly wage of £6.56; and
- a lone parent with one child under 11, working 35 hours a week at the National Minimum Wage will have an effective hourly wage rate of £5.71.

4.66 The lower taper in the Working Families' Tax Credit means that working families keep more of what they earn. In 1997 nearly 750,000 families lost over 70 pence of every extra pound they earned. The number of families facing effective tax rates of over 70 per cent will fall by two thirds as a result of introducing the Working Families' Tax Credit and other tax reforms. Details are shown in table 4.2.

Childcare tax credit

4.67 The Working Families' Tax Credit includes a generous childcare tax credit which provides direct support for childcare costs for the first time. This extra financial support underpins the increase in childcare places being delivered by the National Childcare Strategy.

Box 4.4: The launch of the Working Families' Tax Credit

The Government is committed to ensuring that as many working families as possible who might be eligible for the Working Families' Tax Credit understand the new policy and have easy access to information about their entitlement. The Government has invested £12 million in an 11 week advertising campaign, including television adverts, newspaper publicity and regional conferences, to pass the Working Families' Tax Credit message on.

The first Working Families' Tax Credit advertisement was televised on 8 September. As at 2 November, 56 days after the campaign launch:

- **Around 670,000 calls have been handled by the special telephone response line featured in the campaign - 0800 597 5976**
- **A further 880,000 have contacted the Tax Credit Office Helpline.**
- **Over 380,000 application packs have been issued to potential new Working Families' Tax Credit applicants.**
- **In addition some 162,000 information packs have been issued.**

In the eight weeks since the campaign launch there have been approximately 400,000 applications for Working Families' Tax Credit, representing a mixture of existing claimants moving onto Working Families' Tax Credit when their Family Credit award runs out, and new applicants.

Among those to be helped by the Better Deal for Working Parents are:

Ed is in a couple and has three children. Before the introduction of the Working Families' Tax Credit neither he nor his wife were in work. In fact, Ed had been out of work for eight years. He has just started a full time job as a chef and receives £87.98 a week from the Working Families' Tax Credit.

Jane is a lone parent who had not worked for two years. She has since started work on 11 October. She is now £85 per week better off, because of the more generous rates and the 100 per cent maintenance disregard in the Working Families' Tax Credit.

Jonathan is in a couple - his partner is in full time education and they have a six month old daughter. He had been out of work since July. Jonathan started work for an insurance company on 4 October and now receives £50.60 Working Families' Tax Credit.

4.68 The childcare tax credit will provide help with 70 per cent of eligible childcare costs, up to a limit of £100 a week costs for families with one child and £150 a week for families with two or more children. In addition, there will be a full disregard of maintenance payments in the calculation of income for Working Families' Tax Credit, so that families in work keep the full benefit of any maintenance they receive.

4.69 The Working Families' Tax Credit rates and income threshold will be increased in line with indexation from April 2000. In addition, the child credit for under-11s will be increased by £1.10 a week over and above normal indexation from the same date. These increases will boost the incomes of 1.4 million low-income working families.

Disabled Person's Tax Credit

4.70 The Disabled Person's Tax Credit was launched in October 1999 to give disabled workers a better deal making work pay and increasing employment opportunities. By 200001, the Disabled Person's Tax Credit will boost the incomes of 32,000 working people by on average £25 a week more than the old Disability Working Allowance (DWA) it replaced twice as many as were receiving DWA. It is open to anyone working more than 16 hours a week, and who is receiving or has received one of a range of incapacity or disability benefits within the previous 6 months. And from next October, because all the evidence suggests that people who become disabled while at work are most likely to find employment with their former employer, a new fast track gateway will be introduced to help these people after 20 weeks of sickness.

4.71 The Disabled Person's Tax Credit is more generous because it has higher basic and young child allowances, allows people to earn more and get the full amount of the credit up to a higher threshold of £70 for single people, and £90 for couples and lone parents, and even then it is withdrawn more slowly as earnings increase with a taper of 55 per cent not 70 per cent. This better deal also includes help with childcare costs by giving those on Disabled Person's Tax Credit access to the new childcare tax credit.

4.72 The Disabled Person's Tax Credit, together with the National Minimum Wage, guarantees a minimum weekly income of:

- £230 a week (£12,000 a year) for a family with someone in full-time work and one child at least £80 a week for couples and £120 a week for lone parents more than the family would receive on Income Support;
- £155 a week for childless single people at least £80 a week more than they would have received on Income Support; and £195 a week for childless couples at least £85 a week more than they would have received on Income Support.

4.73 Combined with other tax and benefit measures, the Disabled Person's Tax Credit will mean that:

- working disabled families with children and a weekly income of less than £285 a week (£14,800 a year) will not pay any net income tax;
- a family with two young children earning £13,000 a year will be £2,500 a year (over £45 a week) better off; and
- a single earner family with two children on £20,000 will be £1,500 a year better off and will see their tax burden fall to the lowest level since 1972.

4.74 As with the Working Families' Tax Credit, the Disabled Person's Tax Credit rates and income thresholds will be increased in line with indexation from April 2000. In addition, the child credit for under-11s will be increased by £1.10 a week over and above normal indexation from the same date. These increases will boost the incomes of 32,000 working disabled people.

The Effect of the Government's Making Work Pay Package

4.75 These policies are tackling both the unemployment and poverty traps, making work pay for the unemployed and the inactive and providing a greater incentive for those in employment to move up the earnings ladder.

Tackling the unemployment trap

4.76 The introduction of the National Minimum Wage and the Working Families' Tax Credit has, for the first time, guaranteed a minimum income for those moving off benefits. As Chart 4.3 shows, for people moving off benefit into typical entry-level jobs, the rewards of work have increased.

The gains to work for different households

Tackling the poverty trap

4.77 The tax and benefit reforms have also addressed the poverty trap and allowed low-income families to keep more of every extra pound that they earn. The main measurement of how many are facing a poverty trap in work is the numbers facing high marginal deduction rates (MDRs). MDRs measure the proportion of any increase in income lost through reduced benefit entitlement and increased taxation.

4.78 The combined impact on families who previously faced high MDRs is shown in the table below. It illustrates the estimated number of families who, prior to the 1998 Budget, faced marginal rates in excess of 70 per cent and the numbers who are estimated to face these rates after the Budget measures are implemented over the next three years.

Table 4.2: Combined effect of Government's reforms on high marginal deduction rates

Marginal deduction rate[1]	Before[2]	After[2]
100 per cent or more	5,000	0
90 per cent or more	115,000	15,000
80 per cent or more	255,000	175,000
70 per cent or more	715,000	230,000
60 per cent or more	730,000	950,000

[1] *Figures are for families where at least one partner works 16 hours or more, and are based on estimated 1998-99 caseload and take-up rates.*

[2] *Figures are cumulative.*

4.79 As a result of all Budget measures around half a million fewer families will face marginal rates of 70 per cent or more, significantly reducing the poverty trap for low earning families.

4.80 The Chancellor announced in Budget 99 that he sees a case for going further in tackling work incentives and addressing poverty among low income working households. The long-term aim is an Employment Tax Credit, paid through the wage packet, which would be available to households, with and without children. This would extend the principle of the

Box 4.5: Labour supply effects of Budget measures

The best way to analyse the effect of a financial incentive on work incentives is to look at an individual's position before and after the policy's inception.

For example, research from the Canadian Self-Sufficiency Project, which is a randomly assigned demonstration, suggests that over one in three participants responded to an earnings supplement by leaving welfare for full-time employment.[1]

Recent British studies have attempted to estimate the impact of the tax and benefit reforms announced under this Government and their effect on an unemployed or inactive person's decision whether to enter employment.

One such study[2] estimated that the income tax, NICs and Working Families' Tax Credit package could, on average, increase the expected financial return to work by approximately 8 per cent for men and 7 per cent for women. As a result this could increase the number of people in work in Britain by 47,000 over one-year and by as much as 290,000 over the long-term.

In reaching their conclusions the authors commented that "*the finding is potentially good news for those who see 'welfare-to-work' programmes as a means of reducing unemployment and economic inactivity rates amongst the working-age population*".

Additional evidence from the IFS[3] suggests that the WFTC alone could increase labour market participation by between 10,000 and 45,000 workers depending on take-up of the childcare subsidy.

Because of the forward looking nature of the studies the results should be treated with caution and the authors suggest a wide possible margin of error. However, despite differing methodologies, the findings are unambiguously positive - on average people on benefit have an increased financial return to work and consequently aggregate labour market participation should increase.

[1] W. Lin, P. Robins, D. Card, K. Harknett and S. Lui Gutt (1998) "When Financial Incentives Encourage Work: Complete 18-month Findings from the Self-Sufficiency Project" Ottawa: Social Research and Demonstration Corporation.

[2] Paul Gregg, Paul Johnson and Howard Reed "Entering Work and the British Tax and Benefit System" The Institute for Fiscal Studies, March 1999.

[3] Cited in the Bank of England Inflation Report, February 1999, page 31.

Working Families' Tax Credit, delivering a minimum income guarantee for those seeking to move off benefit and into work. Consideration of the Employment Tax Credit will draw on lessons from the implementation of the Working Families' Tax Credit.

4.81 As a first step towards this long-term goal an employment credit was introduced in October 1999, delivering a minimum income guarantee for over-50s returning to work, as described earlier in the chapter.

SECURING PROGRESSION IN WORK

4.82 Getting a job is the first step to getting a better job, but the Government is also committed to helping people to move up the earnings ladder by enhancing their skills once in work. The key to delivering this is the Government's strategy to provide lifelong learning opportunities for everyone in the workforce, ensuring access to the training and skills necessary for the modern, dynamic labour market.

Lifelong learning

4.83 By providing the right rewards, people can be encouraged to break out of the poverty trap. But all too often people find they do not have adequate skills to make the leap into better paid work. At the same time businesses report significant deficiencies in vocational skills. In order to gain the vocational skills businesses require for higher paid work, many people first need to upgrade their basic skills.

4.84 Countering deficiencies in vocational and basic skills can only be done by building a new culture of lifelong learning. Proposals to begin to tackle these problems were set out in the Government's White Paper *Learning to Succeed*, see Box 4.6.

4.85 Individual Learning Accounts will enable individuals to take responsibility for their own future and to increase their knowledge and skills, so improving their employability. But it is not just the individual who gains from training. Helped by training providers, colleges or the new University for Industry, employers can take responsibility for improving the skills of their workforce, because businesses that train their workforce will not only increase their productivity but are also more likely to retain their workers.

4.86 In the March 1999 Budget, the Chancellor announced an allocation of provision from the Capital Modernisation Fund sufficient to create up to 1000 ICT Learning centres. Though they will be open for all, the centres will focus on adults with no or low skills, who will be able to achieve basic qualifications in ICT and acquire further qualifications through ICT. The discounts available through Individual Learning Accounts will complement this initiative.

4.87 Building on the BBC's Webwise campaign this month, the Government will invest £25 million from DfEE's Service Development Fund to **make opportunities available for up to 50,000 more people to get the ICT skills they need to increase their employability**, and, if they need it, to improve their basic literacy and numeracy skills at the same time. The Government will guarantee widespread promotion of these opportunities.

Box 4.6: "Learning to Succeed"

The failings of the education system in the past have left us a legacy of poor basic skills, which affects those in work as well as those without jobs. Many people in work find themselves trapped in a "low pay, no pay" cycle and that they have inadequate skills to gain better paid work. At the same time businesses report major deficiencies in vocational skills.

The problem for many people starts long before they enter work. Over 160,000 young people between 16 and 18 - around one in 11 of the age group - are neither in learning nor in work. Moreover, six per cent of this age group spend more than six months out of learning or work, and three per cent spend more than a year out of learning or work. The effects of this are long lasting, with non-participation in education, training or employment at age 16-18 being a major predictor of unemployment at 21.

Our failure to educate these young people has produced basic skill shortages. The Moser report, published earlier this year, noted that seven million adults have severe problems with basic skills. One adult in five has lower levels of literacy and numeracy than is expected of an 11 year-old. Without the foundation of such very basic but essential

skills, individuals face severe disadvantages at work and have little chance of being able to learn the more complex vocational skills that employers need.

To tackle this underachievement, we need to revolutionise the way we deliver training for those in work. Many learners do not want to be tied to the classroom and want to learn in more informal self-directed and flexible ways - be it in the evenings or at weekends, in the work place or at home. Flexible learning methods are essential if we are to attract into learning those for whom traditional methods failed.

"Learning to Succeed" proposed a number of changes to the way we deliver training. For the first time, training delivery and planning to tackle skill shortages will become the responsibility of one body, the new Learning and Skills Council. It will have a dedicated sub-council focused on increasing skill levels for adults and will work in partnership with employers, Regional Development Agencies and the Small Business Service to ensure the skills we need to learn are the skills that people are taught.

4.88 The Comprehensive Spending Review allocated an extra £19 billion for education over this and the next two years. This investment, an increase in education spending of 5.1 per cent a year in real terms between 1998-99 and 2001-02, will help raise achievement, improve skill levels and increase employability.

The New Deal providing skills

4.89 The New Deal for 18-24 year olds offers a £750 in-work training grant for young people who are on options. As discussed earlier in the chapter, an in-work training grant of up to £750 is available to participants in the New Deal 50 plus. These grants will help people to develop their skills, thereby providing opportunities for people to climb the earnings ladder. In addition, similar grants are being piloted for lone parents through the New Deal.

4.90 Programmes to equip people with the specific skills they need to enter a particular industry, and to progress once in work, are also being run within the New Deal. A customised gateway to train people to enter the construction industry is being trialed in Manchester, and the Government is exploring the possibility of extending this on a national basis. A sector specific strategy for the engineering and manufacturing sector is also being developed.

Childcare in Further Education colleges

4.91 Some 38 per cent of those lone parents out of work have no qualifications. Without access to childcare many lone parents find it difficult to take meaningful advantage of their entitlement to free access to Further Education places to gain qualifications that will help them find jobs. Current funding for childcare in Further Education colleges is inadequate and is too administratively complex.

4.92 A new package will abolish the Further Education Funding Council (FEFC) tariff - used by only half of all colleges at present, and add its funds to £5 million of Access Fund money. **A further £12.5 million, from within the Departmental Expenditure Limit of DfEE will be added to Access Funds dedicated to childcare. This will help create places for 10,000 more children, an increase of a third**.

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[1] The nine Pathfinder Areas are the Black Country, City Pride Manchester, Dorset, Durham, Edinburgh East and Midlothian, Hull, North Derbyshire, North East Wales and Oxfordshire. [back]

5

Fairness for families and communities

The Government is committed to building a fairer and more inclusive society in which everyone can contribute to and benefit from economic prosperity. In particular, it is pursuing an extensive programme to tackle the causes of poverty, especially child poverty which it is committed to abolishing within the next 20 years.

The key elements of the Government's strategy to meet these aims include:

- **support for families and children to give every child the best possible start in life, with increased support for all families while targeting extra resources on those who need help the most;**
- **fairness for pensioners, through the Government's commitment to ensure that pensioners who have contributed a life of work and caring share fairly in the increasing prosperity of the nation;**
- **delivering strong public services as the bedrock of strengthening communities and increasing fairness for all, with an increased focus on outputs and efficiency;**
- **promoting the role of the voluntary and community sector and the work of charities; and**
- **ensuring a fair tax system which encourages work, promotes saving, raises sufficient revenue to pay for high quality public services and tackles tax abuse and avoidance.**

INTRODUCTION

5.1 The previous two chapters have discussed the importance of raising productivity and increasing employability for improving the economy's long-term growth potential. But quality of life and economic prosperity cannot be measured by these factors alone. The Government is committed to building a fairer and more inclusive society in which everyone can contribute to and benefit from economic prosperity. A strong and productive economy is one which maximises the potential of every individual, regardless of gender, disability, family circumstance or where they live.

5.2 Work - where it is an option - provides the best route out of poverty and social exclusion. It helps people to become more independent, rather than locking them into dependency. Chapter 4 discusses the Government's strategy to provide employment opportunity for all.

5.3 At the heart of the Government's economic agenda, therefore, is a society in which no group or individual is trapped in poverty, or socially excluded. It recognises that while those who can work have a responsibility to do so, those who cannot have a right to security and support. Opportunity has to be looked at in a dynamic context. It is people's lifetime trajectories that matter most, not simply their current status. Support must therefore be available at the right time in people's lives, to prevent problems becoming entrenched and opportunities being denied.

5.4 In October 1999, the Government published the first of its annual poverty reports. *Opportunity for all: Tackling poverty and social exclusion* sets out the Government's strategy to tackle poverty. The Government has demonstrated its commitment to tackling the wider problem of social exclusion by setting up, in December 1997, the Social Exclusion Unit. It occupies a central position at the heart of Whitehall challenging traditional approaches to social exclusion and producing "joined up solutions to joined up problems".

5.5 In particular, Britain's level of child poverty is unacceptably high. Evidence shows that disadvantage in childhood frequently leads to disadvantage in adult life, with adverse implications for educational attainment, incomes and employment opportunities. In this way, poverty can lead to a cycle of disadvantage that persists across generations. The Government's long-term economic ambition is to halve child poverty by the end of the next decade as the Government moves forward with its commitment to end child poverty in Britain within the next twenty years. The Government attaches the highest priority to supporting families with children.

5.6 Having access to high quality public services is an important factor in delivering a better quality of life. The Government recognises the vital importance of health and education and has announced that it will spend an extra £40 billion over the three years from April 1999 to embark on a long-term programme of modernisation to bring standards up to those of the very best. Spending on public services for future years will be allocated in the 2000 Spending Review.

5.7 Ensuring adequate Government resources for these priorities partly relies on achieving high and stable levels of economic growth. But it also requires prudent management of the public finances, careful prioritisation of spending programmes and the assurance that everyone pays their fair share of tax.

5.8 Strong and safe communities are an essential element of ensuring a fair and inclusive society. The Government believes that everyone should have access to a decent home in a neighbourhood in which they feel safe to live. Community and voluntary groups and charities also have an important role to play in strengthening community life. The Government recognises that solutions do not always come top down from government, but bottom up from the community itself. Often, the most effective solutions are those which bring voluntary and community action, the private sector, and the Government together.

5.9 The physical environment in which we live also affects our quality of life. Chapter 6 discusses the Government's strategy to protect the environment, for current and for future generations.

5.10 This chapter describes how the Government is applying these principles to help deliver a fairer society and a better quality of life for all. It describes the Government's approach to, and support for, the following:

- families and children;
- people with disabilities;
- pensioners;
- saving and pensions;
- high quality public services;
- strengthening community life; and
- fairness in the tax system.

SUPPORT FOR FAMILIES AND CHILDREN

5.11 The Government recognises that realising Britain's long-term economic potential means investing in our children. Today's children will be our future teachers, our doctors, scientists, employers, workforce, and parents. Society must give them the opportunity to achieve their ambitions. The Government therefore sees it as a national goal that every child should have the best possible start in life. This approach is based on two principles:

- increasing support for all families with children, recognising the extra costs and responsibilities that all parents face when their children are growing up. All families should have access to high quality public services and should receive financial support through the tax and benefit system;
- providing support in the fairest way, targeting extra resources on those who need help the most. Targeted help includes:
    - focusing help on the poorest families, and tackling child poverty;
    - recognising individual needs and the specific problems of particular groups or geographical areas, such as inner cities or children leaving care; and
    - making sure support is available at the right time in children's lives, to prevent problems before they become entrenched.

Box 5.1: The Government's first annual poverty report, 'Opportunity for all: Tackling poverty and social exclusion'

'*Opportunity for all: Tackling poverty and social exclusion*', the Government's first annual report on poverty and social exclusion, was published on 21 September 1999. It sets out the Government's strategy to tackle poverty and reduce social exclusion by:

- **providing opportunities for everyone to fulfil their potential;**
- **tackling the causes of poverty and social exclusion as well as alleviating the symptoms; and**
- **investing in individuals and communities by giving them the means to help themselves.**

The report also identifies key indicators of poverty and social exclusion and the main policy milestones which the Government will publish in future editions of the report to monitor progress. These indicators include measures of worklessness, low incomes, health and poor housing, reflecting the fact that poverty is a multi-dimensional and complex problem.

Child poverty and life chances

5.12 In Britain, poverty and inequality have increased dramatically since 1979. By 1997, 12 million people lived in households with less than half average income almost a quarter of the UK population. Children have fared worse than the rest of the population, with 4.4 million a third of all children living in relative poverty by 1997. The accompanying paper *Supporting Children through the Tax and Benefit System*[1] describes how the evidence on child poverty has informed Government policy. It explains in detail how policies to reform the tax and benefit system have made a difference to family incomes, and will help to lift up to 800,000 children out of poverty by the end of the Parliament.

5.13 Child poverty is a particular problem as deprivation can worsen children's life chances. The evidence of inter-generational transmission of poverty illustrates that children's outcomes as adults are closely linked to those of their parents. A child's chance of subsequently ending up in the top quarter of the earnings distribution are four times higher if their father was also in the top quarter of the distribution rather than the bottom quarter. Children who grow up in disadvantaged families are also more likely to become teenage mothers and live in social housing, be out of work and have a low income.

5.14 The Government's ambition is to halve child poverty within a decade. Its strategy consists of four key strands:

- improving the financial resources available to families;
- improving educational opportunities for all children;
- special intervention where necessary for example the Sure Start programme is helping families of the youngest children in the most deprived areas; and
- community action building on existing strengths and mobilising whole communities to eradicate child poverty.

Improving financial resources available to families

5.15 All families should be fairly supported through the tax and benefit system. Between 1969 and 1997 the tax burden on families with children increased by nearly 20 per cent under successive Governments. This Government has reversed that trend, and it has increased universal support while ensuring that substantial extra resources are targeted on those who most need help.

Child Benefit

5.16 Child Benefit was introduced in 1977, but has failed to rise in real terms throughout the 1980s and most of the 1990s, and in some years has not even increased with inflation. The Government is committed to the principle of universal Child Benefit, paid to the main carer, as the foundation of its support for children. Since coming into office, the Government has raised the level of Child Benefit for the first child from £11.05 a week in April 1997 to its current level of £14.40 a week an increase of 25 per cent. This represents the largest ever increase in Child Benefit. **As announced in Budget 99, from April 2000 Child Benefit will be increased by a further 3 per cent in real terms, to £15 a week for the first child and £10 a week for subsequent children**.

Targeted support

5.17 As discussed in the accompanying Treasury paper *Supporting Children through the Tax and Benefit System*, families on low incomes face particular challenges and difficulties. As well as increasing support for all families with children, the Government therefore believes that additional resources should be targeted towards those who need help most.

Working Families' Tax Credit

5.18 The Working Families' Tax Credit, launched on 5 October 1999, concentrates help on low and middle income working families. For the first time, the Working Families' Tax Credit is integrating the tax and benefit system to tackle the causes of child poverty. The Working Families' Tax Credit will help to make work pay for families with children. Full details are set out in Chapter 4.

5.19 From April 2000 the Working Families' Tax Credit will provide more generous support for families with young children, **increasing the under 11 credit in the Working Families' Tax Credit by a further £1.10 over and above indexation**.

Children's Tax Credit

5.20 The married couple's allowance and its related allowances will be abolished from April 2000. **It will be replaced by a new Children's Tax Credit from April 2001, available to families with one or more children.** The Children's Tax Credit will be tapered away from families where there is a higher rate taxpayer, ensuring the greatest support for those who need it most. The credit will be worth up to £416 a year, more than double the value of the married couple's allowance which it replaces. Around 4.5 million families will benefit as a result:

- with the Children's Tax Credit and increases in Child Benefit, middle income families who were receiving £11 a week in April 1997 for their first child will by April 2001 be receiving £23 a week, £1,200 a year; and
- the measures that the Government has announced, including those in Budget 99, mean that the net tax burden on a family on average earnings with children has been reduced to its lowest level since 1972.

Income Support

5.21 The Government is supporting all families with children in and out of work, including those on Income Support. Families are most likely to be under financial pressure when their children are young. The Government is therefore targeting extra support for children under 11. Budget 99 announced an additional £4.70 per week from October 1999 for children under 11 in families on income-related benefits. **They will receive a further £1.05 a week in April 2000 over and above indexation.** As a result, compared with April 1997 the Government will be providing almost £10 a week more for each of these children.

A better deal for all families and children

5.22 All of the above measures taken together provide extra support for families with children and mean that 7 million families will be on average £740 a year better off. Families with children in the bottom fifth of the income distribution will be on average £1,080 a year better off. Overall, including the National Minimum Wage and the new 10p starting rate of income tax, these measures will lift 1.25 million people out of relative poverty, 800,000 of them children. They constitute the first step towards meeting the Government's aim to abolish child poverty within a generation.

New measures and future policy development

5.23 Although the reforms so far have delivered extra resources targeted fairly, the Government sees a case for going further in improving the transparency and administration of income-related payments for children through the tax and benefit system.

5.24 The Chancellor announced in the Budget that the Government's long-term goal is to bring together the different strands of support for children in the Working Families' Tax Credit, in Income Support and in the Children's Tax Credit, to create an integrated and seamless system of financial support for children, building upon the foundation of universal Child Benefit.

5.25 An Integrated Child Credit, for those in and out of work, would be paid to the main carer, complemented by an Employment Tax Credit paid through the wage packet to working households, with or without children (see chapter 4). In principle, an Integrated Child Credit would have a number of attractions, providing:

- **a seamless and transparent system of support for children,** helping parents to understand what they could expect to receive, and facilitating public debate about the correct level of support in the context of the Government's aim to abolish child poverty within a generation;

  Gains for families as a result of children's measures announced in Budgets 98 and 99

- a **portable and secure income bridge spanning welfare and work,** which is likely to improve work incentives.

Survey evidence suggests that the financial disruption associated with moving from Income Support into employment often discourages parents from making the transition to work;

- **a common framework for assessment and payment,** which would give every family a stake in the system of child payments while allowing extra resources to be directed at those most in need;
- **a system where all support for children was paid to the main carer,** in line with universal Child Benefit;
- **efficiency gains** for the Government and **reduced red tape** for parents, from moving away from a system where income-related support for children is delivered through four different mechanisms, administered by four separate units covering three government departments.

5.26 The introduction of an Integrated Child Credit would be a major structural reform for the longer term, posing a number of operational and policy challenges. A critical test will be whether the integration of child payments can be delivered efficiently and effectively.

5.27 The Government will also examine whether the Working Families' Tax Credit or other measures can give additional help to the mother who wishes to stay at home in the first months after her child is born.

Improving educational opportunities for all

5.28 While increasing financial resources to all families, the Government is committed to raising standards in education to unprecedented levels, enabling more people to fulfil their potential. Over the three years from April 1999, the Government will be spending an additional £19 billion on education, the highest growth in real terms over any period of three years since 1978-79.

Importance of a good start in education

5.29 Education is a crucial influence upon life chances: the link between education and earnings in later life is strong. In the late 1970s people who stayed on at school beyond sixteen had earnings which were, on average, 40 per cent higher than those who had left school by this age. By 1990 this had increased to 60 per cent. To fulfil their potential in later life, children need:

- the best possible start in education: between January 1998 and September 1999, the number of children in infant classes of more than 30 pupils fell by over 300,000; all infants should be in classes of 30 or fewer by September 2001;

- to meet satisfactory standards of literacy and numeracy at age 11; this year, 70 per cent of pupils aged 11 achieved level 4 in English. This was five percentage points higher than in 1998 and compares with attainment of only 58 per cent in 1996. The target for 2001-02 is 80 per cent. 69 per cent of pupils aged 11 achieved level 4 in Maths. This was ten percentage points higher than in 1998 and compares with attainment of only 54 per cent in 1996. The target for 2001-02 is 75 per cent.

5.30 New measures to tackle exclusion and truancy, Education Action Zones and the Excellence in Cities programme are all helping to ensure that more pupils are able to benefit from full-time education. The Government is also radically re-shaping the delivery of education services, including:

- reform of teachers' pay;
- setting up Information and Communications Technology (ICT) learning centres in up to 1,000 communities across the UK, chiefly to help people of all ages with low basic skills;
- connecting schools to the Internet: 62 per cent of primary schools are now on-line;
- promoting specialist schools: there were 222 when the Government took office; there are now 402 with more to come; and
- 100,000 families will be helped to acquire re-conditioned computers to assist their learning and use of the Internet from home.

5.31 The Government has made PFI credits of £350 million a year available to education in England. But even this provision has been over-subscribed and some very good schemes have not yet found a place in the programme: **the Government is now making a further £100 million of credits available, to enable several more major projects to go ahead**.

5.32 The New Deal for Schools has so far funded improvements at about 11,000 schools. **From the receipts of the**

Windfall Tax, the Government is now adding a further £50 million provision to this scheme across the UK. As an illustrative example this could replace 500 mobile classrooms over 20 years old with classrooms equipped with the latest technology**.**

5.33 The piloting of Education Maintenance Allowances from September 1999 aims to encourage pupils who might leave school aged 16 to remain in learning. Education Maintenance Allowances are already proving popular with young people and their families. All sixteen pilot local education authorities have successfully started making payments to young people or their families. Early evidence points to increases in staying-on rates, particularly by young people from the poorest families.

Special intervention where necessary

5.34 The Government also recognises the challenges and difficulties faced by some families, especially at particular times in their children's lives. The early years of a child's life are critical for its future outcomes, so the Government is increasing its investment in support to help in those early years.

Sure Start

5.35 Sure Start is a new programme which aims to promote the physical, social and emotional development of disadvantaged children between birth and three years old. £540 million has been allocated over the three years from April 1999 to build local programmes and to ensure that every child is ready to learn when they begin school. This money will be spent complementing and enhancing existing services, providing new facilities and information, delivering extra training and improving co-ordination between existing service providers.

5.36 The first 60 trailblazers were approved in October 1999 and will shortly come on stream. They will reach about 50,000 children. As announced in July 1999, a second wave of 69 programmes is expected to be underway by the middle of 2000. Sure Start aims to have 250 programmes up and running by 2001-02, each covering between 50 and 1,000 children under four years of age.

5.37 Sure Start programmes are designed to be accountable to local communities, especially parents. The programmes will be led by partnerships which include local authorities, social services departments, local voluntary organisations and local parents themselves. The Government sees the notion of empowering communities going even further in the future. In time, the Government hopes to devolve to local communities the running of partnerships, putting the communities wholly in charge.

Box 5.2: Ensuring equal opportunity for women

Many of the policies which the Government has announced to support families and children will help to promote equal opportunities for women. The Government believes that gender issues should be considered throughout all aspects of decision-making and policy development.

Over the last year, the Government has carried out a major consultation exercise, 'Listening to Women', to reach those women whose voices are not always heard. The Government is:

- **looking at what more can be done to reduce the pay gap;**
- **making women more informed about money, savings and investment;**
- **making the work:home balance easier by spelling out the benefits of flexible working and improving access to childcare;**
- **giving more encouragement to women thinking of starting up or expanding a business;**
- **helping girls fulfil their potential through better careers advice, better and earlier 'education for life' in schools, and greater participation in sport; and**
- **looking at how Government communicates with women, especially the potential to use IT.**

5.38 In addition, 20 Sure Start Plus pilots will pioneer special initiatives to support teenage parents in Health Action Zones.

Sure Start Maternity Grant

5.39 The period before and immediately after childbirth is important for a child's development. **Budget 99 announced that, to help with the initial costs of having a new child, a new Sure Start Maternity Grant will replace the Maternity Payment from next April, with payments doubled to £200**. The increased payments will be linked to contact with a healthcare professional to ensure expert advice on child development and services.

Community action

Children's Fund

5.40 The voluntary and community sector has pioneered work with deprived children and their families for at least a century. The sector is:

- well placed to reach the families that need support, and is able to avoid the stigma that is often attached to services provided by statutory authorities;
- able to respond to the full range of needs of the child, overcoming the fragmentation that can arise from different statutory authorities having responsibilities for different aspects of the child's needs (health, education, social care);
- quick to meet changing needs as the challenges facing families change over time, responding, for example, to changes in family structure; and
- able to mobilise volunteers to bring opportunities to children that would otherwise not benefit from them - for example, through the scout and guide movements, the playgroups and the many activity-based children's organisations.

£6 billion a year extra on children by 2001

5.41 The Government will establish a Children's Fund in the 2000 Spending Review to develop a new strategic partnership with the voluntary sector in tackling child poverty. The Fund will support pioneering work by voluntary and community organisations with children in poverty - work that makes a real difference to the life-chances of disadvantaged children. In the coming months the Government will explore the best way for the fund to deliver to the voluntary sector and to children, through consultation with organisations working in the field.

The Government's commitment to families and children

5.42 The combined effect of the above measures will be to increase fairness for families with children and boost incomes for the poorest families. Together they form a concerted and comprehensive approach to supporting family life. By the end of this Parliament, the Government will be spending an additional £6 billion a year on children. The increases in Child Benefit for all children have been accompanied by targeted measures - including the new Working Families' Tax Credit - and will lift around 800,000 children out of poverty.

FAIRNESS FOR PEOPLE WITH DISABILITIES

5.43 Last year, the Government set out in '*A New Contract for Welfare*' its commitment to provide help and opportunities for people with disabilities to live fulfilling and independent lives. People with disabilities have a huge contribution to make. The Government is committed to tackling discrimination, giving those who want to work the help and rehabilitation they need, and ensuring dignity and independence to those who cannot:

- **from April 2001, severely disabled people under 60 years of age on income-related benefits will receive a guaranteed income of at least £128 a week for single people and £169 a week for couples.**

- the new Disabled Person's Tax Credit (DPTC) - an in-work tax credit replacing the Disability Working Allowance (DWA) - will increase the gains to work for people with disabilities, improve take-up, and remove the stigma and administrative complexity of a separate benefit claim and cheque. Chapter 4 discusses the Disabled Person's Tax Credit in more detail;

- **removing the obstacles to work from the system by introducing a new linking rule to allow people on incapacity benefits whose job does not work out to return to the same rate of benefit within 12 months;**

- giving extra help for those in greatest need. **Children aged three to four with severe disabilities will receive an additional £37 a week from April 2001 through the extension of the Disability Living Allowance.** Reforms to Incapacity Benefit will provide up to £26 a week more for people who were disabled before the age of 20.

Anti-discrimination measures

5.44 Discrimination against people with disabilities is unacceptable in a fair and inclusive society:

- **by April next year, an independent Disability Rights Commission will promote equal opportunities for disabled people,** enforce the Disability Discrimination Act, and provide advice to disabled people, employers and service providers on a range of disability issues;
- **the Disability Rights Task Force will report at the end of November 1999 on how best to meet the Government's manifesto commitment to comprehensive and enforceable civil rights.** Its recommendations will cover a range of areas including employment, education, the environment, transport and the provision of services; and
- the Government has reduced the employer threshold in the Disability Discrimination Act from 20 to 15 employees. As a result, a further 45,000 employers and 810,000 employees (of whom 70,000 are currently disabled) will be brought within the scope of the Act's employment provisions.

FAIRNESS FOR PENSIONERS

5.45 Pensioners who have contributed a life of work and caring deserve help in their retirement, and the Government remains committed to ensuring that pensioners share fairly in the increasing prosperity of the nation. The Government is ensuring fairness for all pensioners by:

- introducing in 1997, a Winter Allowance for all pensioner households. In Budget 99, the Government announced a five-fold increase in this payment. **This winter, and in subsequent winters, every pensioner household - over 7 million in total - will receive a payment of £100**;
- restoring free eye tests for people over 60 from April 1999;
- protecting the value of the basic state retirement pension this and every year to ensure that purchasing power is fully maintained;
- introducing measures to support tax-paying pensioners. The age-related personal allowances were increased by up to £200 more than statutory indexation in April 1999. As a result of this and other changes introduced in the last Budget, 200,000 pensioners have been lifted out of tax. Pensioners aged 65 or more now need to have an income of at least £110 a week before they pay any income tax; and of those that do pay tax, around 1.5 million will each benefit from the Government's decision to extend the 10p rate of income tax to saving income from April 1999.
- recognising that many pensioners receive private income which is fixed in cash terms and are hence vulnerable to high rates of inflation. The historically low and stable rates of inflation which the Government's new monetary policy framework is delivering will therefore help to protect the real value of savings, and ensure that supplementary pensions will not be eroded as they were previously by high rates of inflation;
- significantly **increasing the funding for the Home Energy Efficiency Scheme,** (HEES) which from next year will focus on those at greatest risk from the effects of fuel poverty. The new scheme will offer a complete package of measures. For over-60s in receipt of a qualifying benefit these include central heating systems with the maximum grant rising from £315 to £2000; and
- **providing better security in the homes of pensioners in less prosperous neighbourhoods** from next summer operating alongside the HEES. Up to £11 million will be made available to fit free security packages to vulnerable homes in high crime areas.

5.46 In addition to these measures, free TV licences will be available to pensioners aged 75 and over from autumn 2000. Over three million households - nearly half of which are in the bottom three income deciles - will benefit from this measure, targeted on those pensioners most in need.

Targeted support

5.47 The Government has also focussed additional help on pensioners in most need:

- a minimum income guarantee for pensioners who were unable to build up significant or adequate pension provision during their working lives. This guarantees a minimum income of £75 a week for a single pensioner and £116.60 a week for pensioner couples, subject to income and capital rules. **The Government will increase the minimum income guarantee in line with earnings growth in April 2000 to £78.45 for single pensioners and £121.95 for couples.** The Government will continue to uprate the minimum income guarantee in line with average earnings throughout the remainder of this Parliament;

- the spending allowance for pensioners (and other people on Income Support) in residential care and in nursing homes will be increased by the rate of earnings growth in April 2000; and
- the Government is seeking to ensure that the minimum income guarantee and other benefits are as effective as possible by taking steps to identify why many pensioners do not claim all the benefits to which they are entitled. **The Department of Social Security will launch a campaign in spring 2000 to improve benefit take-up and encourage more people to claim what they are entitled to.**

5.48 As a result of the pensioners package, all pensioners are better off. After all announced measures have been introduced, pensioner households will be on average £300 a year better off. These measures demonstrate that the Government is meeting its commitment to help pensioners.

SUPPORTING SAVING AND PENSIONS

Government's strategy on savings

5.49 The Government has an over-arching strategy on savings, in line with its objectives of:

- encouraging work for those who can, while providing security for those who cannot;
- encouraging people to take responsibility for their own financial security throughout their lifetimes; and
- increasing the public awareness of, and investor confidence in, savings and pensions, through reforming the regulatory framework.

5.50 The Government wants to encourage more people to save for the future. For example, half the population have savings of less than £200 and up to four million people earning between £9,000 and £20,000 a year do not contribute further to their pensions above the compulsory minimum. The Government therefore wants to work with the savings and pensions industry to produce a financial environment which will encourage the emergence of low cost, good value and easily understood savings and pensions products.

10p rate and savings

5.51 Within this strategy, the Government has announced that it is extending the 10p rate of income tax to savings income with effect from April 1999. As a result over 2.5 million people will see their tax bill decline by up to £150 - £30 on average - many of whom (1.5 million) will be pensioners. Corresponding changes will be made to capital gains tax from April 2000 to keep it in line with the tax rates for savings.

Individual Savings Accounts

5.52 Individual Savings Accounts (ISAs) were introduced in April 1999 as part of the Government's strategy to encourage savings. Cash ISAs have been highly popular, taking almost £4 billion and the stocks and shares component has also experienced significant take up (about £3.2 billion in the first quarter).

5.53 ISAs are helping to extend the savings habit to those with little or no savings and encourage saving, mainly for short to medium-term needs, within a tax-free environment. ISA savers can put money into a tax-free bank or building society account, including National Savings, life insurance products, and stocks and shares. And savers can use ISA CAT standards to recognise easily products with fair Charges, easy Access and decent Terms.

Stakeholder Pensions

5.54 At the same time, the Government has set out a framework for flexible, secure and value-for-money stakeholder pension schemes. It wants to encourage those who can to join good-value occupational pensions but there are about 5.3 million people on middle incomes who do not have such occupational pension provision. Many of this group lack any secondary tier pension and find current pension arrangements either unsuitable or too expensive. Stakeholder pensions are intended as a good value, low cost alternative primarily for this group.

5.55 As part of the stakeholder development, the Government has recently proposed the introduction of an integrated tax regime for all pensions other than final salary schemes. Under these radical proposals, contributions could be made up to £3,600 a year without reference to earnings. This opens up pensions to many who do not currently have access to a second pension such as carers, and mature students. These proposals have been very well received, both by independent commentators and by the pensions industry.

5.56 The Government has also proposed that all pensions vehicles, including stakeholder pensions, should be able to invest in a Pooled Pension Investment (PPI). The PPI is a financial instrument which would make it easier and cheaper for people to transfer their savings between pensions and help reduce the confusion that pensions can sometimes cause.

Coordinated savings policy

5.57 The stakeholder and ISA initiatives are fully compatible since:

- they offer more choice to savers to meet their needs for different lifetime events. For example an individual can save in an ISA and could then move some or all of those funds (up to £3,600 pa regardless of their earnings) into a stakeholder pension;
- furthermore, and subject to the annual subscription limit, a person can make a transfer of shares into an ISA from a tax-approved all-employee share scheme; and
- most people will find it easier to put money withdrawn from an employee share scheme into their stakeholder pension. The best means of achieving such transfers is currently being considered as part of the development of the stakeholder pension arrangements.

5.58 Together, these measures provide a clearer and simpler framework than available in the past, within which people will be better able to make well-informed decisions about how best to provide greater financial security for their own and their families' futures.

HIGH QUALITY PUBLIC SERVICES

5.59 Everyone is entitled to expect access to high quality public services, including good schools and a modern health service. In particular the Government has embarked upon a programme of modernising public services, the first results of which are already becoming apparent.

Focusing on outputs and improving service delivery

5.60 On coming into power the Government reviewed the spending plans it inherited. The Comprehensive Spending Review (CSR), completed in July 1998, re-allocated Government expenditure to its key priorities for the three financial years from April 1999.

5.61 Over the three years from April 1999, the Government is investing an additional £40 billion in health and education, as well as investing for reform in other areas of the public services. It is focusing on concrete improvements and service delivery, and has set over 600 output and efficiency targets through Public Services Agreements (PSAs). These are being closely monitored in order to ensure that services become more modern, efficient and responsive, bringing all areas up to the level of the best. The Government will report on progress against these targets in spring 2000.

5.62 The Government's emphasis on improving outputs from public services is demonstrated by significantly increased provision for renewal, reform and modernisation of the UK's infrastructure. The Government has set up a £2.5 billion Capital Modernisation Fund to support innovative capital projects which will improve the quality of public service delivery.

5.63 The Government also believes in applying private sector expertise to raising public sector productivity where appropriate. The Public Sector Productivity Panel is working with government departments to highlight and tackle key areas for improvement. The Government also believes that many of the best ideas for improving efficiency will come from within public services themselves. The Invest to Save Budget therefore allows services to bid for funds for innovative projects which will improve efficiency and effectiveness through joint service delivery.

5.64 The Government is determined to further improve public services as the bedrock to strengthening communities and increasing fairness for all.

Education

5.65 Reflecting the importance it places on education, the Government is investing an additional £19 billion in education over three years from April 1999, doubling the capital budget for schools, expanding further and higher education and providing resources to meet its manifesto commitment on reducing class sizes for children aged 5, 6 or 7.

Health

5.66 One of the Government's central objectives is to improve the health of the nation, especially that of those on low incomes, delivering care of a uniformly high standard right across the country. An additional £21 billion has been allocated to health over the three years from April 1999.

Transport

5.67 The CSR announced that spending on transport, excluding one-offs, will increase by 27 per cent in real terms between 1998-99 and 2001-02 - an additional £1.8 billion. The CSR gave priority to tackling the road maintenance backlog, improving traffic flow, and improving and integrating public transport.

Crime and Justice

5.68 The Government is investing significant additional resources in tackling crime and the causes of crime. Over three years (1999-2002) it will put an extra £1.24 billion into the police in England and Wales, and spend £250 million on a Crime Reduction Programme to fund promising new approaches.

2000 Spending Review

5.69 As discussed in chapter 2 the 2000 Spending Review will review the efficiency with which public services are delivered and public money is spent, and will consider how best departments can contribute to the achievement of the Government's objectives.

STRENGTHENING COMMUNITY LIFE

5.70 Strong community networks are an essential foundation for the future success and prosperity of the nation. A strong community gives its members freedoms and responsibilities - freedom to work and earn a living, responsibilities to care for the weaker, younger or older members of the community. A strong community is able to adapt to a constantly changing environment and use the experience of all its members to meet new challenges.

5.71 In addition to improving access to all public services, the Government recognises individual needs and the specific problems of particular groups or geographical areas. To deliver a better quality of life for all, and a fairer and more inclusive society, the Government is supplementing investments in all public services with a number of targeted initiatives to strengthen community life.

The New Deal for Communities

5.72 The New Deal for Communities puts local people in charge of their own futures. It provides the resources they need - in partnership with business and the statutory agencies - to close the gap between their neighbourhoods and the rest of the country. The Government has set aside £800 million for the programme over the three years from April 1999. The New Deal for Communities is set against four key outcome goals:

- higher levels of employment;
- better health;
- higher educational attainment; and
- lower crime.

5.73 A further 22 communities will shortly be invited to join the New Deal, and the Government will respond to the first of the 17 pathfinders' detailed delivery plans. National targets for the programme as a whole will be announced shortly.

5.74 Business has a key role to play if the New Deal for Communities is to succeed in bringing jobs and enterprise back to deprived urban neighbourhoods. Last year the Government provided a further incentive for businesses to engage with schools by reintroducing tax relief on the salaries of staff seconded from business to educational establishments. The Government is now considering whether more needs to be done to make sure business secondments to regeneration partnerships can benefit from the same advantages. The New Deal for Communities will be fully monitored and evaluated to ensure that the lessons learnt can benefit other deprived neighbourhoods.

Box 5.3: Our wider community: debt forgiveness for the Heavily Indebted Poor Countries

Poverty and social exclusion are international as well as national issues. Not only does the Government have a moral obligation to help those in suffering worldwide, but the British people themselves have a natural sympathy for those in need. Poverty breeds conflict, disease and environmental problems. As the world becomes a smaller place, these overseas problems increasingly become our problems. The Government is committed to the International Development Target of halving world poverty by the year 2015: debt relief is an important part of achieving this goal.

The first agreement on a strategy to reduce the debt burdens of the poorest countries the Heavily Indebted Poor Countries (HIPC) Initiative was reached at the Annual Meetings of the World Bank and IMF in 1996, but by 1997 not one country had been through the process. Concerned that debt relief was not sufficient and was not getting through fast enough to the countries that needed it, the Government launched its Mauritius Mandate soon after coming to office in order to speed up the timetable of countries coming forward for assistance.

In September 1998, the Government called for, and got agreement to, a review of the HIPC Initiative. It has since led the way in proposing an improved HIPC Initiative, and at the IMF-World Bank Annual Meetings in September 1999 an enhanced framework was agreed. This will:

- **provide faster, deeper and broader debt relief;**
- **make it possible for three quarters of eligible countries to reach their decision points by the end of 2000 and for the remaining countries to embark on the process as soon as possible thereafter;**
- **link debt relief directly to poverty reduction; and**
- **mean that, together with the forgiveness of Overseas Development Debt, the debt burden of 38 HIPC countries should be reduced by some $100 billion.**

More importantly though, this debt relief will go not to finance military weapons or bureaucracy, but to the social priorities of improving basic health and education and the reduction of poverty. A new IMF-World Bank Poverty Reduction and Growth facility will help to ensure:

- **better targeting of budget resources on health and education;**
- **better monitoring of country's expenditures;**
- **country ownership of the poverty reduction process; and**
- **monitorable performance indicators.**

In order to fund the enhanced HIPC initiative, a new HIPC Trust Fund has been set up. The UK Government is contributing $221 million to the Trust Fund - the largest bilateral pledge with the exception of the US. In addition, the UK Government has persuaded the European Union that monies from the European Development Fund should be made available for debt relief up to 1 billion euros.

These developments, which the UK Government has been at the forefront of bringing about, offer new hope to families and children in the world's poorest countries. By targeting resources on priorities in health and education, including prevention and treatment of AIDS and measures to reduce infant mortality, real social progress can be achieved. The Government will follow the progress of these poverty reduction measures carefully and will maintain its leadership in this area. In the long run, the key measure of success will be not just how much debt is cancelled, but how many people in the world community are lifted out of poverty.

Housing

5.75 Housing policies are central to building strong communities, but in the past they have often had the opposite result, creating unbalanced communities and concentrations of deprivation. The Government's aim is to avoid this by building communities that involve a mix of tenures and by improving the way the social housing sector works.

5.76 Social tenants need to be given more choice and social landlords need to deliver a better service to their communities. The newly created Housing Inspectorate and the success of the transfer programme should both contribute to these aims. Progress also needs to be made on achieving a more coherent pattern of rents in the social housing sector.

5.77 The Government will set out its housing vision in a Housing Green Paper which it expects to publish early next year. The Green Paper will also consider ways of improving the housing benefit system.

National Strategy for Neighbourhood Renewal

5.78 Communities suffering from multiple deprivation need special help. **The Government's *National Strategy for Neighbourhood Renewal*, which is currently being drawn together by the Social Exclusion Unit to be published next year, will set out a comprehensive long-term agenda for tackling the problems of Britain's poorest estates**. The strategy will draw on the reports of the 18 inter-departmental fast track Policy Action Teams, which have brought together policy makers from across Whitehall, outside experts, and those on the ground to take a renewed look at issues facing low income estates.

Capacity building in local communities

5.79 Social enterprises are businesses run for social goals not for profit. They can play a significant role in the regeneration of local economies by providing missing goods and services, as well as employment opportunities. The activities of social enterprises range from credit unions, local finance initiatives and retailers to operators of childcare facilities. The contribution this sector makes to the regeneration of deprived areas is, however, inhibited by difficulties in accessing support services and finance, due to a lack of awareness and understanding of their needs by providers.

5.80 The Small Business Service and Regional Development Agencies, together with local authorities, have key roles to play in recognising the contribution that social enterprises can make to neighbourhood regeneration. Chapter 3 describes a series of new measures to stimulate comprehensive and effective service delivery through locally-rooted partnerships between the public and private sectors.

Our wider community

5.81 The Government also recognises our moral obligation to help those in need worldwide. Box 5.2 describes the Government's recent efforts to reduce the debt burden of the world's poorest countries.

The vital role played by the voluntary and community sector

5.82 Voluntary and community activity is fundamental to the development of a democratic, socially-inclusive society. Community self-help groups solve local needs - such as the need for children's playgroups - by engaging local skills and enlisting volunteers. Voluntary organisations often act as pathfinders, involving users in the design and delivery of services and bringing new issues to light . The voluntary and community sectors are important agents of change, enabling society to adapt continually and informing government of the changing needs of its citizens. The Government is currently promoting the voluntary and community sector through a series of initiatives:

- The Millennium Volunteers and Older Volunteers initiatives, launched last year, aim to encourage a more active role in local communities by young and older people alike;
- **Investing £3.7 million over three years to help black and minority ethnic volunteering organisations gain access to mainstream expertise and funding;**
- **Investing almost £1 million this year in a national database of volunteering opportunities;**
- **Piloting two funds to support community entrepreneurs and small community groups in deprived areas (£500,000 this year).**

Review of charity taxation: *Getting Britain Giving in the 21st Century*

5.83 Charities make an enormous contribution to the life of the nation. In fields as diverse as poverty relief, the arts and international aid, millions of people in the UK give their time, their money or both to charities and other voluntary organisations. In parallel with its wider policies, the Government has undertaken a comprehensive review of charity taxation, including a consultation exercise which invited responses to a wide-range of proposals aimed at encouraging more people to give to charity and modernising the tax system as it affects charities.

5.84 Independent research has shown a decline in recent years in the number of people giving to charity. Research undertaken as part of the review of charity taxation shows that the UK is still a nation of givers. However, although a large proportion of the population are aware that there are tax effective ways of giving, fewer than 10 per cent of givers take advantage of them. These findings confirmed that there is a pressing need to make the tax incentives for giving more attractive and easier to use, and to increase awareness of them.

5.85 In the light of the responses to the consultation and the research findings, the Government has decided to go further than the proposals that were set out in the consultation document[2], with a radical package of measures to encourage more individuals and businesses to give more, and to make the taxation system simpler for donors and charities to use. Most of these measures will be enacted in the 2000 Finance Bill or through regulations as necessary.

Deed of Covenant and Gift Aid

5.86 The Deed of Covenant scheme provides tax relief on regular, fixed donations to charity over a period of at least three years. There are no maximum or minimum amounts for donations. Gift Aid provides tax relief for one-off donations to charity. There is no maximum limit for donations, but there is currently a minimum limit of £250, which must be paid in a single payment. The consultation exercise and the research show that while there is much support for a tax relief for regular giving to charity, many find the Deed of Covenant scheme complicated to use. The responses to the consultation also show that the minimum limit for Gift Aid donations makes that scheme inaccessible to many donors.

5.87 The Government has therefore decided to remove the minimum limit for Gift Aid donations, so that the scheme will apply to all donations, large or small, one-off or regular. There will no longer be a need to enter into a deed of covenant to get tax relief for regular, small donations, although donors will be able to continue using a deed if they wish. In addition, the Government is reforming the Gift Aid rules to make the scheme more accessible to low-income donors who pay tax at a rate below the basic rate. These changes will take effect in April 2000.

Boosting the Payroll Giving Scheme

5.88 Under the Payroll Giving scheme, employees authorise their employer to deduct charitable donations from their pay packet and receive tax relief on the donation at their top rate of tax. There is relatively low take-up of the scheme by employers and employees. Responses to the consultation and the research indicate that there is considerable untapped potential for Payroll Giving. 21 per cent of respondents to the research exercise whose employer did not offer the scheme said that, were their employer to offer the scheme, they would be likely to take it up. The Government has therefore decided to boost Payroll Giving with a promotional campaign, starting in the summer of 2000, to increase awareness of the scheme and encourage more employers to offer the scheme to their employees and operate it more effectively. To back up the scheme, the Government has also decided to introduce a 10 per cent supplement on donations, to be paid to charities from April 2000 for three years. In addition, the Government has decided to remove the £1,200 maximum limit for Payroll Giving donations.

Other measures to encourage giving

5.89 The Government has also decided to introduce further new tax reliefs to encourage giving to charity, including new income tax reliefs for gifts to charity of quoted shares and securities and for people who settle property on trusts for charity.

Making life easier for charities themselves

5.90 For tax and charity law reasons, charities who want to raise funds from trading activities normally have to set up a trading subsidiary which then pays all its income to the parent charity under a deed of covenant or Gift Aid. This is a burdensome arrangement for smaller charities. The Government has therefore decided to introduce a de minimis exemption which will allow charities that engage only in small-scale trading activities to do so directly, without the need to set up a subsidiary company. Broadly the exemption will apply to all trading with a turnover of less than £5,000, and where the trading turnover represents less than 25 per cent of the charities' total income, up to a maximum of £50,000. The Charity Commission for England and Wales supports this proposal and has confirmed that this could significantly reduce the need for charities to set up trading subsidiaries. The existing tax and VAT exemptions for indirect tax treatment of charity fundraising events will also be changed to exempt a wider range of events and to align them to produce consistent treatment. New measures will also be introduced to make the VAT tax system more generous for specific transactions such as advertising.

FAIRNESS IN THE TAX SYSTEM

5.91 Unfairness in the tax system can take various forms. For example, where individuals and businesses develop schemes to avoid paying tax or National Insurance Contributions (NICs), or to defer or reduce their liabilities, it leads to a higher burden of tax falling on the majority of taxpayers. But also the detailed workings of the system may unintentionally skew the distribution of the tax burden in favour of particular groups of individuals or businesses and against others. The Government is committed to addressing unfairness in the tax system, whatever form it takes.

Tackling tax abuse

5.92 Tax driven schemes, devices and structures, if allowed to flourish unchecked, not only cause ordinary taxpayers to have to make good the resultant loss of revenue but can also give one business an unfair competitive advantage over another. They can also undermine the credibility of the tax system generally. The Government remains firmly committed to tackling tax abuse and avoidance.

5.93 Among the key measures the Government is introducing to tackle avoidance and protect the revenue base are:

- **new rules to stop avoidance of tax and NICs through the use of personal service companies by workers who would otherwise be treated as employees.** Announced in the last Budget, these proposals have been revised in the light of extensive consultation with industry, and will take effect from April 2000. The necessary NICs legislation is contained in the Welfare Reform and Pensions Bill, and the necessary tax legislation will be included in Finance Bill 2000;
- **new rules to prevent avoidance of capital gains tax through arrangements using gifts relief on the transfer of shares to companies by individuals and trustees.** Gifts relief on such transfers will be withdrawn for transfers on or after today; and
- **changes to the tax rules for Controlled Foreign Companies (CFCs) to counter the use of so called designer rate regimes in Guernsey, Jersey, the Isle of Man, Gibraltar and Ireland.** These changes were announced in an Inland Revenue Press Release on 6 October 1999 and will apply to CFCs' accounting periods beginning on or after that date.

5.94 Faced with growing avoidance of Stamp Duty, the Government will bring forward changes in Finance Bill 2000 to prevent the use of devices which seek to reduce the rate at which duty is payable. The Government is also considering how best to modernise Stamp Duty legislation so that any new devices can be countered as they arise.

5.95 The Government also remains committed to international initiatives aimed at fighting tax abuse and evasion and promoting fair tax competition. Harmful preferential tax regimes distort investment decisions and erode tax revenues, thereby undermining fiscal stability. British business has much to gain from being able to compete internationally on a level playing field.

Tobacco

5.96 Tobacco use is detrimental to health, with significant wider social costs. The price of tobacco plays an important role in cutting levels of smoking. The increases under the current escalator, which was introduced by the previous Government in 1993 and increased under this Government, have been effective in increasing the cost of tobacco.

Forestalling

5.97 However, the success of this policy has been threatened by increases in tax evasion and tax avoidance. Predictable annual increases have encouraged tobacco manufacturers and importers to build up large stocks of cigarettes in the months leading up to a Budget change and pay duty on their accumulated stocks only very shortly before the Budget increase takes effect. In this way they have been able to avoid paying the new, higher, rate of duty for up to six months, and have therefore been able to avoid passing it on in prices. It also costs the public purse some £300 million a year and leads to greater uncertainty over the timing of revenue flows to the Exchequer.

Smuggling

5.98 Smuggling undermines legitimate businesses, puts consumers at risk, and erodes social responsibility through the participation of many normally law-abiding people in illegal acts.

5.99 Customs' latest estimates for revenue lost (excise duty and VAT) through cross-Channel smuggling in 1999 and cross-border shopping in 1998 are set out in table 5.1 below:

Table 5.1: Revenue lost through cross-Channel smuggling and legitimate cross-border shopping

£ million	Cross-border shopping in 1998	Cross-Channel smuggling in 1999
Tobacco	85	1,055
Alcohol	290	215
Total	375	1,270

Figures have been independently rounded to £5 million. Components may not therefore sum to the totals shown.

Figures do not include any amounts for smuggling by air passengers, or revenue evaded through commercial fraud or in very large freight consignments.

The figures shown use Customs' assumption that between 70 per cent and 80 per cent of all alcohol purchased abroad substitutes for similar purchases in the UK.

5.100 Customs' latest assessment of overall revenue losses associated with all forms of tobacco smuggling in 1999 is of the order of £2$^1/_2$ billion.

5.101 The Government will take further steps to ensure that tobacco smuggling does not pay. Having taken advice from Martin Taylor, the Government will introduce a range of measures designed to tackle the evasion of tax on tobacco. These will include:-

New technology

5.102 This year, almost £1$^1/_2$ billion of revenue is expected to be lost through illegally-imported tobacco hidden in freight containers. The Government will invest in a national network of x-ray scanning equipment. A start will be made immediately. There is a range of technology being developed:

- **mobile scanners** are relatively small and completely mobile. They are ideal for scanning small vehicles and small containers. Their mobility makes them suitable for rapid re-deployment as smuggling patterns change and they will be a valuable deterrent to smugglers shifting traffic in order to try and avoid detection. The intention is to deploy a number of these;
- **relocatable scanners** - capable of providing a good quality image are suitable for larger containers and can be dismantled, transported and re-installed in a matter of days. They will enable Customs to respond quickly to changing smuggling patterns; and
- finally, **fixed scanners** are capable of providing high powered images of the contents of large containers.

Pack marks

5.103 From early 2001cigarette packs and hand rolling tobacco pouches sold in the UK will be required to carry a mark to show that UK duty has been paid on them:

UK DUTY PAID

Not to be sold after
(date)

5.104 The complete pack mark will fill the centre of the top third of the front face of the pack. So anyone buying or selling tobacco will know immediately whether they are dealing with legitimate goods and it will make it easier for the police and trading standards officers to help HM Customs and Excise in their enforcement role.

5.105 Following the introduction of pack marks, **new offences will be brought in to ensure that those who deal in smuggled goods can be prosecuted more quickly and effectively.**

5.106 As already outlined above, tobacco manufacturers and importers avoid duty increases by building up large stocks of cigarettes in the months leading up to a Budget change. The new mark will help to reduce stockpiling at all points in the supply chain by making it an offence to sell tobacco products after the date shown on the mark.

5.107 HM Customs and Excise will publish a technical note setting out the practical details of the pack mark scheme shortly.

Other measures

5.108 The travelling public should not be under any illusions about the extent of their right to import excise goods. Except where such goods are purely for personal use, their importation without paying UK duty is illegal. **The Government will publicise these arrangements more widely so that people know what they can and cannot do.**

5.109 Asset confiscation powers can already be used in criminal proceedings against smugglers. Next year the Government will announce new arrangements for improving the system of confiscation to make it both more effective and a better deterrent.

5.110 HM Customs and Excise already have powers to confiscate those assets which are used directly in smuggling, especially vans and other vehicles. These powers and the level of payments for return of the assets are discretionary. **Customs will use these powers vigorously to combat smugglers.**

5.111 Smuggling relies on an illicit retail network. People pushing illicit tobacco often operate in pubs or other licensed premises. Licensees have a duty to ensure that their premises are not abused in this way. To enforce this effectively, a graduated range of penalties such as temporary closure as well as the existing option of revoking the licence is required. **Further details of the proposed new licensing framework will be published early next year.**

Health

5.112 The Government is fully committed to reducing smoking. The Government's Smoking Kills and Saving Lives White Papers set out an integrated policy approach to reducing smoking and tackling cancer and coronary heart disease. The White Paper policy framework includes ambitious outcome-based targets, including reducing the death rate in people under 75 with cancer by at least a fifth and reducing the death rates in people under 75 with heart disease and stroke by at least two-fifths. The Government is committed to meeting those targets. The integrated policy includes a three year public education campaign, a ban on tobacco advertising, better help for people who want to quit smoking, identifying high-risk groups and giving people effective treatment when they need it.

Tobacco duty

5.113 There is a strong ongoing health case for year-on-year real terms increases in the price of cigarettes and tobacco to complement such measures. **The Chancellor will in future form his Budget judgements on the appropriate level and timing of increases taking into account a wide range of factors including the Government's health objectives. Any additional revenue raised from real increases in tobacco duties in future would be spent on improved health care.** For example, the extra revenue from a 5 per cent real terms rise in tobacco duty next spring would raise £300 million that would go to a further additional investment in the National Health Service from next April.

Off-shore betting

5.114 The Government has been disappointed by the actions of a number of bookmakers in using off-shore centres to take 'tax-free' bets from UK customers. The Government takes this threat to the revenue and to the future funding of horse and greyhound racing very seriously.

5.115 The Government has ruled out no options for maintaining the revenue from betting and gaming, and maintaining a thriving bookmaking and racing industries within the UK. As a first step, the Government will be reinforcing the advertising ban on offshore bookmakers and is considering what additional measures it could bring forward in the Budget.

Air Passenger Duty

5.116 Air passenger duty was introduced under the last Government, but was implemented in a legally defective way. Seeking to rectify this breach of the Treaty by extending the return leg exemption to European Economic Area flights would mean that such flights bore no UK duty at all. So the Governmnet will in the next Budget remove the return leg exemption and introduce duty rate reductions to ensure this change is revenue neutral.In the pre-Budget period HM Customs and Excise will consult on a reduced rate structure for lower fares to achieve that.

5.117 The Government also recognises the importance of air transport to the most remote areas of the UK. HM Customs and Excise will, therefore, also consult on introducing an exemption from air passenger duty for flights from airports in the Scottish Highlands and Islands when the return leg exemption is abolished.

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[1] *Supporting Children through the Tax and Benefit System,* No. 5 in the Modernisation of Britain's Tax and Benefit System (November 1999). Copies can be obtained from the Treasury Public Enquiry Unit on 0171 270 4558, or on http://www.hm-treasury.gov.uk. [back]

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[2] *Review of Charity Taxation, HM Treasury, March 1999*. [back]

6

Protecting the environment

Economic growth needs to take place in a way which ensures the effective protection of the environment and the prudent use of natural resources. The environmental consequences of economic policies have often been ignored. Global threats such as climate change must be limited, hazards such as poor air quality must be reduced and the natural resources that people value, such as wildlife and the landscape, should be protected. Natural resources need to be used efficiently and renewable resources, such as water, should not be used in ways that could endanger those resources.

The Government has set out a clear framework for considering environmental objectives alongside its economic and social objectives. Key elements of the Government's environmental policy include:

- **climate change: taking action to reduce greenhouse gas emissions to meet the UK's legally-binding Kyoto target and move towards the Government's long term domestic goal;**
- **supporting integrated transport: reducing emissions of carbon dioxide and other harmful pollutants from road transport, while at the same time encouraging people to use cleaner vehicles, fuels and modes of transport, and ensuring that people have safe, reliable and accessible alternatives to road use;**
- **land use and urban regeneration: reducing the environmental consequences of competing demands placed on land, including reducing the amount of waste going into landfill and promoting urban regeneration; and**
- **water and pesticides: improving the quality of both river water and drinking water and minimising pesticide use consistent with adequate crop protection.**

INTRODUCTION

6.1 The Government is committed to ensuring that economic growth takes place in a sustainable way through close co-ordination between the economic, social and environmental dimensions of policy. The Government will deliver on its environmental commitments as it meets its economic goals. Its approach to sustainable development, set out in Box 2.4, means protecting the environment now and for future generations and building a society in which every citizen has a stake.

6.2 Too often in the past, economic growth has been at the expense of increased pollution and the wasteful use of natural resources. The consequences can be seen all around - global warming, poor air quality, pressures on scarce water and land all threaten our quality of life. This chapter shows how the Government is working to integrate effective protection of the environment and prudent use of natural resources into the heart of economic decision making.

Climate change

6.3 Climate change is one of the key environmental challenges facing the world today. There is a growing scientific consensus on the potential impacts on the climate of increasing concentrations of greenhouse gases in the atmosphere. The Inter-Governmental Panel on Climate Change predicts that if no action were taken to limit greenhouse gases, global average temperatures could rise by up to 3.5°C by the end of the next century.

6.4 The effects of climate change on this scale could be potentially catastrophic across large parts of the world. Rising sea levels could cause devastating losses to coastal communities and environments, and result in the dislocation of millions of people. Around 80 per cent of this population displacement would be likely to occur in southern and south east Asia. The impacts would be far from uniform, with rising sea levels and flooding in some regions but water shortages and famine in others. Large areas of the tropical rainforests are predicted to die-back from 2050 unless considerable action is taken to limit climate change.

6.5 The first signs of climate change are already being observed, as shown in Chart 6.1. Over the last decade, England has seen four of the five warmest years since records began 340 years ago. In eastern England, sea levels are already rising by 1.5 cm per decade.

Global surafce temperature variations, 1860-1998

6.6 Climate change is not the only environmental issue confronting the UK, although it may be the most serious. At a more localised level, the quality of the air we breathe and the water in our rivers and lakes, as well as increased pressures on the land, represent serious challenges to our quality of life.

Air quality

6.7 Poor quality air degrades the environment and poses risks for both human health and biodiversity. The air quality levels at which experts consider there could be harm to human health are, on average, breached on more than one day in every ten. Although everyone suffers on days when air quality is poor, the frail and sick are particularly vulnerable. Recent evidence suggests that between 12,000 and 24,000 early deaths and between 14,000 and 24,000 hospital admissions and re-admissions for respiratory and cardiovascular problems are associated with short-term air pollution from particles, sulphur dioxide and ozone each year.[2] Poor air quality can bring on asthma attacks among the UK's 3 million sufferers.

6.8 Urban air pollution (a largely traffic-related problem) has a particular impact on drivers and their passengers - they can be exposed to up to three times as much pollution as pedestrians and cyclists since they effectively travel through a "tunnel" of air pollution. Improvements in fuel quality and vehicle emission technology have helped reduce pollution levels in urban areas over recent years. Annual emissions of lead have fallen by over 50 per cent and annual emissions of nitrogen oxide and particles have fallen by over 30 per cent. But this improvement is predicted to reverse early in the next century as growth in road traffic offsets the reduction in emissions from individual vehicles.

6.9 Poor air quality is not just an urban phenomenon. Air pollutants can travel hundreds of miles leading to health problems for people living in rural areas and damaging forests, lakes, crops and wildlife.

Land and waste

6.10 The UK has one of the highest population densities of any country in the world and pressures on the land are growing. Household projections for England indicate that an additional 3.8 million households could form between 1996 and 2021, an increase of approaching 20 per cent. 71 per cent of the newly-formed households are currently projected to consist of a single-person, reflecting the growing numbers of older people, young people living alone and people who are divorced or unmarried in the population.

6.11 The rate of new household formation and the geographical distribution of these households will have major environmental impacts in both rural and urban areas. New urban developments need to offer a high quality of life. Unrestrained greenfield development can accelerate the depletion of natural resources, damage biodiversity and threaten urban vitality and regeneration, leading to increased social deprivation in urban areas. Similarly, unsympathetic rural development can detract from the quality of life in rural areas.

6.12 Industry and commerce in England and Wales produce around 70-100 million tonnes of waste each year. Local authorities collect a further 30 million tonnes, principally from households, and this is growing by around 3 per cent a year. If this trend continues, nearly twice as many waste management facilities will be needed by 2020 than if municipal waste levels could be stabilised.

6.13 Disposing of all of this waste places further pressure on scarce land due to the UK's heavy reliance on landfill as a means of waste disposal - one of the highest rates in the EU. As the biodegradable element of the waste decomposes, it releases methane, a powerful greenhouse gas. Landfilled waste can pollute water by leachate, creating a hazard to human health.

6.14 The Government is committed to ensuring a sufficient supply of aggregates. But the extraction and transport of aggregates generates adverse environmental effects including noise, dust, visual intrusion, loss of amenity and adverse effects on nature.

Water

6.15 Water is a renewable resource, vital for both public health and protecting the environment. Although the UK does not face severe problems of water availability, there are marked pressures in certain regions at certain times of the year. Water demand is likely to continue to grow, largely due to increased household use.

6.16 Better water quality is an important environmental goal, not only to protect biodiversity but also for leisure use. Currently 82 per cent of rivers in England and Wales comply with River Quality objectives. The Government's target is to improve water quality further so that at least 91 per cent of rivers meet the objectives by the year 2005. Following a sharp rise in major pollution incidents in 1997, the number dropped to 128 in 1998, the lowest since records began.

THE GOVERNMENT'S APPROACH TO ENVIRONMENTAL TAXATION

6.17 Economic instruments such as taxes, charges and trading can offer the scope for delivering environmental gains in a cost effective way. By making use of the price mechanism, economic instruments allow those involved in environmentally damaging activities to respond according to their own circumstances. Those facing the lowest costs of pollution abatement are given an incentive to make larger pollution reductions. Attaching a price to environmental 'bads' creates a permanent incentive for innovation and investment in less polluting and resource intensive methods of production, and encourages the consumption of 'cleaner' products.

6.18 The Government will consider using the tax system to deliver environmental benefits on a case by case basis, taking account of its wider economic and social objectives. Taxation will often be most effective in tackling environmental problems when introduced as part of a package of policies. Trading, local charging, public spending, regulation and education all have a role to play.

6.19 The Government aims to target public spending where it will bring the greatest benefits and raise revenues in ways which cause least distortion to the economy. The revenues from environmental taxes may allow reductions in other more distortionary taxes or increased spending on public services. Generally, how revenue is raised will not determine how it is spent. But the merits of using the revenues from environmental taxes to fund complementary spending measures, for example to enhance the environmental impact of the tax, will be considered on a case by case basis.

6.20 Environmental taxation is not simply an excuse for raising revenue. How and what a government taxes sends a clear signal about the economic activities which it wants to encourage or discourage, and the values it wishes to entrench in society. Over time, the Government aims to shift the burden of tax from 'goods' such as labour and capital to 'bads' such as pollution. But, in line with the Government's Statement of Intent on Environmental Taxation, published in July 1997, any environmental taxes should meet the tests of good taxation.

6.21 *Polluters should face the true costs which their actions impose on society.* When individuals and firms do not bear the full costs to society of their activities, despoiling the environment can seem like an easy option. But pollution imposes real costs on the rest of society - and not just on the present generation. Some of the biggest problems faced today - such as contaminated land - have been caused by the short-termism of the past. This must change. Polluters should not be able to treat the environment as a free resource, and our children should not be expected to foot the bill for our decisions.

6.22 *The social consequences of environmental action must be acceptable*. Environmental improvements should not be at the expense of hurting the most vulnerable in society. The Government reduced the rate of VAT on domestic fuel and power to the lowest rate allowable under EU regulations as part of its determination to combat fuel poverty. The Government recognises the particular needs of rural communities. That is why additional resources have been provided for public transport provision in rural areas.

6.23 *Economic instruments must deliver real environmental gains cost effectively.* Environmental taxes will be most effective where they target the polluting activity directly and avoid perverse side effects. This is why the Government intends to exempt 'new' renewables from the climate change levy. Taxes must not cause excessive administration or compliance costs. The Government will continue to provide a clear, long-term signal of its intentions so that firms with long investment cycles have the time they need to adapt. In some cases, national taxes may not be the best way of dealing with localised environmental damage. This is why the Government has ruled out a national tax charge on water pollution.

6.24 *Environmental policies must be based on sound evidence*. The body of scientific evidence on global warming has forced governments worldwide to act, but in other cases, damage is more localised. In most of these cases, there is uncertainty about the nature and scale of the effects involved. Developing practical and effective policies requires detailed research, careful planning and extensive consultation. But uncertainty cannot necessarily be used to justify inaction. Today's greenhouse gases may be tomorrow's climatic disaster. Sustainable development means taking action on the basis of the best available evidence and taking full account of the risks of environmental damage occurring.

6.25 *Environmental policies must not threaten the competitiveness of UK business*. Well-designed policies need not damage growth and employment in the economy. Taxing environmental 'bads' may allow lower taxes on 'goods' such as labour and capital. The introduction of the climate change levy will entail no increase in the burden of the tax on business since it will be fully offset by a cut in employers' National Insurance Contributions and increased support for energy efficiency schemes. This increases the cost to firms of using energy but reduces the costs to firms of hiring workers, and should generate an increase in overall employment.

6.26 Where environmental taxes meet these tests, the Government will use them. The remainder of this chapter reviews the progress the Government has already made in using economic instruments to deliver its environmental objectives, and the further steps which are now under consideration.

CLIMATE CHANGE

6.27 Climate change is a global problem requiring actions on a global scale. At the Earth Summit in Rio in 1992, the developed countries agreed a voluntary target to return their emissions of greenhouse gases to 1990 levels by 2000. The UK is one of the few countries on course to achieve that target.

6.28 At Kyoto in 1997, the developed countries agreed a legally-binding commitment to reduce greenhouse gas emissions by 5.2 per cent below 1990 levels over the period 2008-2012. Collectively, the EU Member States agreed to deliver an 8 per cent reduction. The UK's contribution to this target has been set at a $12^{1}/_{2}$ per cent reduction on 1990 levels in emissions of a basket of six greenhouse gases. The UK has also set itself a more challenging domestic goal to reduce emissions of carbon dioxide by 20 per cent on 1990 levels by 2010.

6.29 The Government is developing a draft UK climate change programme, which it aims to publish early next year for further consultation. The programme will set out a strategic long-term framework for reducing the UK's greenhouse gas emissions. The programme developed in the light of the consultation will take a balanced approach, recognising that all sectors should play a part in reducing greenhouse gas emissions. The climate change levy and the negotiated agreements will be central to reducing emissions from the business sector. The Home Energy Efficiency Scheme is helping to reduce emissions from the domestic sector. Increases in fuel duties since 1993, and proposed reforms to VED and company car taxation, will help reduce emissions from the transport sector.

Climate Change Levy

6.30 The Government believes that all sectors of the economy must play their part in meeting the UK's emissions targets. In March 1998 the Chancellor asked Lord Marshall to produce a report on economic instruments and the business use of energy. Lord Marshall's report, published in November 1998, recommends that there "probably is a role for a tax if businesses of all sizes and from all sectors are to contribute to improved energy efficiency and help meet the UK's emissions targets".

6.31 In Budget 1999 the Government announced that it would bring forward legislation in Finance Bill 2000 to introduce a climate change levy on energy use by business with effect from April 2001. Simultaneously, HM Customs and Excise launched a major consultation exercise with business and other interested parties on the design issues surrounding the levy.

Outcome of consultation exercise

6.32 The aim has been to design the levy in a way that maximises its environmental effectiveness whilst safeguarding the competitiveness of UK business. Views from a wide range of organisations have fed into this consultation process. **In light of the responses to the consultation exercise, and other representations made, the Government intends to**

increase the environmental effectiveness of the levy by:

- **exempting from the levy electricity generated from 'new' renewable sources of energy and in 'good quality' combined heat and power plant; and**
- **trebling the support for energy efficiency measures arising from the levy package to around £150m in 2001-02, to allow for the introduction of a system of enhanced capital allowances for energy saving investments; and**

protect competitiveness by:

- **reducing the overall size of the levy to £1.0 billion in 2001-02, with a commensurate reduction in the main levy rates;**
- **offering an 80 per cent discount for those energy intensive sectors that sign energy efficiency agreements that meet the Government's criteria; and**
- **recycling all the revenues raised back to business as a whole through a 0.3 percentage point cut in employers' National Insurance Contributions and the additional support for energy efficiency measures.**

6.33 The levy package as a whole is therefore expected to be revenue neutral for the *private* sector. Its introduction will entail no net financial gain for the public finances. Furthermore, the levy package as a whole is expected to be broadly neutral between the manufacturing and service sectors.

6.34 These refinements will also mean that the environmental benefits of the revised package, in terms of the carbon savings generated, will be bigger than those arising from the proposal outlined in Budget 99. The levy package itself is expected to save at least 2 million tonnes of carbon a year by 2010. The levy's negotiated agreements with the energy intensive sectors could deliver as much again.

6.35 Draft legislative clauses reflecting the revised design of the levy announced in this report will be published shortly.

Detailed design of the levy

6.36 The climate change levy is designed to be revenue neutral for the private sector, with the revenues raised being fully recycled to business, primarily through a reduction in employers' National Insurance Contributions (NICs). This is consistent with the Government's policy of switching the burden of taxation from 'goods' like labour, to 'bads' like pollution. **In 2001-02, the levy is expected to raise £1.0 billion, all of which will be recycled back to business as a whole via a 0.3 percentage point reduction in employers' NICs and the additional support for energy efficiency measures. The rates of the levy are expected to be:**

Energy Product	Levy Rate in 2001-02 (pence per kilowatt hour)
Electricity	0.43
Gas	0.15
Coal	0.15

6.37 The Government will continue to monitor and evaluate the contribution the levy makes to the UK's targets for reducing greenhouse gas emissions. As with excise duties, the Government expects that the rates of the levy will at least keep pace with inflation over time.

6.38 Responses to the HM Customs and Excise consultation document and other representations made on the design of the climate change levy indicated widespread support for increasing the resources directed to energy efficiency measures within the climate change levy package. **In light of the representations made, the Government is minded to treble its support for energy efficiency measures under the climate change levy package - meaning the £50 million announced in Budget 99 for 2001-02 would rise to around £150 million. This would allow for a system of 100 per cent first year capital allowances for energy saving investments to be introduced alongside the £50 million energy efficiency fund announced by the Chancellor in Budget 99.** Subject to any practical or legal considerations, such enhanced allowances - which businesses would be able to set against their corporation or income tax bills - could be introduced alongside the climate change levy in April 2001.

6.39 The Government will be consulting business on exactly which energy efficient products and technologies might qualify for the enhanced allowances. Views will also be
sought on the Government's detailed proposals for using the energy efficiency fund announced in Budget 99, which is intended to:

- provide energy efficiency advice/audits to small and medium sized enterprises;
- promote the development of 'new' sources of renewable energy; and
- encourage the research and development and take up of low carbon technologies and energy saving measures through a 'Carbon Trust'.

Final decisions on the use of the energy efficiency fund will be made in the spending review 2000.

Energy intensive sectors

6.40 The Government recognises the case for giving special consideration to the treatment of energy intensive sectors given their high energy costs and their exposure to international competition.

6.41 The basis for determining eligibility for special consideration will remain sites in those sectors covered by the EU's Integrated Pollution and Prevention Control (IPPC) Directive. These installations will be subject to a regulatory requirement, in terms of having to operate in an energy efficient manner, that other non-IPPC sites are not subject to. This definition covers the main energy intensive sectors and most manufacturing sites. It provides the legal certainty required for determining who is, and is not, eligible to enter into negotiated agreements. The Government has indicated that small sites in sectors covered by the IPPC Directive, but which fall beneath the Directive's size threshold, will be eligible to be covered by a negotiated agreement.

6.42 The Government remains willing to consider suggestions for alternative definitions which would target the relief on energy intensive sectors exposed to international competition. But any alternative definition would have to have a clear rationale, provide legal certainty, administrative simplicity and be consistent with EU State Aids rules. The Government does not intend to extend eligibility to *all* firms, since that would involve offering lower rates of the levy to firms who are already net gainers from the levy/NICs package.

6.43 Those energy intensive sectors which enter into legally-binding agreements to implement all energy saving measures which are cost effective, will qualify for an 80 per cent discount from the levy rates.

6.44 Discussions with the main energy intensive sectors have been underway since spring 1999. Considerable progress has been made. But in order to provide more time for the sector associations to consult their members, the deadline for Heads of Agreement to be signed has been extended to 20 December 1999. Smaller trade associations will be expected to sign Heads of Agreement in early 2000.

Increasing the environmental effectiveness of the levy

6.45 From the outset, the Government has made clear that it wishes to maximise the environmental benefits of the climate change levy. **Subject to legal and practical considerations, the Government intends to exempt electricity generated from renewable sources of energy (other than large scale hydro plant) from the levy.** Electricity suppliers will be able to provide electricity to businesses without incurring the levy up to the total amount of any contracts they have with eligible generators of renewable power.

6.46 The Government recognises the environmental benefits that the additional energy efficiency of combined heat and power (CHP) plant can offer. It therefore proposes to exempt electricity generated in 'good quality' CHP plant from the levy. Guidelines on the definition of what constitutes 'good quality' CHP are being published by HM Customs and Excise.

6.47 In designing the levy the Government has taken into account its wider policy objectives, including the promotion of rail-freight transport. **The Government therefore intends to exempt the traction electricity used by rail-freight locomotives from the levy.**

6.48 The Government recognises that in some cases energy products are used for non-energy purposes and the amount used is determined by the nature of the process. **With this in mind, the Government intends to exempt from the levy those energy products which serve a dual purpose as a fuel and as a feedstock within the same process. The Government also intends to extend the electrolysis exemption announced in July to cover electricity used in electrolytic processes**

similar to chlor-alkali production and primary aluminium smelting.

Environmental benefits of the climate change levy

6.49 The climate change levy package, including the negotiated agreements and the additional support for energy efficiency measures, forms an important part of the UK's climate change programme. The exemptions for 'new' renewables and 'good quality' CHP will increase the environmental effectiveness of the levy. As a result of this, and the trebling of support for energy efficiency measures, it has been possible to set the levy at a lower level than the illustrative rates contained in the HM Customs and Excise consultation document, whilst increasing the environmental benefits of the package as a whole. This underlines the Government's commitment to design the levy in such a way as to achieve its environmental goals whilst protecting UK business.

6.50 The levy package - including additional support for energy saving measures and environmental exemptions for 'new' renewables and 'good quality' CHP - is projected to save the equivalent of at least 2 million tonnes of carbon a year by 2010, compared to the 1.5 million tonnes associated with the proposal outlined in Budget 99. The levy's negotiated agreements with energy intensive sectors could deliver as much again. Together, these will make a very significant contribution to meeting the UK's legally binding target for reducing greenhouse gas emissions.

Emissions trading

6.51 In his November 1998 report, *Economic instruments and the business use of energy*, Lord Marshall urged the Government to "step up its consultations with interested parties to resolve the complex issues involved in designing a trading scheme". Following on from this report and subsequent discussions led by the CBI and ACBE, an Emissions Trading Group (ETG) was established to take the work forward.

6.52 The ETG, which now includes around forty major firms and trade associations, presented their proposals for a UK emissions trading system to the Government on 27 October. The Government has been encouraged by the positive way that the ETG has developed principles for an emissions trading scheme and is considering its proposals in detail.

6.53 The Government believes that emissions trading has a key role to play in the long-term solution to reducing greenhouse gas emissions. A domestic trading scheme would complement other climate change measures in the business sector by offering cost-effective and flexible options for achieving emissions reductions. It will also open the way to international trading opportunities and will enhance UK expertise in this field.

6.54 In designing the climate change levy's negotiated agreements for intensive energy users, the Government will seek to facilitate emissions trading between those firms covered by an agreement. The Government shares businesses' aim of having a UK emissions trading scheme operational as soon as possible and will be looking at further ways to encourage participation in a domestic scheme.

SUPPORTING INTEGRATED TRANSPORT

6.55 The Government's White Paper on the future of transport, *A New Deal for Transport*, was published in July 1998. The White Paper aims to extend choice in transport and secure mobility in a way which supports sustainable development.

6.56 A centrepiece of the White Paper is the introduction of Local Transport Plans. Local authorities will set out five year strategies for transport, together with long-term targets for improving air quality, road safety and public transport and reducing road traffic. In implementing these Plans, local authorities will be empowered to introduce local charging schemes and taxes on workplace parking to combat congestion and its attendant pollution. The revenue from these local schemes will be used to fund further improvements in local public transport as part of the Government's wider long term strategy of investing in local public transport.

6.57 A Commission for Integrated Transport has been set up to advise on implementing the Government's integrated transport strategy. Amongst other things, it is considering proposals for the reform of bus subsidies and for linking the level of the Bus Fuel Duty Rebate to emissions in order to encourage the use of cleaner buses. The Commission is also expected to report on targets for road traffic and freight before the end of this year, and is conducting research on road user charging.

6.58 The White Paper recognises that fiscal measures and economic instruments have a major role to play in influencing travel choice and encouraging sustainable development. Draft revised planning guidance aimed at reducing reliance on the car and promoting alternatives such as walking, cycling and public transport where these are valid alternatives has been issued for consultation.

Road transport

6.59 Road transport accounts for over 20 per cent of carbon dioxide and almost 50 per cent of nitrogen oxide emissions. In October 1998, the EU concluded an agreement with ACEA, the European car manufacturing industry group, to reduce average carbon dioxide emission levels from the new car fleet. Under the terms of the agreement, all European car manufacturers are required to reduce average emissions from their new cars to 140 grams per kilometre (down from 186g per kilometre) by 2008. The Government's package of tax incentives for cleaner cars will support this historic agreement by giving an incentive for individual motorists to demand more fuel efficient models. The agreement has recently been extended to Korean and Japanese car makers.

6.60 Since 1997, the Government has maintained and increased the fuel duty escalator introduced by the previous Government in 1993. This has given a clear signal to motorists and manufacturers to design more fuel efficient vehicles, avoid unnecessary journeys and consider alternatives to the car. Increases in fuel duties since 1996 are estimated to produce carbon savings of between 1 and 2.5 million tonnes of carbon by 2010.

6.61 The Government is committed to meeting its environmental targets. The time has now come to review the way that any increases in the fuel duties are determined. **The Chancellor has, therefore, decided that the appropriate level of fuel duties will be set on a Budget by Budget basis, taking account of the Government's economic and social objectives as well as the UK's environmental commitments.**

6.62 The Chancellor has decided that the revenues from any real terms increases in fuel duties will, in future, go straight in to a ring-fenced fund for improving public transport and modernising the road network.

6.63 The environmental signals from the significant increases in fuel duty over recent years will be reinforced by the reforms announced in Budget 99 to Vehicle Excise Duty and company car taxation. These are intended to provide incentives to purchase and use cleaner, more fuel-efficient cars.

Air Quality

Tackling air pollution is one of the Government's top environmental priorities. The UK Government and the devolved administrations published a Draft Air Quality Strategy in August 1999, setting out proposals for delivering cleaner air. The Government expects to publish its Air Quality Strategy for the UK in January 2000. The Strategy sets health-based objectives to be achieved during the next eight years for the eight most significant air pollutants which will be met through a combination of national policies, regulation of industrial processes and action by local authorities.

This Strategy is being prepared following a review of the 1997 National Air Quality Strategy published by the previous administration. This will set tougher objectives for five of the pollutants addressed.

Road fuel duty differentials

6.64 In Budget 99, the Chancellor increased duty on diesel by 2 pence a litre more than the duty on unleaded petrol. This moves the Government closer to its objective of fairer treatment of petrol and diesel when calculated on an energy or carbon basis.

6.65 Sulphur in fuel leads to emissions of fine particles which present a health risk when inhaled. Sulphur is also associated with emissions of nitrogen oxide, a precursor to ground-level ozone. So Budget 99 increased the differential between Ultra-Low Sulphur Diesel (ULSD) and conventional diesel to 3 pence a litre to encourage take up of the cleaner fuel. This policy has already succeeded in turning almost the entire diesel market over to ULSD.

6.66 The Chancellor also announced a 29 per cent cut in the duty on environmentally-friendly road fuel gases. The UK now has the widest duty differential between road fuel gases and other types of fuel of any country in the EU. This provides a real incentive for individuals and companies to convert to road fuel gases, and for manufacturers and fuel companies to respond to rising consumer demand by increasing the availability of gas-powered vehicles and gas-fuelling stations.

Vehicle Excise Duty

6.67 Reforms to VED to encourage the use of more environmentally friendly vehicles will provide a powerful signal to motorists when they are making car purchases. Budget 99 delivered on the Government's promise to cut the rate of VED for smaller cars, introducing a reduced annual VED rate of £100 for cars with engines up to 1,100cc. This has delivered a £55 reduction in the VED bill for drivers of 1.8 million smaller cars.

6.68 The Budget also outlined plans for the introduction of a graduated VED system for new cars. Under this system, cars first registered after autumn 2000 will be placed in one of four VED rate bands according to their carbon dioxide emissions, the most accurate indicator of fuel efficiency. The system, which is being introduced on a revenue-neutral basis, will be introduced in a flexible way with the potential, for example, to create further incentives for cars which run on less-polluting fuels.

6.69 The Driver and Vehicle Licensing Agency (DVLA) has opened technical discussions with a range of bodies so that the environmental information upon which the new system is to be based can be collected when a new car is registered. Cars first registered before the new system is introduced will continue to be taxed under the existing engine size-based system. Further details of the scheme will be announced in the next Budget, in advance of the system's introduction.

6.70 Budget 99 doubled the maximum VED concession for lorries and buses meeting the most stringent emissions standards to £1,000. The Government also took steps to discourage the use of road damaging 40-tonne lorries on 5 axles which had only been allowed in the UK since January 1999. Whilst VED rates were frozen for the vast majority of lorries, higher VED rates were set for these road damaging lorries. And procedures for down-plating (i.e. reducing maximum running weight to qualify for lower VED) were simplified in response to the industry's requests.

Company cars

6.71 Budget 99 announced that the Government is planning a major revenue-neutral reform of company car taxation. This will give fleet managers a greater incentive to take fuel efficiency in to account when making purchasing decisions. It will also remove the perverse incentive in the current system to reduce the tax due by driving unnecessary, extra business miles. Since the Budget, the Inland Revenue has been consulting on the precise details of the proposed link between emissions and the tax charge and has held a series of meetings with interested bodies.

Improving the transport system

Roads

6.72 There is a long-term trend towards increased car use. Rising incomes have led to rising car ownership and car use, with attendant increases in personal mobility, choice and independence. The geography of rural areas, and the mobility demands of some travellers mean that in some cases, the car will continue to be the main mode of transport. Congestion is the motorist's greatest enemy and a major cause of pollution. So the Government is taking steps to improve road conditions through a targeted programme of road improvements, traffic management, and the provision of new or improved public transport.

6.73 The Government is taking forward a range of measures to reduce delays and disruption on the road network, and to ensure that those who have to use the roads are able to do so as efficiently and safely as possible. £700 million has been allocated centrally to tackle the backlog in road maintenance and halt the decline in the condition of the road network. The funds available from local transport plans for maintenance of local authority roads have also been significantly increased. The Government has begun consultation on charging utility companies for causing unnecessary delays in carrying out roadworks.

6.74 The Comprehensive Spending Review allocated £530 million over three years to making better use of the network, for example by greater use of modern technology to improve traffic flow. A £100 million PFI project will develop Traffic Control Centres, using global positioning satellites to provide information on traffic conditions such as accidents and congestion. This intelligence will be disseminated to drivers through dedicated electronic roadside signing fixtures, motorway gantries, radio and commercial driver information systems. The Chancellor has announced that any above inflation increases in fuel duties announced in the Budget will go straight in to a ring-fenced fund for the modernisation of roads and public transport.

6.75 The Government recognises that it is not enough to encourage greater fuel economy or provide incentives to use cleaner vehicles and fuels. It also needs to ensure that people have real alternatives to road transport - alternatives which are safe, reliable and accessible to all. So the Government is taking forward a number of complementary measures which will improve the provision of alternatives to using a car, and encourage people to take them up.

Increased investment in rail transport

6.76 The Strategic Rail Authority (SRA) has been set up to enable new investment in the rail network where it is most needed. It will be re-negotiating long-term franchises in return for higher levels of investment and improved services. The SRA aims to revitalise and modernise the rail network through partnerships between the public and private sectors. Other services such as the Docklands Light Railway extension to Lewisham have already benefited from the injection of capital through public-private partnerships.

Rural transport

6.77 In Budget 99, the Government announced a 20 per cent increase in funding for rural transport initiatives, taking the total to be spent over the next two years to £120 million. This will be used to provide additional services and to continue developing innovative and community-based rural transport initiatives. The scheme has already led to the introduction of over 1800 new or improved rural bus services in England alone, providing longer running times, extended routes, greater frequency and better integration with other bus and rail services.

Green transport plans

6.78 Budget 99 included a package of seven tax measures designed to encourage people to use more environmentally-friendly modes of transport when travelling to work. The removal of the employee benefits charge on employer-provided work buses and public bus subsidies and the provision of new reliefs for commuter and business cycling were widely welcomed as practical measures by employees and employers alike. There are welcome signs that people are responding to these incentives, and the Government will continue to seek ways of encouraging the take up of 'green transport' schemes in the future.

6.79 Budget 99 revalorised the level of the Bus Fuel Duty Rebate for the second successive year to promote public transport use. This followed a long period when the level of the rebate had been declining in real terms.

The haulage industry

6.80 The Government fully recognises the importance of the haulage industry to the UK economy. But - like all other road users - it believes that hauliers must play their part in reducing the environmental damage caused by road transport. The Government remains convinced that the best way of maintaining the competitiveness of the UK haulage industry is to create a climate of sustainable economic growth and long-term investment in business. Like all British firms, hauliers will benefit from the measures announced in previous Budgets to achieve this.

6.81 Following Budget 99, the Government set up the Road Haulage Forum to bring together Treasury, DETR and DTI Ministers with representatives of the haulage industry and unions. The Forum has held a series of constructive meetings to consider the competitive position of UK haulage firms and discuss ways to enhance their efficiency.

LAND AND WASTE

6.82 The Government is committed to reducing the environmental consequences of the growing demands placed on land from waste disposal, quarrying and housing.

Waste strategy

6.83 The UK currently landfills more of its waste than most other European countries. The recently adopted Landfill Directive aims to reduce the environmental impacts of landfilling waste by placing limitations upon what, how much and how waste can be landfilled. The Directive sets challenging targets which aim to reduce the amount of biodegradable municipal waste sent to landfill to 35 per cent of 1995 levels by 2020. The Government has also set itself targets of reducing the amount of industrial and commercial waste landfilled to 85 per cent of 1998 levels by 2005 and recovering 40 per cent of municipal waste by 2005. Reducing methane emissions from landfill will contribute towards efforts to reduce global climate change.

6.84 Following the Government's consultation document, *Less Waste: More Value*, a draft waste strategy for England and Wales, *A Way with Waste*, was published in June 1999. The draft strategy sets out the Government's vision of sustainable waste management over the next 20 years. A final waste strategy will be published in early 2000.

6.85 In October 1999, the Government published a consultation paper, *Limiting Landfill*, which considered possible instruments for meeting the targets set out in the Directive. The results of this consultation exercise, which ends on 29th November, will be reflected in the final waste strategy. Parallel strategies for Scotland and Northern Ireland are also being prepared.

Landfill tax

6.86 The Government's landfill tax can be expected to make an important contribution to meeting these targets by diverting waste from landfill. Budget 98 increased the standard rate of landfill tax, which applies to active waste, from £7 to £10 per tonne from April 99. The lower rate of tax on inert wastes remained at £2 per tonne. **In Budget 99, the Chancellor announced a five year landfill tax "escalator" which will increase the standard rate of tax to £15 per tonne by 2004.** This sends a clear economic signal to waste managers to develop alternative waste management services and facilities.

6.87 Budget 98 announced an exemption from landfill tax for any inert waste used to restore landfill sites and to fill quarries, where planning obligations require them to be filled. This was introduced in October 1999 and will help to secure an adequate supply of inert material to reclaim sites in an environmentally beneficial way.

6.88 The Environmental Bodies Tax Credit scheme has already raised £183 million for sustainable waste management education and research projects. Waste disposal firms are allowed to claim a tax credit of 90 per cent of any contributions made to environmental trusts (up to a total credit of 20 per cent of tax liability). Budget 99 announced a number of changes to this scheme such as adding recycling to the list of projects which can benefit under the scheme. These will be implemented towards the end of this year by statutory instrument.

Producer responsibility and packaging regulations

6.89 Producers need to take account of the environmental impacts of the disposal of their products. Provisional figures suggest over 10 million tonnes of packaging entered the waste stream in 1998.

6.90 The UK is committed to meeting the objectives and targets in the EC Directive on packaging and packaging waste. The Directive requires Member States to :

- reduce the amount of packaging waste for final disposal;
- achieve a minimum of 50 per cent recovery and 25 per cent recycling; and
- achieve 15 per cent material-specific recycling targets.

6.91 Achieving these targets presents a challenge to the UK, which starts from a low base (around 30 per cent recovery in 1996-97). Annual interim targets have been set for 1998-2000 to ensure that the UK is on course to meet the Directive targets by 2001.

6.92 Packaging regulations, introduced in 1997, impose tonnage recovery and recycling obligations on certain businesses in the packaging chain calculated on the basis of the packaging handled. This provides a cost incentive for firms to reuse packaging and to reduce their use of packaging as this will reduce the tonnage obligation and thus the cost of compliance. Businesses may join compliance schemes which take on and discharge the legal obligations for them.

Aggregates

6.93 Pre Budget Report 98 announced that research commissioned by DETR into the environmental costs attached to quarrying, and in particular the supply of aggregates, had demonstrated significant environmental costs not already covered by regulation. Budget 99 clearly stated that should the quarrying industry not be able to commit to an acceptably improved voluntary environmental package, then it would implement an aggregates tax.

6.94 The draft clauses for a potential aggregates tax were published for consultation by HM Customs & Excise in April 1999, and a number of responses on a range of technical issues have been received.

6.95 The Quarry Products Association submitted a revised package of voluntary environmental measures to the Government in July. The Government welcomed this package which shows some improvement on their original package, notably in the areas of aggregates transport and air quality. In particular there is an extra £20 million a year from seven major companies to promote and develop recycling. But this continues to fall short of what is necessary to match the overall environmental and economic effects of a tax on primary aggregates. So the Government is minded to introduce a tax in the next Budget unless the industry can further improve on this package.

URBAN REGENERATION

6.96 The Government is determined to reverse the legacy of neglect and decline that has scarred our towns and cities. A lasting urban renaissance will not only enhance the quality of life and competitiveness of Britain's towns and cities, but relieve pressure on the countryside. Revitalising urban areas helps narrow inequalities within regions and ensures more even patterns of growth.

6.97 The Government - working in partnership with local authorities and business - has already put in place many initiatives which tackle the causes of urban decline, including action on social exclusion and housing, planning reforms to promote 'in town' development, and improvements in local transport services. The Regional Development Agencies (RDAs) are also playing a key role in developing an integrated and strategic approach to economic development and promoting business clusters.

6.98 The Government's strategy for successful cities must include physical, social and economic development. Earlier initiatives had not succeeded in delivering these three mutually supporting and reinforcing aspects of regeneration, which are now being actively pursued :

- The Urban Task Force, chaired by Lord Rogers of Riverside, published its report *Towards an Urban Renaissance* in June. The report, which was welcomed by the Deputy Prime Minister, focused principally on **physical regeneration** issues such as housing and land reclamation. Urban housing issues will also be addressed in the forthcoming Housing Green Paper.
- The Social Exclusion Unit (SEU) has been developing the Government's National Strategy for Neighbourhood Renewal, with particular emphasis on **social regeneration** (addressing issues such as jobs, skills, health and crime). Some of the ideas emerging from this work are being piloted in New Deal for Communities pathfinder areas.
- The SEU's Policy Action Team reports on business and financial services both contain proposals that would help boost the competitiveness of our inner cities and support **economic regeneration**. The new Regional Development Agencies and the Small Business Service will support this agenda.

6.99 The Government will set out its strategy in more detail in the Urban White Paper, due in summer 2000. This will take forward the Government's programme for achieving an urban renaissance and build on the recommendations of Lord Roger's Urban Task Force. In particular, the Government will give consideration to the merits of using fiscal measures to support sustainable development of our town and cities.

WATER

6.100 The Government is determined to improve the quality of river water in the UK and reduce the environmental damage caused by over-abstraction.

Water pollution

6.101 The quality of rivers has improved significantly in recent years. Almost 25 per cent of the total monitored length of rivers and canals in England and Wales showed a net improvement in chemical quality between 1990 and 1998. In the UK, about 95 per cent of river length is now classified as "very good", "good" or "fair".

6.102 Results of research by DETR suggested that a national tax or charge would not be the most effective way to secure further improvements in local river quality. Budget 99 announced that the Government was not inclined to introduce a national tax or charge on pollution discharges, but it would seek further improvements in water quality through focussed use of the regulatory system.

6.103 The Government intends to ensure that the quality of drinking water continues to improve over time. Much of the investment necessary to deliver these quality and environmental improvements will be agreed as part of the current Periodic Review of water company price limits. The Regulator's draft determinations, published in July 1999, envisaged that alongside this substantial investment, average price cuts of 13.7 per cent in 2000-01, followed by broadly stable real prices thereafter, were achievable due to the growing efficiency of water companies. As part of the Periodic Review, a comprehensive analysis has been carried out at river basin level on what steps need to be taken to improve water quality. These include investment in sewage disposal, Environment Agency enforcement actions and better farming and industrial practices.

Water abstraction

6.104 The Government carried out a review of the Water Abstraction Licensing System in England and Wales in 1998. Part of that review outlined the possible use of economic instruments alongside regulation to bring gains in water efficiency and encourage abstractors to take account of the value of water to the environment.

6.105 The Government has commissioned a research project to consider the possible design of such economic instruments and this will be completed shortly. Following this, DETR will publish a consultation paper early in 2000.

PESTICIDES

6.106 The Government accepts that there is increasing evidence that there are significant environmental impacts associated with pesticide use, and will continue to pursue its policy of minimising pesticide use consistent with adequate crop protection. The Government recognises that the agrochemical and farming industries have made good progress in adopting measures which seek to minimise pesticide usage. But there is scope for further action to be taken to address the adverse impacts of the use of pesticides on the environment.

6.107 In March 1999, DETR published an ECOTEC report, *Design of a tax or charge scheme for pesticides*. This showed that a carefully designed tax or charge scheme could be used to address the environmental impacts of pesticides use. The Government received 99 responses to the consultation on the issues raised in this research. A summary of these responses has been published today. Responses were received from a range of organisations with around 30 per cent being received from farms and agricultural organisations, 13 per cent from the agrochemical industry, 10 per cent from crop consultants and 9 per cent from environmental groups. In broad terms, 17 per cent of respondents were in favour of a tax, and 72 per cent were opposed.

6.108 The Government believes that a tax or charge could be a useful tool, in conjunction with other measures, in addressing the environmental impacts of pesticides. However, over the next few months the Government intends to explore with the agrochemical industry whether its objectives can be better achieved through a partnership approach between the Government and the industry. The Government remains keen to build on the valuable work which the Pesticides Forum has completed to date.

ENVIRONMENTAL APPRAISAL OF POLICY MEASURES

6.109 The Government is committed to conducting a full evaluation of all impacts on the environment when considering alternative policy options[1]. This applies to all Government measures regardless of whether their aim is primarily environmental.

6.110 The Government's environmental assessment of those measures whose primary aim is environmental, or which have a significant impact on the environment, is shown in Table 6.1. For example, estimates are shown for the savings of carbon dioxide emissions expected to accrue from the climate change levy. The table also refers the reader to any related policy documents, as well as citing 'headline' indicators of sustainable development[2], which the policy reform influences.

6.111 It is not always easy to quantify the costs or benefits that different policies impose on the environment, and there are large uncertainties involved in trying to estimate the behavioural response to alternative policy measures. Wherever possible, the table gives quantitative estimates of the impact on the environment, but these are subject to significant margins of error and should not be given undue weight. Precise figures have been omitted where there is extreme difficulty in quantifying environmental effects or where the precise details of the reform are yet to be finalised.

6.112 The Government welcomes the role of the Environmental Audit Committee (EAC) in scrutinising the contribution that government departments make to environmental protection. The EAC's work plays an important part in reinforcing the

Government's commitment to environmental appraisal.

Table 6.1: The environmental impact of tax measures

	Environmental impact[1]	Policy objective
A - Announced tax measures		
Climate change levy	Levy package estimated to produce savings of at least 2 million tonnes of carbon (MtC) a year by 2010[2] Levy's negotiated agreements could well deliver around the same emissions savings again	Kyoto target of 12.5% reduction in UK greenhouse gas emissions on 1990 levels by 2008 - 2012 Domestic goal of 20% reduction in CO_2 emissions by 2010
Company car tax reform	Estimated to produce savings of around 0.5 to 1 MtC[3]	Kyoto target of 12.5% reduction in greenhouse gas emissions
Tax measures to encourage green transport plans	Small reductions in congestion and emissions of carbon dioxide and local air pollutants	Encourage more environmentally sensitive commuting and business travel Greenhouse gas reduction targets Air Quality Strategy (AQS) targets
Fuel duty increases	Escalator over the period 1996 to 1999 estimated to produce carbon savings of 1 to 2.5MtC[4] by 2010 and small reductions in emissions of local air pollutants	Greenhouse gas reduction targets AQS targets
Increase duty on standard diesel relative to unleaded petrol[5]	Reduction of 1-3% of particulates and NO_x Very small increase in emissions of CO_2	AQS targets
Increase duty differential for ULSD[5]	Reduction of 8% of particulates and up to 1% of NO_x; also enables the early introduction of particulate traps for heavy duty vehicles	AQS targets
Reduction in duty on road fuel gases	Reduction in emissions of particulates and NO_x	AQS targets
Minor oils duties	Small reduction in emissions of CO_2 and other local air pollutants	Greenhouse gas reduction targets AQS targets
Graduated Vehicle Excise Duty for cars	Reduction of emissions of CO_2, NO_x and particulates	Greenhouse gas reduction targets AQS targets
New rates of Vehicle Excise Duty for lorries	Reduce road wear	Internalise costs of lorry use
Increase Vehicle Excise Duty reduction for clean lorries and buses up to £1,000	Reduction in emissions of particulates and NO_x	AQS targets
Increase standard rate of landfill tax by £3 from April 1999, and by £1 per year for the following five years	Reduction in proportion of waste going to landfill	Reduce landfill and encourage a more sustainable approach to waste management
B - Measures under consideration		
Aggregates tax or alternative package of voluntary measures	Possible reductions in noise, dust, visual intrusion, damage to wildlife habitats and other environmental	Internalise environmental costs of aggregates

	impacts	extraction Encourage use of recycled aggregate
Pesticides tax	Improve water quality, biodiversity and reduce impact on wildlife	Reduce the environmental impact of pesticide use.

1 These estimates are subject to significant margins of error.

2 Based on estimates produced from the DTI energy model.

3 Exact size of effects will depend upon design of the measures.

4 Based on estimates produced from the DTI energy model and the DETR 1997 Road Traffic Forecast.

5 Estimates for the reduction in urban emissions from road transport are based on NAEI road transport emission projections, and are for the period 2000-2005.

6 The "prudent use of natural resources" is one of the four aspects of sustainable development, rather than a headline indicator of sustainable development.

Other relevant policy initiatives	**Sustainability indicator affected**
See climate change consultation document *UK Climate Change Programme*, DETR October 1998 Draft UK Climate Change Programme expected early next year	Emissions of greenhouse gases
Measures in *A New Deal for Transport: Better for Everyone*,	Emissions of greenhouse gases
DETR July 1998; and *Breaking the Logjam*, DETR December 1998	Road traffic
Measures in *A New Deal for Transport: Better for Everyone*,	Road traffic
DETR July 1998	Days of air pollution
Report on the Air Quality Strategy for England, Scotland, Wales and	
Northern Ireland, A consultation document, DETR August 1999	
Consultation document *UK Climate Change Programme*	Emissions of greenhouse gases
Measures in *A New Deal for Transport: Better for Everyone* and	Road traffic
Breaking the Logjam	Days of air pollution
Consultation document *Report on the Air Quality Strategy*, DETR August 1999	
Consultation document *Report on the Air Quality Strategy*, DETR August 1999	Days of air pollution
Consultation document *Report on the Air Quality Strategy*, DETR August 1999	Days of air pollution
Consultation document *Report on the Air Quality Strategy*, DETR August 1999	Days of air pollution
Consultation document *Report on the Air Quality Strategy*, DETR August 1999	Emissions of greenhouse gases
	Days of air pollution
Consultation document *Report on the Air Quality Strategy*, DETR August 1999	Emissions of greenhouse gases
	Days of air pollution
See *Sustainable Distribution*, DETR March 1999	Road traffic
Consultation document *Report on the Air Quality Strategy*, DETR August 1999	Days of air pollution
Consultation document *Less Waste: More Value*, DETR June 1998	Waste arisings and
Draft Waste Strategy for England and Wales, *A Way with Waste*,	management
DETR June 1999	
Consultation document, *Limiting Landfill*, DETR October 1999	
See *Minerals Planning Guidance: Guidelines for Aggregates*	Prudent use of natural resources[6]

Provision in England, DoE 1994	
Consultation document *Economic Instruments for Water Pollution,*	Rivers of good or fair quality
DETR November 1997	Populations of wild birds

[2]Committee on the Medical Effects of Air Pollutants (1998). [back]

[1]Government guidance on undertaking such evaluation is published in *Policy Appraisal and the Environment: Policy Guidance*, Department for the Environment, Transport and the Regions, 1991. [back]

[2]As set out in *A Better Quality of Life*, Department for the Environment, Transport and the Regions, 1999. [back]

A

The Economy

Under the new policy framework, the Government is delivering economic stability:

- **with low inflation, sound public finances and a healthy private sector financial position, the UK economy was well placed to respond to the deterioration in the global economy last year;**
- **monetary policy responded pro-actively to developments, with base rates falling rapidly;**
- **as expected at Budget time, the pause in UK growth was relatively short-lived and damaging falls in output were avoided; and**
- **the economy continued to create jobs throughout and there are now more people in work than ever before.**

Creating a platform for stronger stable growth:

- **the near-term outlook for growth is stronger than expected at the time of the Budget, with some clearer upside risks;**
- **by maintaining a pro-active monetary policy and prudent fiscal policy, the economy can follow a stable path and deliver sustained increases in output and employment;**
- **the sustainable level of unemployment has probably fallen in recent years. With inflation expected to remain close to target, lower unemployment can be preserved through responsible wage bargaining; and**
- **the evidence points to trend economic growth of $2^1/_2$ per cent a year over the medium term as a neutral assumption. Through a comprehensive range of policies to deliver stability, higher productivity growth and increased employment opportunity, the Government is aiming for a better outcome.**

INTRODUCTION[1, 2]

A1 This annex provides an overview of domestic economic prospects over the next three years, followed by a full discussion of the main forecast issues and risks. It ends with a summary of the world economic outlook.

A2 Projections for GDP growth are again presented as ranges, based on alternative assumptions about the supply-side performance of the UK economy (Table A1). The mid-point of the ranges is based on the assumption of $2^1/_2$ per cent a year for the trend rate of growth, which is the Government's neutral assessment of the economy's growth potential over the medium term. As before, the public finances projections are based on the low end of the ranges, consistent with a deliberately cautious assumption of $2^1/_4$ per cent a year trend growth. The upper ends of the ranges meanwhile illustrate the clear potential for stronger growth based in part on Government policies to raise productivity growth and to increase the labour supply. Full details are provided later in this annex (pages 122-123).

Table A1: Summary of forecast

			Forecast		
	1998	**1999**	**2000**	**2001**	**2002**

GDP growth (per cent)	$2\frac{1}{4}$	$1\frac{3}{4}$	$2\frac{1}{2}$ to 3	$2\frac{1}{4}$ to $2\frac{3}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$
RPIX inflation (per cent, Q4)	$2\frac{1}{2}$	2	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$

UK ECONOMY OVERVIEW

Recent economic developments

A3 The slowing in UK growth evident at the time of the Budget was expected to be relatively short-lived. Inflation was low following a timely, and coordinated, tightening of monetary and fiscal policies in the period to mid-1998. Avoidance of a damaging boom also meant that the private sector had preserved a relatively secure financial position, underpinning the Budget forecast of continued economic expansion at moderate rates, prior to a strengthening of activity into 2000 as trade pressures eased.

A4 Under the Government's new policy framework, therefore, the economy was well placed to respond to the deterioration in the global economy and business confidence in autumn last year. Monetary policy responded pro-actively and, from a relatively low peak of $7\frac{1}{2}$ per cent in June 1998, base rates were rapidly reduced to 5 per cent a year later. Mortgage rates fell to their lowest level for more than 30 years.

A5 Subsequent developments have broadly confirmed Budget expectations. Latest data now show the economy growing just below its trend rate from late 1997, with a temporary pause around the end of 1998. This was largely a result of falling export volumes, particulary in Asian markets, later compounded by the slowdown in European growth. By contrast, and as expected, household financial strength and historically low interest rates were reflected in high levels of consumer confidence.

A6 Indeed, buoyant household spending has driven a stronger than expected economic expansion in 1999. Quarterly GDP growth was 0.6 per cent in the second quarter and the preliminary ONS estimate shows it rising to 0.9 per cent in the third quarter. Manufacturing output has also out-performed most expectations, rising by 1 per cent in the third quarter. This brings the recent pace of expansion in manufacturing into line with the service sector, where growth has remained healthy throughout. Business survey indicators have also recovered rapidly from last autumn's lows. The apparent temporary breakdown in the relationship between surveys and economic developments is examined in Box A1.

A7 Household consumption is now estimated to have grown by between 1 and $1\frac{1}{2}$ per cent a quarter since last autumn. This surprising strength at least partly reflects continued labour market improvements, with growth in employment remaining unexpectedly robust following the pause in GDP growth at the turn of the year. Business investment has also continued to rise, despite the earlier deterioration in survey investment intentions. However, buoyant final domestic demand was partly offset by an apparently sharp run-down in inventories during the spring.

A8 By contrast, net exports fell heavily early this year, continuing to exert a strong drag on GDP growth. From this low base, net trade contributed 0.5 percentage points to output growth in the second quarter, though partly due to weak imports as inventories fell. However, the rebound in export volumes has strengthened further since mid-year, boosted by the strong recovery in the Asian economies, continued buoyancy in the US, and firming in Eurozone activity. It seems likely that net trade again contributed positively to growth during the third quarter.

Box A1: Business survey indicators

Business survey indicators deteriorated sharply last autumn culminating, notably, in a 20-year low for the CBI manufacturing optimism balance in October 1998. Partly due to their timeliness, key surveys such as the CBI Industrial Trends Survey have long influenced assessments of economic prospects, and the autumn readings contributed to sharp downward revisions in independent forecasts for the UK economy. The use of such surveys in forecasts is often summarised by the familiar relationship between CBI business optimism balance and GDP growth.

Business optimism and GDP growth

With GDP strengthening rapidly in 1999, the causes of the autumn survey lows, and the apparent breakdown in their relationship with official data, have come under close scrutiny. Manufacturing activity itself has also outperformed confidence-based survey estimates, and this was only partly reflected in more buoyant ex-ante survey

expectations of manufacturing output and demand. As on some other past occasions, the surveys were probably disproportionately influenced by external events: in autumn 1998 there was a strong negative shock to confidence associated with global economic and financial turbulence. The move to operational independence for the Bank of England in setting monetary policy may also have led to more negative survey responses for given economic conditions, relative to the past.

As the CBI itself notes, it is important to consider manufacturing survey results alongside all other sources of information1. For example, other surveys showing much stronger consumer and service sector confidence last year illustrated the good prospect of a continued expansion in domestic demand, helping to contain the impact of global conditions. In addition, because economic cycles do vary, past survey relationships cannot be assumed to be stable. Unlike the early 1990s, for example, the slowing of the UK economy in late 1998 was not driven by company spending. Finally, there is little evidence that most survey indicators exhibit long leads over official statistics. So if there are good reasons to expect a strengthening in the economy, as there were late last year, the surveys themselves can recover rapidly. All major survey indicators have returned to at least normal levels since last autumn.

[1]'*Crying wolf? Relating results from the CBI Industrial Trends Survey to official statistics*', **CBI Economic Situation Report, July 1999.**

A9 Stronger than expected growth in output this year, together with upward revisions to GDP in 1998, mean that non-oil output is now provisionally estimated to have risen just above its trend level in the third quarter of 1999. Survey indicators broadly support this picture, with the CBI measures of capacity utilisation and skilled labour shortages having recently risen close to their long-run averages. At the time of the Budget, the negative output gap had been expected to widen to around -1 per cent of GDP. While these judgements are subject to large margins of uncertainty, the starting position of stronger growth and correspondingly little slack in the economy relative to expectations has significant implications for the economic outlook.

The labour market

A10 Labour market activity has remained unexpectedly robust given the slowing in GDP growth to below trend rates in late 1998. Growth in Labour Force Survey (LFS) employment has stayed buoyant during 1999, with a sharp 100,000 increase in the three months to August compared to the previous three months. This is confirmed by strong growth in the alternative workforce jobs series, though there has been some slowing compared to the rapid job gains during the second half of 1998.

A11 Overall, LFS employment has risen by nearly 300,000 over the past year and nearly three quarters of people of working age are now employed, close to the last peak in spring 1990. This partly reflects some further switch towards part-time work, though the majority of jobs created over the past year have been full-time. While one in four people now work part-time, this is mainly through choice. The proportion of these who cannot find full-time employment is low.

Chart A1: LFS employment, unemployment and participation

A12 Non-oil labour productivity growth has slowed markedly, from around $1^1/_2$ per cent in mid-1998 to $^3/_4$ per cent in the second quarter of 1999. Output per head measures of productivity may understate the underlying productivity position given that hours worked are typically pro-cyclical. However, broadly offsetting trends in hours worked by full and part-timers mean that in recent years there is little difference between productivity growth measured on an hours worked or numbers employed basis.

A13 As noted in Budget 99, the recent productivity cycle is likely to have been exaggerated by a greater degree of labour 'hoarding' compared to the past. Because the slowing in UK growth was expected to be relatively short and shallow, firms had a clear incentive to avoid the costs associated with labour shedding. Furthermore, with unemployment at low levels, firms unwilling to tolerate a period of lower labour utilisation would have been relatively poorly placed to respond to improved business conditions later this year.

A14 Productivity is also likely to be depressed temporarily by significant falls in long-term unemployment. Average productivity levels in this group tend to be lower than for those people already in work, as a result of the deterioration in skills associated with long spells of unemployment. Allowing for the impact of the cycle and the increased employment rate, there is no conclusive evidence of an underlying deterioration in productivity performance in recent years. Productivity growth is expected to recover towards its trend rate of around 2 per cent a year[3] as output growth remains buoyant into 2000.

A15 With the economy continuing to create jobs, the downward trend in unemployment has recently firmed, bolstered by some increase in inactivity. In the three months to August, ILO unemployment fell by 83,000 compared to the previous three months. The rate is now under 6 per cent, around $1^1/_2$ percentage points below its level in spring 1997. Independent forecasts made around Budget time of significant increases in unemployment have subsequently been revised away. However, there are still 1.7 million ILO unemployed, and a further 2.3 million working age people who are economically inactive but who want a job. The Government is determined to help such people move from welfare into work through a comprehensive range of policies to make work pay (see Chapter 4).

A16 Alongside low unemployment, labour market tightness is also signalled by a new record ratio of vacancies to unemployment. Currently there are around four claimant unemployed people for every Job Centre vacancy compared to five early last year, over twenty in the early 1990s and never much below eight during the late 1980s' boom. This improvement in employment opportunities per unemployed person has occurred throughout all regions of the UK in recent years. The Federation of Recruitment and Employment Services (FRES) survey also signals reduced availability of staff. On the other hand, excess labour demand is much less clearly reflected in survey indicators of skill shortages. The CBI manufacturing measure is close to long-run levels and the BCC survey has shown an easing for services.

Table A2: Regional claimant unemployed per vacancy[1]

	The South (SE, SW, E)	Midlands (EM, WM)	The North (NE, NW, YH)	Scotland	Wales	GB
1986-89 (average)	7.3 (109)	13.0 (33)	16.5 (48)	15.5 (19)	12.1 (12)	11.0 (221)
September 1999	3.6 (122)	3.5 (54)	4.5 (78)	3.9 (33)	3.9 (16)	3.8 (303)

[1]*Number of Job Centre vacancies (thousands) in brackets.These are estimated to account for about one third of all vacancies.*

A17 The unemployment rate at which, other things being equal, inflation is stable is known as the non-accelerating inflation rate of unemployment (NAIRU). It is likely to depend on a number of factors affecting wage and price-setting behaviour and labour and product market flexibility, and so will vary over time. Tighter eligibility criteria for unemployment benefits and reduced regional labour market mismatch (see Box A3), for example, are commonly thought to have contributed to a decline in the NAIRU since the 1980s.

A18 The economy is still judged to have moved above its trend level during the first half of 1997 suggesting a NAIRU of around 7 per cent on the ILO definition at that time (assuming participation was also close to its equilibrium rate). But despite a further 1 percentage point fall in the unemployment rate since then, earnings growth has eased since spring 1998 and settlements have come down. By contrast, in 1989 when the employment rate was last around 75 per cent, earnings growth was rising towards double digit rates. The recent downward trend in earnings growth provides evidence that the NAIRU may have declined broadly in line with actual unemployment over the past two years.

Trend output growth

A19 Over the medium term, the trend rate of growth determines the pace at which the economy can expand without putting upward pressure on inflation. One of the main lessons from previous economic cycles is that macroeconomic policy based on an over-optimistic assumption for trend growth leads to instability, with severe policy changes eventually required to correct macroeconomic imbalances[4].

A20 Trend output growth can be considered in terms of growth in labour productivity and employment[5], the latter comprising growth in the population of working age and changes in the sustainable employment rate. Table A3 decomposes trend growth between comparable cyclical points during the 1990s and sets out the Government's considered view of prospects. The interaction between this neutral assessment and the GDP forecast ranges presented in this Annex is described in Box A2.

Table A3: Contributions to trend growth

	Labour productivity[1] underlying	actual	Change in employment rate[2]	Population of working age[3]	**Estimated trend growth**
					Per cent per annum
1990s[4]	2·1	2·3	-0·3	0·3	$2^1/_4$
Forecast[5]	2·1	2·0	0·1	0·4	$2^1/_2$

[1] *Output per workforce job.*

[2] *Change in ratio of workforce jobs to UK household population, percentage points per annum.*

[3] *Based on estimates of UK household population.*

[4] *Between estimated on-trend points at the end of 1990 and 1998.*

[5] *Neutral assumptions underlying the mid-point of the GDP growth ranges from 2000Q1.*

A21 GDP growth averaged $2^1/_4$ per cent a year between the economy's estimated on-trend points in the fourth quarters of 1990 and 1998, a little below the post-war average. Productivity growth also averaged $2^1/_4$ per cent a year, stronger than during the 1980s, though this was boosted a little by the declining employment rate. Changes in the employment rate tend to be associated with partially offsetting movements in productivity growth. This is because those entering and leaving employment at the margin tend to have lower than average productivity levels.

A22 Growth in the population of working age is expected to make a slightly stronger contribution to trend output growth in the period ahead than during the 1990s. However, the population structure is also expected to change, with above average increases in those aged 55-59, who have a relatively low employment rate, and a decline in the number of 25-34 year olds. Other things being equal, this would tend to depress the aggregate employment rate, offsetting the benefit to trend growth from stronger working age population growth.

A23 However, there is clear scope for raising the employment rate by more than the modest amount allowed for by the neutral case assumption for trend growth. At just under 79 per cent, the male employment rate is around $3^1/_2$ percentage points below its level in 1990, with falls having occurred across all age groups. Furthermore, while female participation has risen during the 1990s, it is not clear that the scope for further increases has been exhausted. Government policies to reduce the sustainable rate of unemployment and to raise participation by making work pay will play their part.

Box A2: Trend growth and GDP forecast ranges

The Government inherited public finances which were in substantial structural deficit. As part of its prudent approach to fiscal policy, it adopted a deliberately cautious assumption of $2^1/_4$ per cent a year trend growth for the purposes of projecting the public finances. This NAO audited assumption has been retained in subsequent fiscal projections and is unchanged in this Pre-Budget Report.

In 1997, the economic outlook was highly uncertain due to the emergence of significant macroeconomic imbalances, with the economy further undermined by key structural deficiencies. Against this background, the Government judged that it was sensible to present its forecasts for economic growth as ranges. This illustrated the potential for supply-side improvements to deliver stronger growth above the cautious $2^1/_4$ per cent a year assumption used for the fiscal projections. Actual growth potential would be assessed in the light of subsequent economic and policy developments.

With the accumulation of a further $2^1/_2$ years of evidence on UK economic performance, including clear signs of a decline in the sustainable rate of unemployment, the Government now believes that it is possible to give a firmer indication of the outlook for trend growth. This is made easier by the estimated return of the economy to its trend level in late 1998.

Based on a careful consideration of the evidence, the Government believes that a neutral assumption for the trend rate of growth over the medium term is $2^1/_2$ per cent a year. In this Pre-Budget Report, forecasts for GDP and its components are still presented as ranges, but are now firmly anchored around this neutral view[1]. This is a balanced assessment, assuming only a very modest increase in the employment rate, and not banking any improvement in underlying productivity performance.

The upper ends of the GDP forecast ranges presented in this Annex illustrate the clear potential for stronger non-inflationary growth. Over the past two and a half years, the Government has introduced a wide range of policies designed to raise the economy's growth potential. Measures to deliver economic stability, get more people into work and raise productivity growth are described fully in Chapters 2, 3 and 4. Together with responsible wage bargaining, they offer the potential for growth at or indeed beyond the upper ends of the GDP forecast ranges over the medium term.

[1] The lower and upper ends of the ranges are based on $2^1/_4$ and $2^3/_4$ per cent trend growth respectively. The former assumes no change in the employment rate, and productivity growth just below 2 per cent. The latter is symmetrical around the neutral case.

A24 As a neutral assumption, productivity is projected to grow by an average 2 per cent a year over the medium term. This is below the actual average through the 1990s, but in underlying terms it is exactly in line with the 1990s performance. The projection includes a temporary negative allowance associated with an increasing employment rate. While productivity growth has been lower over the past two years, there is no conclusive evidence that this reflects any shift in underlying performance.

A25 Indeed, there is a good chance that a significantly improved productivity performance can be achieved, supported by the increased share of business investment in GDP over recent years. The benefits of higher investment in Information and Communications Technology (ICT) could also progressively begin to boost trend growth. This is supported by the Government's commitment to high quality long-term investment in science and innovation, new technology and skills. Moreover, the continued pursuit of a pro-active monetary policy and prudent fiscal policy will preserve the platform of stability on which higher sustainable growth depends. With its focus on economic stability, increased employment opportunity, higher productivity, and responsibility in wage setting, the Government is aiming for stronger sustained growth above the neutral assessment of prospects.

Prospects for growth

A26 Latest indicators signal a strong and more broad-based economic expansion in the second half of this year. Household consumption is now forecast to grow by 4 per cent in 1999 as a whole, supported by buoyant real incomes and the recent housing market upturn. This poses the clearest upside risk to activity (see Box A4). Business investment growth in 1999 is also much higher than expected in March, given continued strength in the first half of the year. However, some slowing in investment growth remains likely in the period ahead. Company profits have recently been squeezed, and the lag between last year's deterioration in investment intentions and spending itself could be significant. Nevertheless, as a percent of GDP, business investment is forecast to remain close to its current record level, locking in the strong gains of recent years.

Chart A2: Gross Domestic Product (GDP)

A27 Survey data suggest that inventories may have fallen below normal levels in the spring, implying less scope for de-stocking in the period ahead. Similarly, the period in which UK growth has been held back by weak net exports also appears to have come to an end. Evidence is now emerging that adjustment to sterling's earlier appreciation may be nearing completion and global activity has picked up. Survey measures of export confidence and demand have shown a significant recovery recently, and UK export volumes rebounded during the third quarter. These factors point to buoyant final domestic demand being more fully reflected in GDP in the second half of 1999, although it is not clear how the strength of expenditure in the third quarter, implied by latest preliminary indicators, will be reconciled with output.

A28 Overall, GDP is projected to grow by $1^3/_4$ per cent in 1999, higher than the 1 to $1^1/_2$ per cent Budget forecast and considerably stronger than the independent consensus in March. Domestic demand is forecast to contribute $3^1/_2$ percentage points to growth, although net trade is expected to reduce growth by $1^1/_2$ percentage points during the year as a whole reflecting weak performance during the first quarter. Strengthening exports, and the prospect of a more neutral contribution to growth from inventories than in 1999, implies that some slowing in final domestic demand will be necessary in order to keep the economy close to its sustainable path in 2000. Overall GDP is forecast to grow by $2^1/_2$ to 3 per cent next year, with manufacturing output expected to rise by $1^1/_2$ to 2 per cent.

A29 On that basis, output is now expected to be around $^1/_4$ per cent above its trend level in the first half of 2000. The Bank of England's Monetary Policy Committee has recently noted that the pace of demand would need to be restrained in order for the inflation target to be achieved in the medium term[6]. GDP is now forecast to grow by $2^1/_4$ to $2^3/_4$ per cent in 2001, the mid-point of this range coinciding with the neutral outlook for trend growth. The temporary potential for non-inflationary, above trend, growth in 2001 envisaged at Budget time has been taken up by stronger growth in 1999 and the prospect of continued momentum in 2000. GDP growth is expected to remain within this $2^1/_4$ to $2^3/_4$ per cent range in 2002. Ensuring that the economy does not out-run its potential for non-inflationary growth over the next few years is necessary to secure a continued platform for stability and sustained increases in output and employment.

Chart A3: The output gap

Inflation

A30 RPIX inflation has remained close to target during the past year, fluctuating in a narrow band between 2 and $2^3/_4$ per cent. As expected in March, it drifted below $2^1/_2$ per cent during the summer, helped by the continued influence of weak import prices and a compression of margins at both the producer and retail levels. This has masked the impact of both a doubling in the oil price since the start of the year and strong growth in domestic unit wage costs.

A31 Import prices fell by a cumulative 15 per cent between mid-1996 and the first quarter of 1999, a result of sterling's appreciation and falling commodity prices. The downward effect from sterling is now waning which, together with stronger oil prices, led to a modest rise in import prices in the second quarter of 1999. However, with the exception of petroleum products, there is as yet only limited evidence of import prices starting to exert upward pressure on producer and retail prices. Underlying output price inflation (excluding food, beverages, tobacco and petroleum) is close to zero, with most manufacturers still facing strong competition from cheap imports, though output prices have stopped falling. Retail goods price inflation meanwhile was just 0.5 per cent in September.

A32 Wage growth has eased significantly over the past year and a half, with the Average Earnings Index (AEI) measure down $^3/_4$ percentage points from its peak of $5^3/_4$ per cent in spring 1998. This is backed by an even larger decline in wage growth according to New Earnings Survey, and lower pay settlements. Nevertheless, AEI growth is high relative to weaker productivity. Unit wage cost growth in excess of 4 per cent since last autumn has contributed to stubbornly high services price inflation of around $4^3/_4$ per cent excluding rent and utilities. This can, however, be read as a significant but temporary response to the pause in output growth last year. The forecast assumes it will quickly unwind as strong growth is maintained, as suggested by the latest readings of the Institute of Management Services productivity index.

A33 During the course of next year, RPIX inflation is forecast to rise from its present level of 2.1 per cent, returning to its $2^1/_2$ per cent target by the end of the year. This reflects the effects of rising import price inflation and little further compression of profit margins (implying a less negative contribution to inflation) outweighing the impact of easing unit labour cost growth and lower indirect tax effects. In the first quarter of 2000 RPIX inflation will tend to be held down by Budget 98 tobacco duty increases dropping out of the annual calculation and the absence of duty increases for most alcoholic drinks in Budget 99. From the second quarter the forecast adopts the conventional assumption of fuel and tobacco duty increases in line with RPI inflation, instead of previous escalator uprating, to maintain inflation neutrality. Decisions on any real increases in excise duties, above inflation, will be announced at Budget time.

A34 The Harmonised Index of Consumer Prices (HICP) measure of inflation currently stands at around $1^1/_4$ per cent, 1 percentage point below RPIX inflation. Half of this differential reflects coverage differences, principally the exclusion of relatively fast growing housing components from the HICP. This divergence is expected to narrow into 2000, leaving a more persistent differential of 0.5 percentage points reflecting different index construction methods.

Chart A4: RPIX

Box A3: The regional balance of economic activity

The prospect of stable growth with low inflation is partly dependent upon the balance of economic activity between the various regions of the UK economy. For example, there is evidence that greater regional dispersion in

unemployment rates can increase the sustainable aggregate level of unemployment. Divergences in economic performance exist for a variety of reasons including differences in the structure of regional economies and variations in the quantity and quality of the local labour forces and capital stocks. Because migration in labour and capital tends to be quite sluggish, such divergences in performance can persist over time.

Dispersion in regional unemployment increased sharply during the early 1980s and persisted throughout the decade. For example, the jobless rates in Northern England, Scotland and Wales were over 4 percentage points higher than in Southern England during the 1980s as a whole. In contrast, the recession of the early 1990s hit Southern England disproportionately, resulting in a sharp narrowing of these differentials.

Dispersion in regional unemployment rates

As the economy has gradually returned to trend during the 1990s, regional unemployment rates have fallen broadly in line with one another. This lasting reduction in regional labour market mismatch has helped contain wage pressures and is widely acknowledged to have contributed to a decline in the sustainable rate of unemployment over the past 10 years. Ratios of unemployment to vacancies have also fallen across all regions.

Regional variations in housing market performance have also been less marked in recent years compared to the 1980s. Annual house price inflation in the South East in recent months appears to be running at around 15 per cent against a UK average of around 10 per cent. Stronger cyclical movements in house prices in the South are likely to reflect the relatively fixed supply of land and housing, and possibly greater volatility in local demand.

House price inflation

This does not necessarily imply strong gains in house prices in the south are a direct cause of instability elsewhere. Indeed, evidence of the so-called 'ripple' effect in house price inflation from the South East to proximate regions is quite weak. But because of inelastic supply, housing market pressures do tend to show more in London and the South East, and have tended to lead the rest of the country during previous booms. Under previous monetary policy arrangements, these warnings of wider pressures could too easily be ignored. Under the Government's new framework, by contrast, a build up of similar pressures in 1997 was quickly alleviated through a timely policy response.

A35 There are clear risks either side of this central view. Unit wage cost pressures could prove more persistent than expected, prompting a sharper rise in RPIX inflation later in 2000. Similarly, the recent squeeze in retail and producer margins could go into reverse, though competition among supermarkets and possible utility price reductions provide particular downward pressures. On the other hand, recent inflation outturns have been lower than expected, despite much stronger growth. This may be explained by sterling, though a more persistent improvement in the growth-inflation mix cannot be ruled out. The forecast does not assume this, but the evidence will be closely monitored in the run up to Budget 2000.

A36 GDP deflator inflation was $1^3/_4$ per cent in the second quarter of 1999, its lowest rate for over four years. Despite upward pressure due to the rising terms of trade, it remains 0.5 percentage points below RPIX inflation. This gap is the result of abnormally low consumers' expenditure deflator (CED) and government consumption deflator inflation, the former reflecting coverage differences. It has been reinforced by the subdued investment deflator, with falling import prices exerting downward pressures in the manufacturing sector. CED inflation is assumed to move broadly back in line with RPIX inflation next year and the terms of trade effect should unwind returning GDP deflator inflation to $2^1/_2$ per cent in 2000-01.

Independent forecasts

A37 Further risks to the economic outlook are discussed in the remainder of this annex. They are reflected in the range of independent forecasts for the UK economy (Table A4). However, on average, outside views on the growth outlook have strengthened markedly since the Budget. The independent consensus for GDP growth has risen to 1.6 per cent for 1999 and 2.6 per cent for 2000, from respective lows of 0.6 per cent and 1.8 per cent in March. The latest consensus is in line with the Pre-Budget Report forecast and, for 1999, has moved beyond the upper end of the original Budget forecast ranges.

Table A4: Pre-Budget Report and independent1 forecasts

	Percentage changes on a year earlier unless otherwise stated					
	1999			2000		
		Independent			Independent	
	Pre-Budget Report	**Average**	**Range**	**Pre-Budget Report**	**Average**	**Range**
Gross domestic product	$1^3/_4$	1·6	0·7 to 2·0	$2^1/_2$ to 3	2·6	1·1 to 3·7
RPIX (Q4)	2	2·1	1·5 to 2·5	$2^1/_2$	2·4	1·7 to 3·0
Current account (£ billion)	$-12^1/_4$	-11·7	-17·4 to -6·0	$-10^1/_4$	-14·0	-29·0 to -4·0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts', October 1999.*

A38 These upward revisions to growth projections have not been accompanied by any significant increase in forecasts for inflation. The average independent expectation for RPIX inflation in the fourth quarter of 1999 has edged down to 2.1 per cent and, like the Pre-Budget Report forecast, independent forecasters see inflation returning to the Government's target by the end of next year. Forecasts for the balance of payments current account have deteriorated more significantly, with deficits equivalent to around $1^1/_4$ to $1^1/_2$ per cent of GDP expected in both 1999 and 2000.

FORECAST ISSUES AND RISKS

The household sector

A39 Household consumption has rebounded rapidly from its slowing in mid-1998. Quarterly growth has exceeded 1 per cent since late last year, well above the Budget forecast. Goods expenditure in particular has strengthened considerably, with latest monthly data signalling robust retail spending into the second half of 1999. Durables purchases have been supported by buoyant housing market turnover, though total spending in this category has been affected by changes to the system of vehicle registrations.

A40 It is sometimes suggested that these trends are a direct result of muted retail goods price inflation, either due to the implied boost to real incomes or substitution effects. However, stubbornly high services price inflation has not prevented rapid growth in demand and output in the service sector. Over the medium term, consumer prices cannot be considered independent of demand. In the longer term, rapid growth in spending will always tend to be reflected in higher prices or imports without a concomitant increase in firms' ability to supply.

Table A5: Household sector[1] expenditure and income

	Percentage changes on previous year				
			Forecast		
	1998	**1999**	**2000**	**2001**	**2002**
Household consumption[2]	$3^1/_4$	4	$2^1/_2$ to $2^3/_4$	2 to $2^1/_2$	$2^1/_4$ to $2^3/_4$
Real household disposable income	0	$3^3/_4$	3 to $3^1/_2$	$2^1/_4$ to $2^3/_4$	$2^1/_2$ to 3
Saving ratio (level, per cent)	$6^1/_2$	6	$6^1/_4$	$6^1/_2$	$6^3/_4$

[1] *Including non-profit institutions serving households.*

[2] *At constant prices.*

A41 With growth in employment remaining robust, real household disposable income is now expected to grow by $3^3/_4$ per cent in 1999. Moreover, feelings of job insecurity have eased following continued falls in unemployment. Independent forecasters now expect these gains to be sustained and the EC/GfK balance of households expecting job losses has fallen well below its long-run average. As expected, the negative impact from income tax self-assessment on disposable income growth has been less potent this year than last and, as a proportion of gross disposable income, household net interest payments have also fallen. Together, these factors account for the rapid rebound in real income growth this year.

A42 The household saving ratio showed a marked fall last year, suggesting that consumers were confident that the sharp dip in real income growth would be short-lived. This allowed households to smooth their spending in the face of a temporary decline in income growth. In the early 1990s, by contrast, the saving ratio rose sharply as expectations of future incomes were heavily scaled back and spending curtailed. The saving ratio is expected to rise only gradually over the next three years, with historically high wealth to income ratios and low inflation underpinning continued growth in spending. The Government is aiming to encourage saving in the medium term through its strategy on savings (see Chapter 5), including Individual Savings Accounts introduced in April this year.

A43 Overall, the near-term prospect is one of continued strength, and household consumption is now forecast to grow by 4 per cent in 1999. As with independent forecasts, this is expected to slow to $2^1/_2$ to $2^3/_4$ per cent in 2000, eventually settling at sustainable rates in later years. The clearest risks to the short-term outlook lie on the upside. This is reflected in high levels of consumer confidence which, on the basis of past associations, is likely to be boosted by recent rapid gains in housing wealth. The risk to stability posed by too rapid growth in house prices and consumption is examined in Box A4.

Box A4: Housing, consumption and economic stability

House prices have risen rapidly since the spring, lifting annual house price inflation above 10 per cent on all measures. While the strengthening is not uniform across the UK, regional divergences are more modest compared to previous cycles (see Box A3). Most regions are now experiencing price gains in excess of rates that are likely to be sustainable over the longer term. Similarly, annual growth in housing transactions has risen to around double-digit rates and new mortgage approvals are running at high levels.

The UK housing market appears particularly prone to demand-driven house price inflation due to inelastic housing supply, both in the short and longer term. Clear evidence of this has been seen in strong house price volatility and the long-run tendency of house prices to rise in line with earnings rather than prices in general. Housing market volatility might in turn pose a threat to wider economic stability.

Most obviously, higher house prices might boost consumer spending through general wealth effects, though it is not clear that such gains make the household sector better off in aggregate. They may nevertheless enable increased borrowing against housing collateral, releasing additional funds for consumption. Arithmetically, this process - known as mortgage equity withdrawal could account for the sharp decline in the household saving ratio to 3 per cent during the late 1980s. A strong association between house prices and consumer confidence at least is clear. Irrespective of the precise nature of this relationship, and in particular whether any causality is necessarily implied, this means that house prices do provide relevant information on future spending.

Strong growth in real incomes and the relatively low mortgage interest burden signal continued near-term strength in housing demand. However, as noted by most commentators, fundamental indicators of housing market balance point to a greater degree of stability than in past cycles. Real growth in house prices has been quite modest in recent years, probably signalling continued household caution following sharp falls in nominal house prices and resulting negative equity during the early 1990s. As a result, the house price to income ratio remains close to its long-run average, suggesting recent comparisons with the booms of the 1970s and 1980s are misplaced.

Nevertheless, past experience also illustrates a clear tendency for house prices to continue accelerating after initial momentum has gathered. This probably reflects inelastic supply and the importance of expected price gains in determining current housing demand. It poses the clearest upside risk to consumer spending into 2000. However, the process is far from automatic. The Government's introduction of a credible and transparent framework for monetary policy setting should provide a more effective anchor for household expectations of future house price gains. The Government has taken further action to promote sustainable growth in the housing market through the abolition of MIRAS from April 2000 and raising stamp duty at the top end of the market.

Companies and investment

A44 Business investment has risen very rapidly in recent years, with annual average growth of 10 per cent since 1995. As a share of GDP, it surpassed its previous 1980s' high in late 1997, rising further to $14^1/_4$ per cent of GDP by the second quarter of 1999. It has risen 2 percentage points since 1997. Given the relatively small cyclical peak in output in 1998, much of the increase in the business investment ratio is likely to reflect structural factors. Annual growth in business investment has remained at double-digit rates during the first half of 1999, despite the pause in output growth around the turn of the year. With lower growth and global factors exerting downward pressures on profits, private non-financial companies net borrowing is forecast to rise to around $2^1/_2$ per cent of GDP in 1999.

A45 Rising business investment since the mid-1990s is partly explained by increased capacity utilisation as the economy returned to trend in 1997. The real cost of capital has been very supportive too. Interest rates have fluctuated within an historically low range and the relative price of investment goods has fallen, partly due to lower import prices but also a result of sharp reductions in the price of ICT capital goods. Indeed, gross investment may have been boosted by faster depreciation, reflecting the increasing share of ICT investment with shorter asset lives. At the same time, equity finance has been relatively cheap due to buoyant stock market conditions. Nevertheless, even taking account of all these factors, a significant part of the recent strength in business investment cannot be explained via conventional models.

Chart A5: Business and non-residential investment ratios

A46 The ratio of business investment to GDP is forecast to remain close to its recent record level over the next three years (Chart A5), locking in the particularly strong gains of recent years. This will be important in reversing the past legacy of under-investment in the UK economy, so helping to close the productivity gap with our international partners (see Chapter 3). Given the clear tendency of past spurts in investment to be followed quickly by strong retrenchments in company spending, maintenance of this high share of capital spending in GDP would be a very strong performance. Under the new policy framework, the Government is delivering the platform of economic stability necessary to achieve this. Indeed, the unexpected strength of investment spending in recent years is probably partly explained by the clear reduction in macroeconomic instability and uncertainty.

A47 The investment forecast implies continued non-financial companies net borrowing close to its recent level. With company balance sheets currently strong, such deficits appear readily financeable (see Box A5). A continuation of the recent rapid growth rates in investment spending, by contrast, would bring the scale of company net borrowing much closer to that seen in the late 1980s and early 1990s. Firms may be reticent to make this move, given strong capital spending in recent years, although their desired capital stock, and hence this judgement, is highly uncertain. With the employment rate already at high levels, medium term growth prospects are now more strongly dependent upon firms securing an improved productivity performance. Further strong growth in investment therefore remains a clear possibility.

Table A6: Gross fixed capital formation

			Percentage changes on previous year		
			Forecast		
	1998	**1999**	**2000**	**2001**	**2002**
Whole economy[1]	$9^3/_4$	$4^1/_4$	$2^1/_4$ to $2^1/_2$	$2^1/_2$ to 3	$3^1/_4$ to $3^3/_4$
of which:					
Business[2,3]	$12^1/_2$	$5^3/_4$	1 to $1^1/_4$	$1^3/_4$ to $2^1/_4$	2 to $2^1/_2$
Private dwellings[3]	6	$-1^1/_4$	5 to $5^1/_2$	2 to $2^1/_2$	2 to $2^1/_2$
General government[3,4]	$3^1/_4$	$3^1/_4$	$9^1/_2$	$10^3/_4$	$14^3/_4$

[1] *Includes costs associated with the transfer of ownership of land and existing buildings.*

[2] *Private sector and public corporations' (except National Health Service Trusts) non-residential investment. Includes investment under the Private Finance Initiative.*

[3] *Excludes purchases less sales of land and existing buildings.*

[4] *Includes National Health Service Trusts.*

A48 However, in view of recent strong growth in capital spending and softer investment intentions since the middle of last year, despite some firming this year, business investment is cautiously forecast to grow more slowly over the coming year. Whole economy investment is forecast to grow somewhat faster, rising above trend rates beyond next year as the

Government's CSR commitment to raise public investment continues to take effect. Growth in general government investment is expected to average almost 12 per cent over the next three years.

Trade and the balance of payments

A49 From a position of broad balance in 1998, the current account deficit rose to £$7^1/_4$ billion, or $1^3/_4$ per cent of GDP, in the first half of 1999. In line with the Budget forecast, this movement was dominated by a £$5^1/_2$ billion reduction in the surplus on investment income between the second half of 1998 and the first half of this year. The income surplus had risen strongly above normal levels last year, boosted by losses made by UK-based foreign owned banks and oil companies as a result of global financial turbulence.

A50 Net trade in goods and services also weakened, with the overall deficit rising to £$8^3/_4$ billion in the first half of 1999 compared to £$5^1/_2$ billion in the previous half year. Detailed statistics showed a clear and continued impact from global economic developments. The trade in services surplus remained healthy in the first half of 1999, buoyed by its relatively high dependence on the fast-growing US economy. By contrast, goods exports fell by around £3 billion compared to the second half of 1998, with sales to slower growing EU markets down £$2^1/_4$ billion. With growth in imports relatively subdued, this fully accounted for the larger than expected current account deficit during the first half of this year.

Table A7: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices[1]			Goods and services
	Exports	**Imports**	**Exports**	**Imports**	**Terms of trade[2]**	**balance**
1998	2	$8^1/_2$	$-4^1/_4$	$-6^1/_4$	$2^1/_4$	$-8^1/_2$
Forecast						
1999	$2^1/_4$	$6^1/_4$	$-^3/_4$	-2	$1^1/_4$	-15
2000	$6^1/_2$ to $6^3/_4$	6 to $6^1/_2$	$1^1/_4$	$1^1/_2$	0	$-15^3/_4$
2001	5 to $5^1/_2$	$4^1/_2$ to 5	$2^1/_2$	3	$-^1/_2$	$-17^1/_4$
2002	$5^1/_2$ to 6	5 to $5^1/_2$	3	$3^1/_4$	$-^1/_4$	-18

[1] *Average value indices.*

[2] *Ratio of export to import prices.*

A51 However, the recent pick up in world growth and fuller adjustment to sterling's earlier appreciation are now feeding through to a marked improvement in export performance. Total export volumes rose by 6 per cent in the three months to August compared to the previous three months and survey measures of export confidence have also strengthened markedly. Following a sharp rise during the third quarter of 1999, export volumes to non-EU countries have now fully recovered the ground lost last year as a result of turbulence in emerging markets. Excluding Indonesia, exports to the recovering Asian economies are now growing rapidly, though the fastest expansion remains in sales to North America. Export volumes to EU countries have also picked up, with Eurozone activity firming since the spring.

Chart A6: Balance of payments current account

A52 Growth in import volumes has also strengthened recently and is likely to remain buoyant given strong growth in UK demand. Net trade overall therefore is expected to make a broadly neutral contribution to growth from now on, with import growth slowing as UK demand returns to more sustainable rates in 2001 and beyond. Mainly due to the deterioration in the first half of the year, the trade in goods and services deficit is forecast to widen to £15 billion in 1999 as a whole, remaining around $1^3/_4$ per cent of GDP in later years. Movements in the current account deficit both this year and next are influenced by special factors affecting the investment income and transfers balances. Overall, the current account deficit is expected to show a narrowing trend from now, falling to around 1 per cent of GDP in 2002.

Box A5: What does the current account deficit tell us?

The counterpart of the recent move into current account deficit has been seen mainly in the corporate sector, with strong capital spending contributing to a rising company financial deficit. Over the forecast horizon changes in net lending by households and the public sector combined are expected to be relatively modest. So the balance of payments current account deficit will continue to be mirrored mainly in corporate sector net borrowing.

Despite the boost to national saving due to fiscal tightening, the external deficit reflects a shortfall in total domestic saving following rapid increases in investment in recent years. In the first half of 1999 the current price ratios of both business and whole economy investment to GDP were over 1 percentage point up on 1997, accounting for a good part of the $1^3/_4$ percentage point widening in the non-oil goods and services trade deficit. Falling import prices have probably been a contributory factor, with import volumes of finished capital goods manufactures rising by 20 per cent over the same period. The constant price business investment ratio has risen more markedly, up 2 percentage points since 1997, as real investment prices have fallen overall.

Over the forecast horizon, the share of investment in GDP is expected to remain around its recent high level, though with clear risks either side. With total domestic saving not rising enough to match, this is reflected in a persistent external deficits. However, these are expected to remain modest by historical standards, narrowing gradually over the forecast period. They would also appear to be readily financeable for the foreseeable future: company balance sheets are currently healthy and investment spending should boost tangible wealth yielding future returns. Nevertheless, companies have shown little appetite for increasing debt ratios, and so any sharp fall in equity prices, raising the cost of equity finance, could pose a substantial risk to the outlook. In the longer term, domestic saving will probably need to rise to secure current high levels of capital spending.

These developments contrast sharply with those in the late 1980s when the private sector ran large financial deficits associated with a fall in saving. The balance of payments current account deficit then reached $4^1/_2$ per cent of GDP, which was clearly symptomatic of unsustainable excess demand.

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[1]The economic forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 1999 released by the Office for National Statistics on 22 September, and the preliminary GDP estimate for the third quarter released on 22 October. A full set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk), and copies can be obtained on request from the Treasury's Public Enquiry Unit (0171 270 4558). [Back]

[2] The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast. Potential 'Year 2000 problem' impacts are excluded from the forecast (see the 1998 Pre-Budget Report, page 97).[Back]

[3] See the next section, 'Trend output growth'.[Back]

[4] A detailed discussion of the determinants of trend growth and its implications for policy making is provided in *Trend growth prospects and implications for policy*, HM Treasury, November 1999.[Back]

[5] Under this simple decomposition, the contributions of the capital stock per worker and total factor productivity to trend output are subsumed in estimated labour productivity (output per worker).[Back]

[6] Minutes of the Monetary Policy Committee, 78 September 1999.[Back]

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B

The public finances

The latest projections of the public finances show that the underlying position for the public finances remains sound, and that the Government is on track to meet its fiscal rules:

- **the current budget surplus is expected to rise to £9$^{1}/_{2}$ billion (over 1 per cent of GDP) in 19992000. The current budget surplus is projected to remain at around 1 to 1$^{1}/_{4}$ per cent of GDP throughout the projection period; and**
- **public sector net debt is projected to fall to around 38 per cent of GDP by the end of the current financial year. It is projected to continue falling steadily as a percentage of GDP over the following five years.**

Cyclically-adjusted public net borrowing is expected to be close to the Budget projections throughout the projection period.

INTRODUCTION

B1 Chapter 2 explained the Government's fiscal framework, its fiscal rules, and how the latest projections of the public finances are consistent with meeting these rules. This annex explains in more detail the Government's performance against the fiscal rules. It includes:

- five year ahead projections of the current budget surplus and public sector net debt, the key aggregates for assessing performance against the golden rule and the sustainable investment rule, respectively;
- projections of public sector net borrowing (PSNB), the fiscal aggregate relevant to assessing the impact of fiscal policy on the economy;
- consistent projections of the cyclically-adjusted fiscal balances; and
- detailed analyses of the outlook for government receipts and expenditure.

B2 In the interests of transparency, further improvements are to be made to the monthly Public Sector Finances *First Release*. Box B1 explains these changes.

KEY FISCAL AGGREGATES

B3 One of the key roles of the Pre-Budget Report (PBR) is to provide an update of the projections of the public finances contained in the Budget, taking account of developments in both the public finances and the economy since Budget time. It is important to note that the public finance projections in the PBR present an interim forecast update and do not necessarily represent the final outcome the Government is seeking. Therefore, the projections contained in the PBR should *not* be interpreted as the Government's desired outcome.

Box B1: Major improvements to monthly public finance statistics

Significant improvements are in hand for the reporting of public finance statistics by the Office for National Statistics (ONS)1. From 18 November 1999, for the first time, monthly figures for the public sector surplus on current budget will be presented in the Public Sector Finances *First Release*. The improvement means that the key measures needed to assess progress against the Government's fiscal framework will all be published together on a monthly and timely basis. This will aid scrutiny of the Government's fiscal policy.

Monthly estimates will thus be available for:

- **public sector surplus on current budget, the key measure for assessing progress against the golden rule;**
- **public sector net debt, the key measure for assessing progress against the sustainable investment rule; and**
- **public sector net borrowing, a measure of the overall fiscal impact of policy on the economy and the starting point for analysis of the fiscal stance.**

The surplus on current budget is defined as net saving, plus receipts from capital taxes, in line with national accounts under the European System of Accounts 1995 (ESA95). ESA95 also defines net borrowing. From March 2000 general government net borrowing (included in the *First Release*) will be reported to the European Commission on an ESA95 basis under the requirements of the Maastricht Treaty.

In addition, there will be a new summary of monthly central government receipts and expenditure on a national accounts basis, as defined by ESA95. This new summary will show the central government transactions which help determine the surplus on current budget and net borrowing. These are: taxes on production, taxes on income and wealth, other taxes, social contributions, interest and dividend receipts, the total of other receipts, interest payments, net social benefits paid, the total of other current expenditure, gross investment and depreciation. This will enable users to see the components of monthly central government net borrowing more clearly than was previously possible, and so help improve understanding of recent trends.

For the public sector as a whole, the release will also include for the first time, monthly estimates of net investment.

[1] The Public Sector Finances *First Release* is issued jointly by the ONS and HM Treasury. More information can be found on the internet at http://www.ons.gov.uk.

B4 Table B1 compares the PBR projections for the key fiscal aggregates, used for assessing performance against the two fiscal rules, with those made at the time of the last Budget. A current budget surplus of £9.5 billion is now estimated for 1999-2000, compared with the Budget projection of £2 billion. A similar improvement is seen for public sector net borrowing. A net repayment of £3.5 billion is now expected in 1999-2000, compared with a projected deficit of £3 billion in Budget 99.

Table B1: Fiscal balances comparison with Budget 991

	Outturn[2]	Estimate		Projections		
	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**
Fiscal balances (£ billion)						
Surplus on current budget - PBR	7.2	9.5	11	13	13	12
Surplus on current budget - Budget 99	4.1	2	4	8	9	11
Net borrowing - PBR	-2.5	-3.5	-3	-3	1	4
Net borrowing - Budget 99	-1.0	3	3	1	3	4
Cyclically-adjusted fiscal balances (per cent of GDP)						
Surplus on current budget - PBR	0.6	0.9	1.0	1.2	1.2	1.1
Surplus on current budget - Budget 99	0.2	0.6	1.0	1.1	0.9	1.0
Net borrowing - PBR	0.0	-0.2	-0.2	-0.2	0.1	0.4
Net borrowing - Budget 99	0.1	0.0	-0.2	-0.1	0.3	0·4

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

[2] *The 1998-99 figures were estimates in Budget 99.*

B5 Table B2 shows latest outturns for the key fiscal aggregates, together with estimates for the current year and projections up to 2004-05. Outturns and projections of other important measures of the public finances, including net borrowing and net worth, are also shown.

Table B2: Summary of public sector finances[1]

	Per cent of GDP							
	Outturns		Estimate	Projections				
	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**
Fairness and prudence								
Surplus on current budget	-0.6	0.8	1.1	1.2	1.3	1.2	1.1	1.0
Long-term sustainability								
Public sector net debt[2]	42.2	40.3	38.2	36.9	35.3	34.1	33.2	32.5
Net worth[2,3]	14.7	13.7	15.6	16.6	17.8	18.3	18.9	19.2
Primary balance	1.9	3.2	2.9	2.9	2.8	2.3	1.9	1.5
Economic impact								
Net investment	0.6	0.6	0.7	0.9	1.1	1.3	1.5	1.5
Public sector net borrowing	1.2	-0.3	-0.4	-0.3	-0.3	0.1	0.4	0.5
Financing								
Central government net cash requirement[2]	0.4	-0.5	0.1	0.0	-0.1	0.1	0.6	0.7

[1] *Excluding windfall tax receipts and associated spending.*
[2] *Including windfall tax receipts and associated spending.*
[3] *Previously net wealth, end-calendar year.*

MEETING THE FISCAL RULES

B6 The current budget balance improved from a deficit of over $^{1}/_{2}$ per cent of GDP in 1997-98 to a surplus of nearly 1 per cent of GDP in 1998-99. The surplus is expected to rise further in the current year, to over 1 per cent of GDP. Beyond this year, the current budget surplus is projected to remain in a range of 1 to $1^{1}/_{4}$ per cent of GDP to 2004-05.

B7 Net borrowing is equal to net investment minus the surplus on the current budget. Public sector net investment is projected to be around $^{3}/_{4}$ per cent of GDP this year, implying a repayment of net borrowing of around $^{1}/_{2}$ per cent of GDP. The ratio of net investment to GDP is projected almost to double between 1997-98 and 2001-02, and to increase to $1^{1}/_{2}$ per cent of GDP by 2003-04.

B8 The primary balance is equal to (minus) net borrowing excluding net debt interest payments- thus abstracting from the implications of past fiscal deficits. Assuming real interest rates exceed trend GDP growth, a primary surplus is required to stabilise the net debt ratio. The primary balance has swung from a deficit of $^{1}/_{2}$ per cent of GDP in 1996-97 to an estimated surplus of nearly 3 per cent of GDP this year. It is projected to be in surplus by between $1^{1}/_{2}$ per cent of GDP and 3 per cent of GDP throughout the next five years.

B9 The central government net cash requirement is projected to remain modest on average over the next five years. The approximate stock counterpart to the net cash requirement is net debt. With the stock of public sector net debt rising only slowly over the next five years, steady GDP growth gradually reduces the debt-GDP ratio. The debt ratio falls from just over 40 per cent last March, to just over 38 per cent at the end of the current financial year. The debt ratio continues to fall, to under 33 per cent by March 2005.

Chart B1: Public sector net debt[1]

B10 The approximate stock counterpart to the current budget balance is public sector net worth (previously known as net wealth). The projection of steady current budget surpluses of over 1 per cent of GDP a year begin to raise net worth, after a prolonged period in which the poor state of the public finances had eroded net worth to under 15 per cent of GDP, from 77 per cent of GDP in 1980. The Office for National Statistics (ONS) is currently in the process of improving the quality of balance sheets by taking advantage of new data from the introduction of resource accounts for central government departments. These developments are reported in an article in November 1999 *Economic Trends*.

Chart B2: Public sector net worth[1]

Table B3: Fiscal balances[1]

	Per cent of GDP							
	Outturns		Estimate	Projections				
	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**
Fiscal balances								
Surplus on current budget	-0.6	0.8	1.1	1.2	1.3	1.2	1.1	1.0
Average surplus since 1997-98	-0.6	0.1	0.4	0.6	0.8	0.8	0.9	0.9
Net borrowing	1.2	-0.3	-0.4	-0.3	-0.3	0.1	0.4	0.5
Cyclically-adjusted fiscal balances								
Surplus on current budget	-0.6	0.6	0.9	1.0	1.2	1.2	1.1	1.0
Net borrowing	1.2	0.0	-0.2	-0.2	-0.2	0.1	0.4	0.5
Memo								
Output gap	0.5	0.3	0.2	0.2	0.1	0.0	0.0	0.0

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

B11 Table B3 shows the updated projections of the current budget and net borrowing as a per cent of GDP, and their cyclically-adjusted equivalents, which allow underlying, or structural, trends in the indicators to be seen more clearly, after the estimated effects of the economic cycle are removed. The state of the public finances has been transformed since 1996-97. From a deficit of nearly 3 per cent of GDP in 1996-97, the current budget is expected to be in surplus by over 1 per cent of GDP this year. The current surplus is projected to remain at around 1 to $1^1/_4$ per cent of GDP over the next five years.

B12 The cyclically-adjusted current budget has moved from a deficit of over $^1/_2$ per cent of GDP in 1997-98 to a surplus of over $^1/_2$ per cent last year. It is expected to rise further this year, to an estimated surplus of nearly 1 per cent of GDP. With the economy projected to be slightly above trend over the following two years, the cyclically-adjusted current budget surpluses are a little smaller than the unadjusted projections.

B13 There has been a corresponding improvement in cyclically-adjusted net borrowing. From a deficit of over 1 per cent of GDP in 1997-98, cyclically-adjusted net borrowing is estimated to become a small net repayment in 1999-2000. In following years, the cyclically-adjusted PSNB is small and very similar to the projections in Budget 99.

Chart B3: Cyclically-adjusted current budget

B14 The fiscal projections are based on prudent and cautious assumptions (see paragraphs B18 to B20 and Box B2). A particularly important matter, however, is the risk of misreading trend output. Chart B3 therefore illustrates a still more cautious case, in which the level of trend output is assumed to be 1 per cent lower than in the central projection above. This scenario would imply that a greater proportion of the projected surplus on current budget was due to cyclical strength of the economy: a 1 per cent larger output gap reduces the structural surplus on current budget by about $^3/_4$ per cent of GDP a year. Nonetheless, even under this scenario, the cyclically-adjusted current budget is estimated to have been in balance last year, and is projected to move into surplus from this year onwards.

Forecast errors and risks

B15 The fiscal balances are the difference between two large aggregates of spending and receipts, and forecasts of them are inevitably subject to wide margins of error. Over the past five years, the average absolute error (ie the average error irrespective of whether the errors have been positive or negative) for one-year ahead forecasts of net borrowing has been over 1 per cent of GDP, or plus or minus £9 billion at today's prices. The error tends to grow as the forecast horizon lengthens. (See Table B13 on page 122 of the November 1998 PBR). Much of this error arises from errors in the forecasts of GDP.

B16 Short-term forecasts of the public finances are critically dependent on the path of the economy, as most tax revenues and some public expenditure (especially social security) vary automatically with the economic cycle. If GDP growth were 1 per cent higher or lower than assumed over the coming year, net borrowing might be lower or higher by about $^{1}/_{2}$ per cent of GDP in the first year (equivalent to about £4 billion) and lower or higher by a further $^{1}/_{4}$ per cent (£2 billion) in the second year. As illustrated above, errors in estimating trends carry significant implications for public finance projections.

ASSUMPTIONS

B17 The fiscal projections assume that:

- the economy follows the path described in Annex A. As always, and in the interests of caution, the projections are based on the lower end of the GDP growth ranges (which is based on a trend growth rate of $2^{1}/_{4}$ per cent a year);
- there are no tax changes beyond those already announced in past Budgets and in this PBR and the indexation of rates and allowances. It is assumed that all excise duties, including those for road fuel and tobacco, increase in line with inflation (see paragraph 2.51);
- Departmental Expenditure Limits (DEL) are in line with the plans set out in the July 1998 Comprehensive Spending Review (CSR). An estimated DEL underspend of £0.7 billion in 1998-99 has been carried forward to the current year; and
- Annually Managed Expenditure (AME) is unchanged from the Budget projections, with new projections of its component programmes resulting in offsetting changes in the margin.

Table B4: Economic assumptions for public finance projections

	Percentage changes on previous year						
	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**
Output (GDP) - PBR	$1^{3}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$	$2^{1}/_{4}$
Output (GDP) - Budget 99	$1^{3}/_{4}$	1	$2^{1}/_{2}$	$2^{3}/_{4}$	$2^{1}/_{2}$	$2^{1}/_{4}$	-
GDP deflator - PBR	$2^{1}/_{2}$	$2^{1}/_{4}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$
GDP deflator - Budget 99	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	$2^{1}/_{2}$	-
Money GDP (£ billion) - PBR	851	890	934	978	1024	1073	1124
Money GDP (£ billion) - Budget 99	848	880	925	975	1023	1072	-

B18 The key assumptions underlying the fiscal projections have been audited by the National Audit Office (NAO). Ten of the eleven key assumptions and conventions used for the last Budget projections are unchanged. In accordance with these assumptions and conventions, trend GDP growth is assumed to be $2^{1}/_{4}$ per cent a year; UK claimant unemployment is assumed flat at recent levels; equity prices are projected to grow from current levels in line with money GDP; and interest rates are projected in line with market expectations (Box B2).

B19 However, a new, and more cautious, assumption has been adopted for oil prices. Previously, the fiscal projections were based on flat oil prices (in real terms) at or around their current levels. This assumption was audited and endorsed by the NAO in November 1997. The new assumption is that when the average of independent forecasts shows a fall in the oil price, this average is used for projecting North Sea revenues. Oil prices are then assumed to remain unchanged in real terms at this lower level beyond the next year. When the average shows a rise, oil prices are assumed to remain unchanged in real terms from current levels, as in the previous assumption. This approach has been endorsed by the NAO, whose report, *Audit of the Oil Price Assumption for the Pre-Budget Report November 1999*, is published as a House of Commons Paper (HC873).

B20 The latest projections of North Sea revenues are based on the average of independent forecasts of oil prices for the year ahead, compiled in '*Forecasts for the UK Economy*' (HM Treasury, October 1999). The independent average forecast is currently that Brent oil prices fall from their present level of around $22 a barrel to $18.70 a barrel in 2000.

Box B2: Key assumptions audited by the NAO

• **Privatisation proceeds**[1]	**Credit is taken only for proceeds from sales that have been announced.**
• **Spend to Save**[1]	**Only direct effects of the Spend to Save programme on receipts and spending are allowed for.**
• **Trend GDP growth**[1]	**$2^1/_4$ per cent a year.**
• **UK claimant unemployment**[1, 4]	**Constant at recent levels, 1.23 million.**
• **Interest rates**[1]	**3 month market rates change in line with market expectations as of November 4.**
• **Equity prices**[2]	**FT-All share index rises from 2,850 in line with money GDP.**
• **VAT**[2]	**Ratio of VAT to consumption falls by 0.05 percentage points a year.**
• **GDP deflator and RPI**[2]	**Projections of price indices used to plan public expenditure are consistent with RPIX.**
• **Composition of GDP**[3]	**Shares of labour income and profits in national income are broadly constant in the medium term.**
• **Financing**[3]	**Financing assumptions used to project debt interest are consistent with the public finances forecast and with financing policy.**
• **Oil prices**[5]	**$18.70 a barrel in 2000, the average of independent forecasts, and then constant in real terms.**

[1] See Audit of Assumptions for the July 1997 Budget Projections, 19 June 1997 (HC3693)

[2] Audit of Assumptions for the Pre-Budget Report, 25 November 1997 (HC361)

[3] Audit of Assumptions for the Budget, 19th March 1998 (HC616)

[4] Audit of the Unemployment Assumption for the March 1999 Budget Projections, 9 March 1999 (HC294)

[5] Audit of the Oil Price Assumption for the Pre-Budget Report November 1999 (HC873)

FISCAL AGGREGATES

B21 Table B5 shows projections for the current and capital budgets in £ billion and Table B6 shows the current and capital budget projections as a per cent of GDP. The tables show the current surplus and net borrowing both including and excluding windfall tax receipts and associated spending. The latter gives a better picture of underlying movements. Latest estimates of associated spending are given in Table 4.1.

Table B5: Current and capital budgets

			£ billion				
	Outturn	Estimate			Projections		
	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**
Current budget							
Current receipts	335.5	352.1	370	389	407	426	444
Current expenditure	312.5	329.7	346	362	380	398	417
Depreciation	13.6	13.8	14	15	15	16	16
Surplus on current budget (including WTAS[1])	9.5	8.5	10	12	13	12	11

Surplus on current budget[2]	**7.2**	**9.5**	**11**	**13**	**13**	**12**	**11**
Capital budget							
Gross investment	22.9	24.0	26	29	32	35	36
less asset sales	*-4.3*	*-3.8*	*-4*	*-4*	*-4*	*-4*	*-4*
less depreciation	*-13.6*	*-13.8*	*-14*	*-15*	*-15*	*-16*	*-16*
Net investment	5.0	6.4	8	10	13	16	17
Net borrowing (including WTAS[1])	-4.5	-2.1	-1	-1	1	4	6
Net borrowing[2]	**-2.5**	**-3.5**	**-3**	**-3**	**1**	**4**	**6**
Public sector net debt - end year	349.4	349.2	352	353	357	364	374
Memos:							
General government net borrowing[3]							
ESA79	-7.2	-4.4	-5	-3	-2	3	4
ESA95	-4.2	-2.8	-2	-2	1	4	6
General government gross debt[3, 4]	399.6	399.4	403	404	409	416	427

[1] *Windfall tax receipts and associated spending.*

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

[3] *Maastricht measures of the government deficit and debt. From February 2000, the Maastricht measures will move from being reported under ESA79 to ESA95 accounting conventions.*

[4] *The stock of gross debt is not affected by the move to ESA95 accounting conventions.*

B22 The current budget surplus in 1999-2000 is estimated to be £9$^1/_2$ billion. This is a higher surplus than the Budget forecast by £7 billion. Receipts are higher by £7 billion; current spending is higher by nearly £1 billion; and depreciation is lower by £1 billion. Public sector net borrowing is estimated to be in surplus by £3$^1/_2$ billion this year, a similar improvement on the Budget forecast as for the current budget. Within the capital budget, a lower estimate of depreciation, following downward revisions to outturn data, increases net investment relative to the Budget forecast.

B23 The stronger position in 1999-2000 than anticipated at the time of the March 1999 Budget reflects three main factors:

- higher outturn figures for both the current balance and PSNB in 1998-99 than expected at the time of Budget 99. This has had the effect of raising the forecast base, and hence the profile into future years;
- a stronger than expected cyclical path for output and employment. GDP growth so far during 1999-2000 has been stronger than expected at the time of the Budget; and
- a more favourable composition of GDP growth than expected. Not only has GDP growth been stronger than anticipated, but its composition has been more favourable to the public finances, increasing the tax base relative to that expected at Budget time. In particular, the share of wages and salaries within national income is estimated to be a little higher this year than forecast at Budget time, and the consumption share of national expenditure is higher by around 1 percentage point. This increase in the tax base for given GDP has increased receipts of income tax and social security contributions, non-North Sea corporation tax, North Sea revenues and VAT.

B24 The current budget surplus is projected to rise slightly, to £11 billion in 2000-01. With net investment projected to increase relatively strongly, the repayment on net borrowing is expected to remain at about £3 billion next year.

B25 From 2001-02 onwards, with the economy growing at trend, the projected current budget surpluses gradually build up. Current expenditure rises in line with GDP, while receipts rise slightly faster. With public net investment increasing as a share of GDP, net borrowing moves from surplus to modest deficits from 2002-03.

B26 Table B6 shows the Maastricht measures of the deficit and debt used in the Excessive Deficits Procedure of the Maastricht Treaty, as a per cent of GDP. From February 2000, the Maastricht measures will move from being reported under ESA79 to ESA95 accounting conventions, and thus will be fully consistent with the UK national accounts, which moved to being on an ESA95 basis in September 1998. Table B6 shows the Maastricht measures under both the ESA79 and ESA95 accounting conventions. The reference levels of 3 per cent of GDP for the deficit and 60 per cent of GDP for debt are achieved comfortably throughout the projection period, on either definition.

Table B6: Current and capital budgets

	Per cent of GDP						
	Outturn	Estimate	Projections				
	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**
Current budget							
Current receipts	39.4	39.6	39.6	39.8	39.8	39.7	39.5
Current expenditure	36.7	37.0	37.1	37.0	37.1	37.1	37.1
Depreciation	1.6	1.6	1.5	1.5	1.5	1.5	1.4
Surplus on current budget (including WTAS[1])	1.1	1.0	1.0	1.2	1.2	1.1	1.0
Surplus on current budget[2]	**0.8**	**1.1**	**1.2**	**1.3**	**1.2**	**1.1**	**1.0**
Capital budget							
Gross investment	2.7	2.7	2.8	3.0	3.2	3.3	3.2
less asset sales	-0.5	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3
less depreciation	-1.6	-1.6	-1.5	-1.5	-1.5	-1.5	-1.4
Net investment	0.6	0.7	0.9	1.1	1.3	1.5	1.5
Net borrowing (including WTAS[1])	-0.5	-0.2	-0.1	-0.1	0.1	0.4	0.5
Net borrowing[2]	**-0.3**	**-0.4**	**-0.3**	**-0.3**	**0.1**	**0.4**	**0.5**
Public sector net debt	**40.3**	**38.2**	**36.9**	**35.3**	**34.1**	**33.2**	**32.5**
Memos:							
General government net borrowing[3]							
ESA79	-0.9	-0.5	-0.5	-0.3	-0.2	0.3	0.3
ESA95	-0.5	-0.3	-0.2	-0.2	0.1	0.4	0.5
General government gross debt[3, 4]							
ESA79	47.4	45.3	43.5	41.7	40.3	39.2	38.3
ESA95	47.0	44.9	43.1	41.3	39.9	38.8	38.0

[1] *Windfall tax receipts and associated spending.*

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

[3] *Maastricht measures of the government deficit and debt. From February 2000, the Maastricht measures will move from being reported under ESA79 to ESA95 accounting conventions.*

[4] *The move to ESA95 accounting conventions does not affect the stock of gross debt, but it does increase money GDP, by about £8 billion in 1998-99.*

RECEIPTS

B27 Table B7 gives projections of receipts, as a percentage of GDP, over the medium term. Changes in the receipts projections since the Budget for this year and next are shown in Table B8. A more detailed breakdown, in £ billion, for 1999-2000 and 2000-01 is given in Table B9. Table B10 sets out the projected change in the tax-GDP ratio.

Table B7: Current receipts

	Per cent of GDP						
	Outturn	Estimate			Projections		
	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**
Income tax (gross of tax credits)	10.4	10.6	10.7	10.9	11.1	11.2	11.3
Income tax credits[1]	-0.2	-0.4	-0.5	-0.7	-0.7	-0.7	-0.7
of which:							
Working Families' Tax Credit		-0.1	-0.5	-0.5	-0.5	-0.5	-0.5
Corporation tax	3.5	3.8	3.5	3.7	3.6	3.5	3.3
Windfall tax	0.3						
Value added tax	6.1	6.3	6.2	6.2	6.1	6.1	6.1
Excise duties[2]	4.2	3.9	4.0	3.9	3.9	3.8	3.7
Social security contributions	6.5	6.3	6.3	6.3	6.3	6.4	6.3
Other taxes and royalties[3]	6.6	6.6	6.7	6.8	6.8	6.7	6.8
Net taxes and social security contributions[4]	37.4	37.0	36.8	37.2	37.2	37.0	36.8
Accruals adjustments on taxes	0.0	0.4	0.3	0.1	0.1	0.1	0.1
less own resources contribution to EU budget	-0.7	-0.7	-0.6	-0.5	-0.4	-0.4	-0.3
Income tax credits[5]	0.2	0.4	0.5	0.6	0.6	0.6	0.6
Other receipts	2.6	2.5	2.6	2.4	2.4	2.4	2.3
Current receipts (including windfall tax)[6]	39.4	39.6	39.6	39.8	39.8	39.7	39.5
Current receipts (excluding windfall tax)[6]	39.1	39.6	39.6	39.8	39.8	39.7	39.5
Memo:							
Current receipts (£bn)[5,6]	335.5	352.1	370	389	407	426	444

1 *Mainly MIRAS and tax reliefs under the Working Families' Tax Credit and Children's Tax Credit schemes.*

2 *Fuel, alcohol and tobacco duties.*

3 *Includes Council Tax and money paid into the National Lottery Distribution Fund, as well as other central government taxes. Net of bus fuel duty rebate.*

4 *Includes VAT and 'own resources' contributions to EU budget. Net of income tax credits. Cash basis.*

5 *Excludes Children's Tax Credit, which scores as a tax repayment in the national accounts.*

6 *Accruals basis.*

B28 Excluding the windfall tax, total receipts are estimated to rise by $5^3/_4$ per cent this year, and by 5 per cent in 2000-01. The expected slowdown in receipts growth next year - equivalent to £$2^1/_2$ billion - cannot be explained by either the behaviour of GDP or the effect of past Budget measures. Rather, the main explanation for this slowdown is a temporary decline in corporation tax revenues, in part reflecting the effects of the new instalment payments system, see paragraph B33. Thereafter, total receipts grow by about 5 per cent a year in 2001-02 and 2002-03. Receipts growth slows slightly in 2003-04, largely reflecting the transitional effects of the new corporation tax regime.

Table B8: Changes in current receipts since Budget 99

£ billion

	1998-99	1999-00	2000-01
Income tax (gross of tax credits)	0.9	3.2	4.1
Income tax credits	0.0	-0.5	0.0
Corporation tax	0.2	3.6	0.6
Capital gains tax	-0.4	-0.7	-0.6
Value added tax	0.6	1.7	1.2
Excise duties[1]	0.0	-1.8	-3.1
Social security contributions	0.2	0.5	1.5
Other taxes and royalties[2]	1.1	1.6	0.6
Net taxes and social security contributions	2.6	7.5	4.4
Other receipts and accounting adjustments	-1.3	-0.4	1.6
Current receipts	**1.3**	**7.2**	**5.9**

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. Net of bus fuel duty rebate.*

B29 Total receipts in 1998-99 were over £1 billion higher than expected at Budget time, mostly reflecting higher than expected income tax and VAT receipts towards the end of the year. In 1999-2000, receipts are expected to exceed the Budget forecast by over £7 billion. In part, this reflects stronger GDP growth this year than expected in March, together with higher than expected growth of the tax base for given GDP.

Income tax receipts

B30 Income tax receipts in 1998-99 were nearly £1 billion higher than forecast at the time of the Budget. About half of this reflects a higher proportion of self-assessment receipts being allocated to income tax rather than to capital gains tax (with a correspondingly lower than expected outturn for the latter). The rest reflects higher PAYE at the end of the year, in turn reflecting higher than expected growth of wages and salaries.

B31 Wages and salaries growth is similarly expected to exceed the Budget projections somewhat this year and next, partly reflecting the recent strength of employment. The expected outlook for wages and salaries adds about £3 billion to the income tax projections next year, relative to the Budget projections. The profile for interest rates implied by the audited assumption adds over £1 billion to income tax receipts next year, reflecting the impact on households' savings income.

Corporation tax

B32 Receipts of corporation tax in 1999-2000 are expected to be about £3$^1/_2$ billion above the Budget forecast. The main contributions to the higher forecast are:

- payments of advance corporation tax (ACT) before its abolition were higher than expected. The original forecast assumed more dividends normally due for payments in the first quarter of 1999 would be delayed to avoid the ACT liability.
- the first instalment payments of corporation tax, for profits in 1999, were above forecast. The explanation of this will not be available until further payments are made and assessments are filed next year.
- the rapid recovery in oil prices during 1999 led to higher tax payments on North Sea production.
- financial companies' profits in 1998 and 1999 have also been higher than expected.
- later data on tax assessments for non-financial companies revealed higher tax accruals in the baseline than expected at the time of the Budget forecast.

B33 Revenue from corporation tax is expected to fall by £1 billion in 2000-01 because of the downturn in non- financial companies' profits in 1999 and the impact of the transition to instalments, which produces less extra yield in 2000-01 than in the preceding and succeeding years. Nonetheless, the forecast yield is higher than expected at the last Budget. Corporation tax to be paid by North Sea companies has been increased by about £1$^1/_2$ billion a year. Tax from financial companies is also expected to be higher, in line with higher profitability. The yield is forecast to rise sharply from £32$^1/_2$ billion in 2000-01, to £36$^1/_2$ billion in 2001-02, and £37 billion in 2002-03. The yield will then level off or fall slightly as the extra yield from the transition to instalments ends. (See Box B3).

VAT receipts

B34 VAT receipts in 1999-2000 are expected to exceed the Budget forecast by £1$^3/_2$ billion. This fully reflects higher levels of consumer spending; the underlying ratio of VAT receipts to consumer spending is expected to fall this year in line with the Budget forecast. The forecast for later years of VAT revenues is governed by the NAO audited assumption that, after allowing for the effects of Budget measures, the ratio of VAT receipts to consumer spending declines gradually over the entire forecast period, by 0.05 percentage points a year.

Excise duties

B35 Cash receipts of excise duties are expected to fall short of the Budget forecast by about £1$^3/_4$ billion this year. Most of this shortfall is in tobacco duty, although the forecast of fuel duties has also been written down slightly, reflecting lower than expected receipts so far this year. The causes of the shortfall in tobacco duty this year are complex, and not fully understood. However, it seems that cigarette purchases have been lower than generally expected, with manufacturers able to meet demand so far this year largely from stocks of duty paid product. In addition, fraudulent evasion of tobacco duty may have increased by slightly more than assumed at Budget time. The forecast is accordingly based on more cautious assumptions for the market share of smuggled cigarettes over the next five years.

B36 The effect of changing the assumption about the future path of road fuel and tobacco excises (see paragraph 2.51) is to reduce receipts in 2000-01 by £1$^1/_4$ billion in cash terms, building up to £6 billion by 2003-04.

Social security contributions

B37 Social security (national insurance) contributions are expected to be about £$^3/_4$ billion higher this year, and nearly £1$^1/_2$ billion higher next year, than the Budget forecast. This fully reflects the revision to the forecast of wages and salaries mentioned earlier.

Other taxes and receipts

B38 The forecast yield from other taxes and royalties has been revised up by nearly £1$^1/_2$ billion this year. This mostly reflects higher receipts of North Sea revenues. Oil prices have been higher than assumed in the Budget so far this year and although, under the new audited assumption (see paragraphs B19 and B20), they are assumed to fall next year, they would remain a lot higher than assumed in the Budget.

List of Abbreviations

ACT	Advance corporation tax
AEI	Average Earnings Index
AME	Annually Managed Expenditure
BCS	British Crime Survey
CAT	Charges Access and Terms
CBI	Confederation of British Industry
CCL	Climate change levy
CED	Consumers' expenditure deflator
CFCs	Controlled Foreign Companies
CGT	Capital gains tax
CHP	Combined heat and power
CSR	Comprehensive Spending Review
DEL	Departmental Expenditure Limits
DETR	Department of the Environment, Transport and Regions
DfEE	Department for Education and Employment
DIS	Departmental Investment Strategy
DMO	Debt Management Office
DPTC	Disabled Person's Tax Credit
DSS	Department of Social Security
DTI	Department of Trade and Industry
DVLA	Driver and Vehicle Licensing Agency
DWA	Disability Working Allowance
EAC	Environmental Audit Committee
EA(PC)	Cabinet Committee on Productivity and Competitiveness
EC	European Commission
EMI	Enterprise Management Incentives
EMU	Economic and Monetary Union
ESA79	European System of Accounts 1979
ESA95	European System of Accounts 1995
ETG	Emissions Trading Group
EU	European Union
FE	Further education
FEFC	Further Education Funding Council
FRES	Federation of Recruitment and Employment Services
FSA	Financial Services Authority
GDP	Gross Domestic Product
HEES	Home Energy Efficiency Scheme

HICP	Harmonised Index of Consumer Prices
HIPC	Heavily Indebted Poor Countries
ICT	Information and Communications Technology
IIP	Investors in People
IFS	Institute for Fiscal Studies
ILA	Individual Learning Account
ILO	International Labour Organisation
IMF	International Monetary Fund
IPPC	Integrated Pollution and Prevention Control
IPRs	Intellectual Property Rights
ISMI	Income Support for Mortgage Interest
ISA	Individual Savings Account
IT	Information Technology
JSA	Jobseekers' Allowance
LFS	Labour Force Survey
MCA	Married Couple's Allowance
MCT	Mainstream corporation tax
MDR	Marginal Deduction Rate
MIT	Massachusetts Institute of Technology
MIRAS	Mortgage Interest Relief at Source
MPC	Monetary Policy Committee
MtC	Million tonnes of carbon
NAIRU	Non-accelerating inflation rate of unemployment
NAO	National Audit Office
NAR	National Asset Register
NDLP	New Deal for Lone Parents
NHS	National Health Service
NICs	National Insurance Contributions
Nox	Nitrogen Oxides
OECD	Organisation for Economic Cooperation and Development
OFT	Office of Fair Trading
OFTEL	Office of Telecommunications
OGC	Office of Government Commerce
PAT	Policy Action Team
PAYE	Pay As You Earn
PBR	Pre-Budget Report
PEP	Personal Equity Plan
PFI	Private Finance Initiative
PPI	Pooled Pension Investment
PPPs	Public Private Partnerships
PSA	Public Service Agreement
PSNB	Public sector net borrowing
PSREs	Public Sector Research Establishments
PUK	Partnerships UK

RAB	Resource Accounting and Budgeting
R&D	Research and Development
RDAs	Regional Development Agencies
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding mortgage interest payments
RSA	Regional Selected Assistance
SBS	Small Business Service
SEU	Social Exclusion Unit
SME	Small and medium-sized enterprise
SRA	Strategic Rail Authority
TESSA	Tax Exempt Special Savings Account
TME	Total managed expenditure
UfI	University for Industry
UK	United Kingdom
VAT	Value Added Tax
VED	Vehicle Excise Duty
WFTC	Working Families' Tax Credit
WTAS	Windfall tax receipts and asso

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Chart 2.1: Inflation performance against target

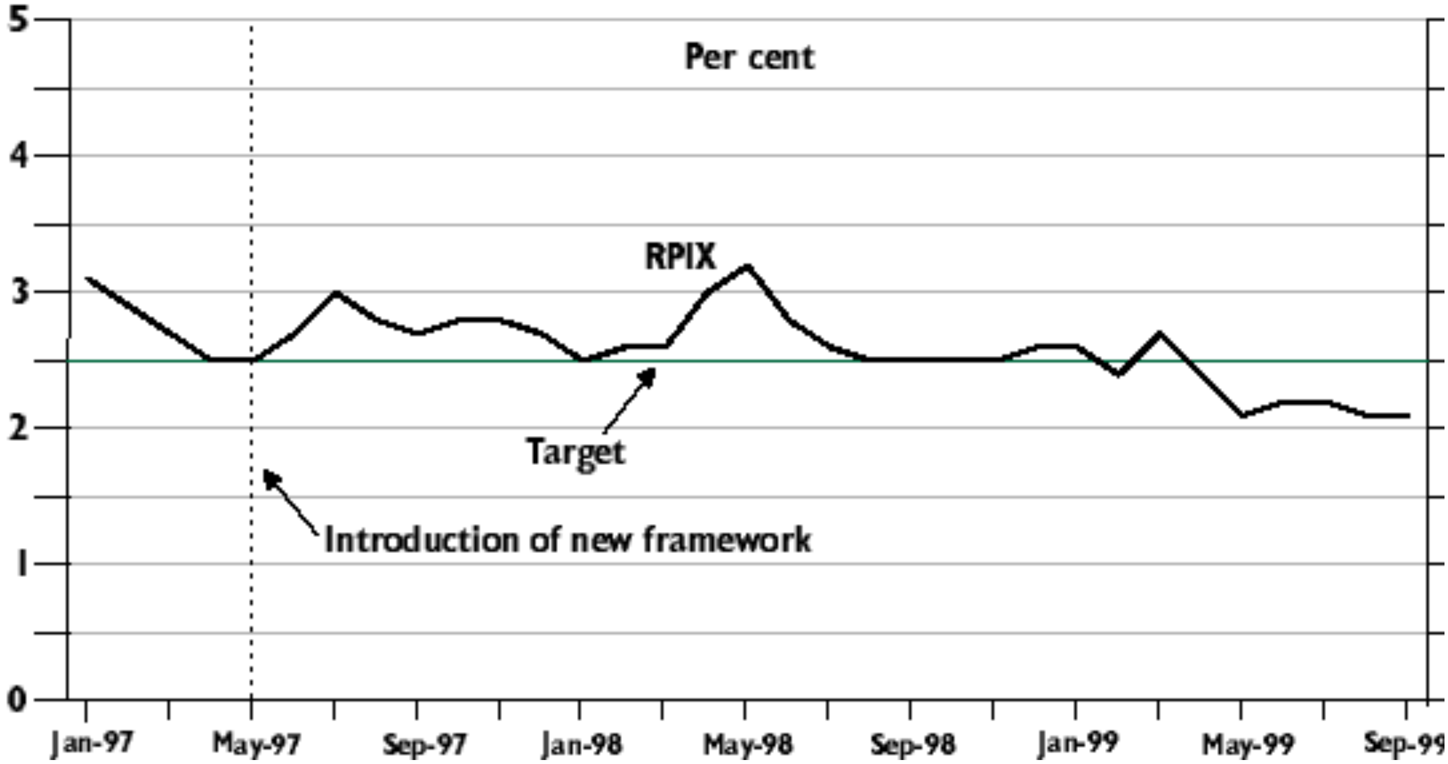
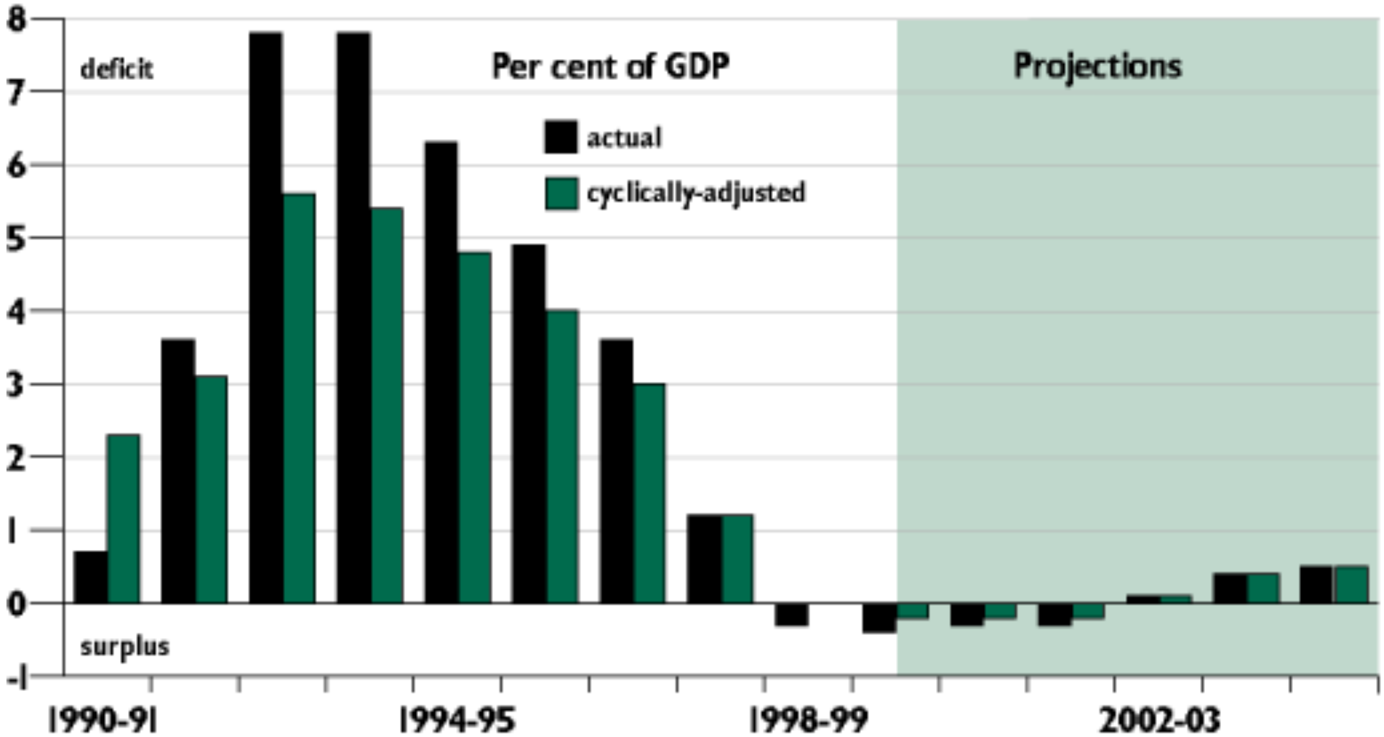


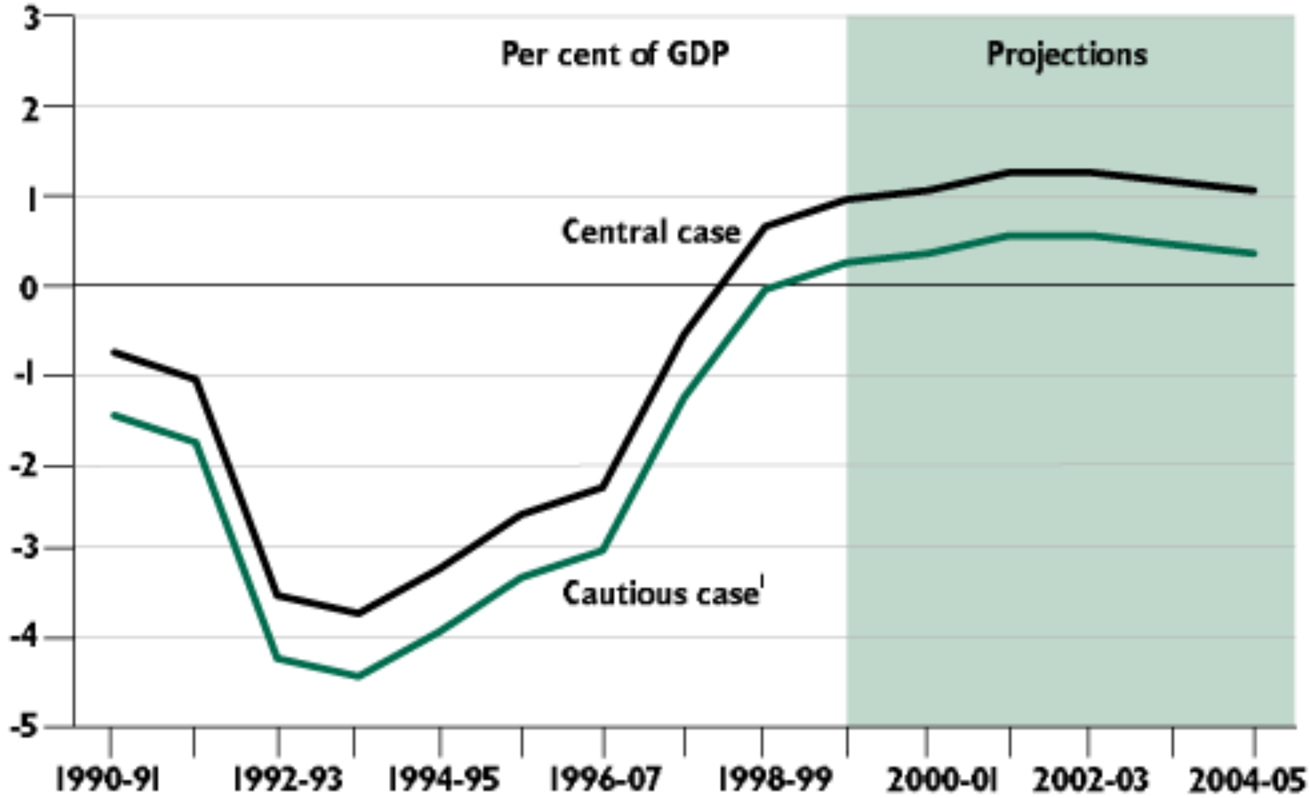
Chart 2.2: Inflation expectations 10 years ahead

Chart 2.3: Public sector net borrowing – actual and cyclically-adjusted[1]



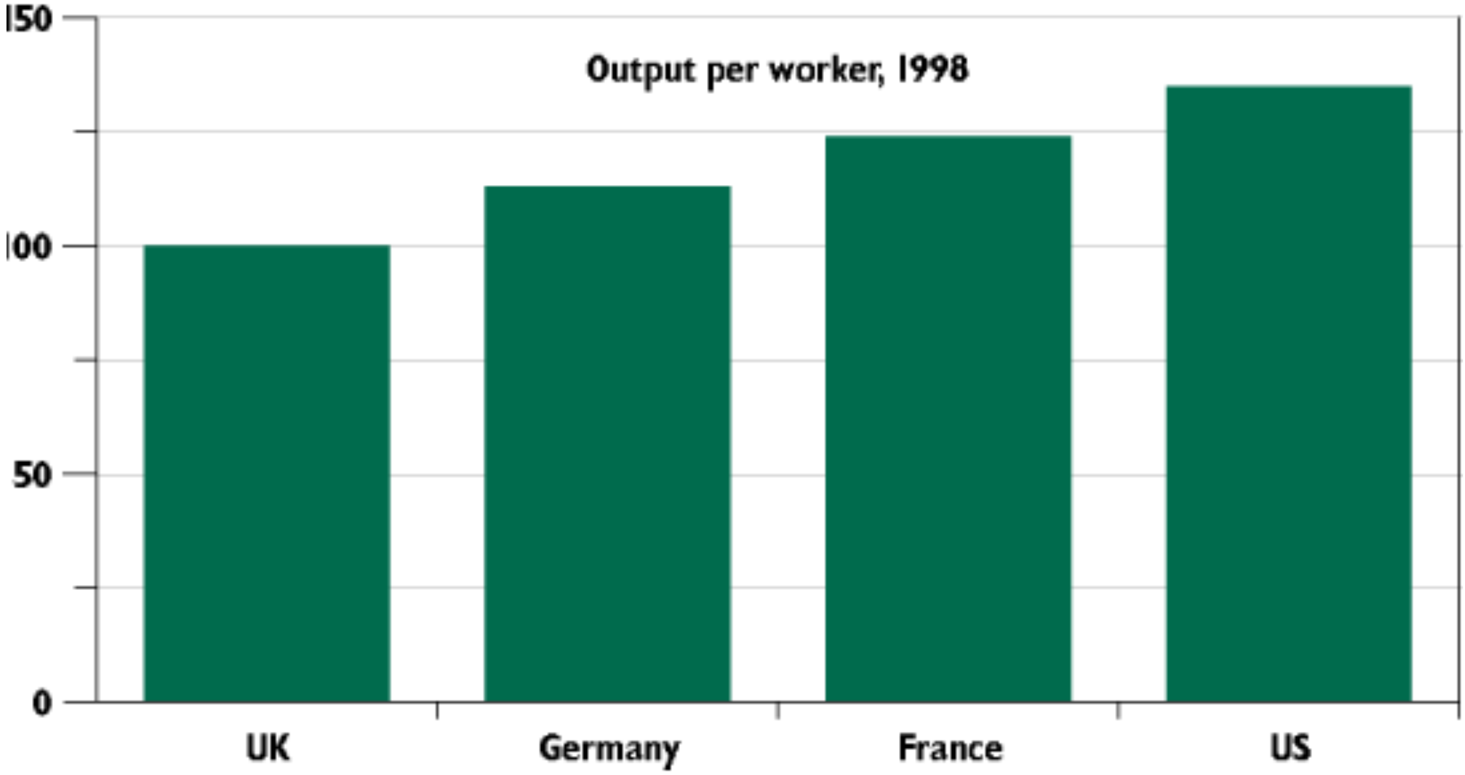
[1]Excluding windfall tax receipts and associated spending.

Chart 2.4: Cyclically-adjusted current budget



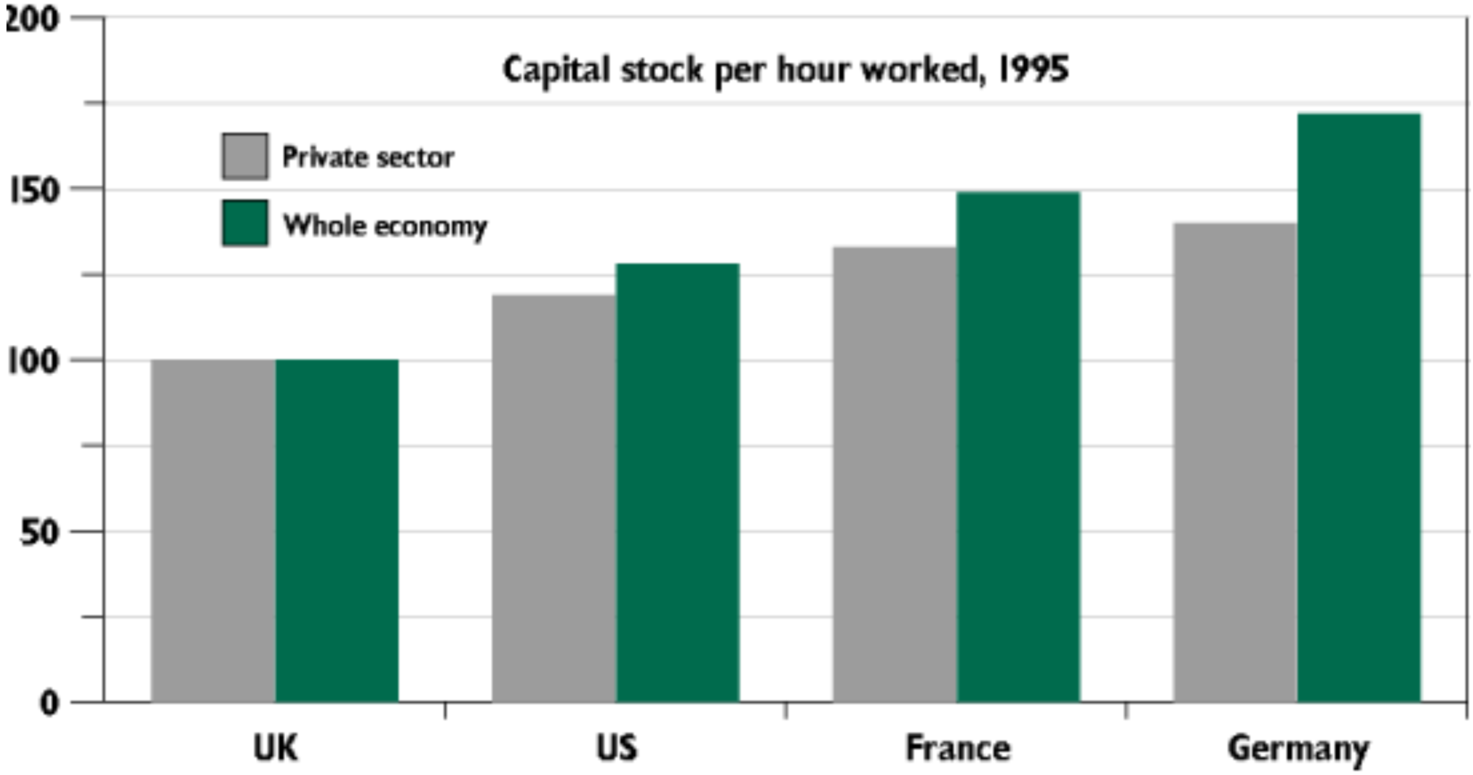
[1] *Cautious case assumes trend output 1 per cent lower in relation to actual output than in the central case.*

Chart 3.1: The productivity gap



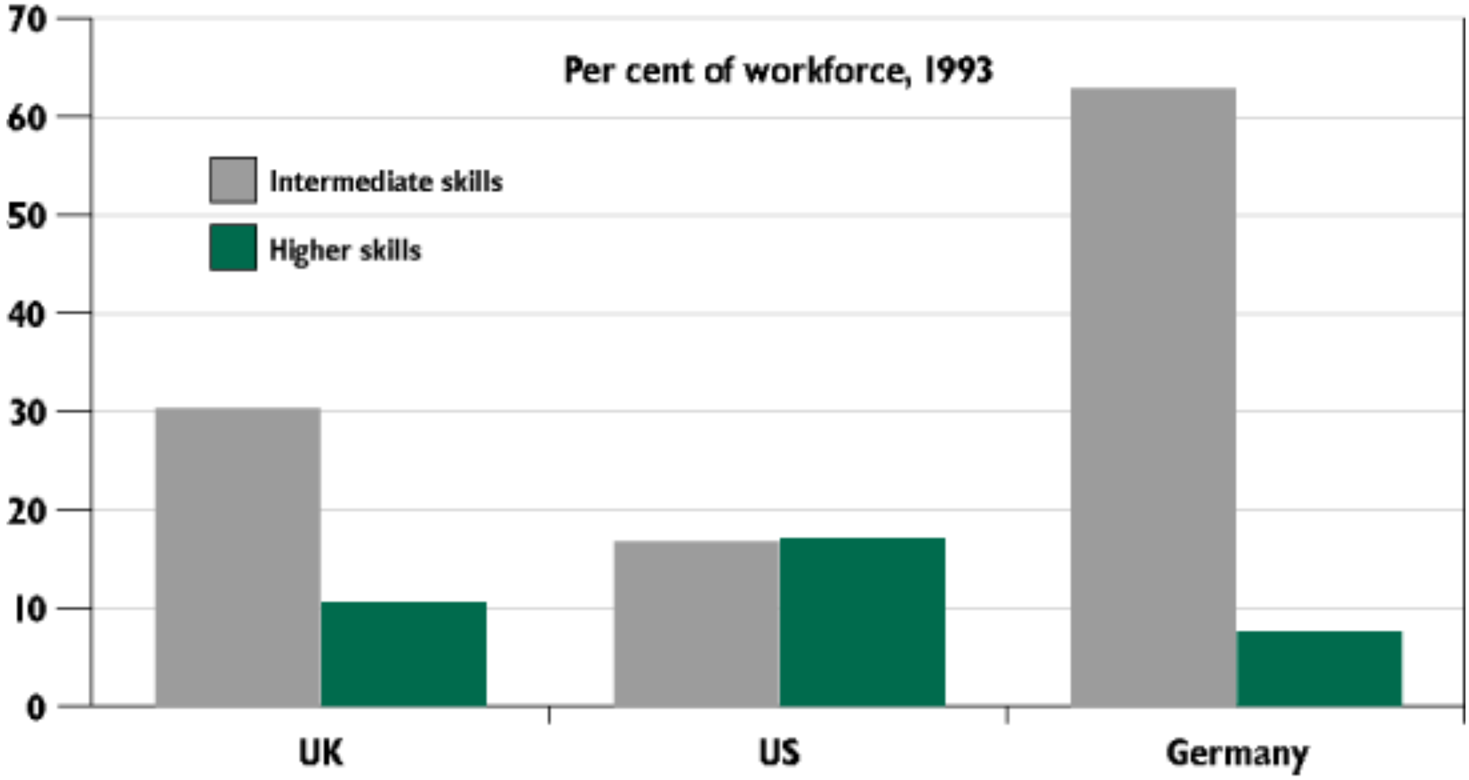
Source: OECD, UK=100.

Chart 3.2: The investment gap



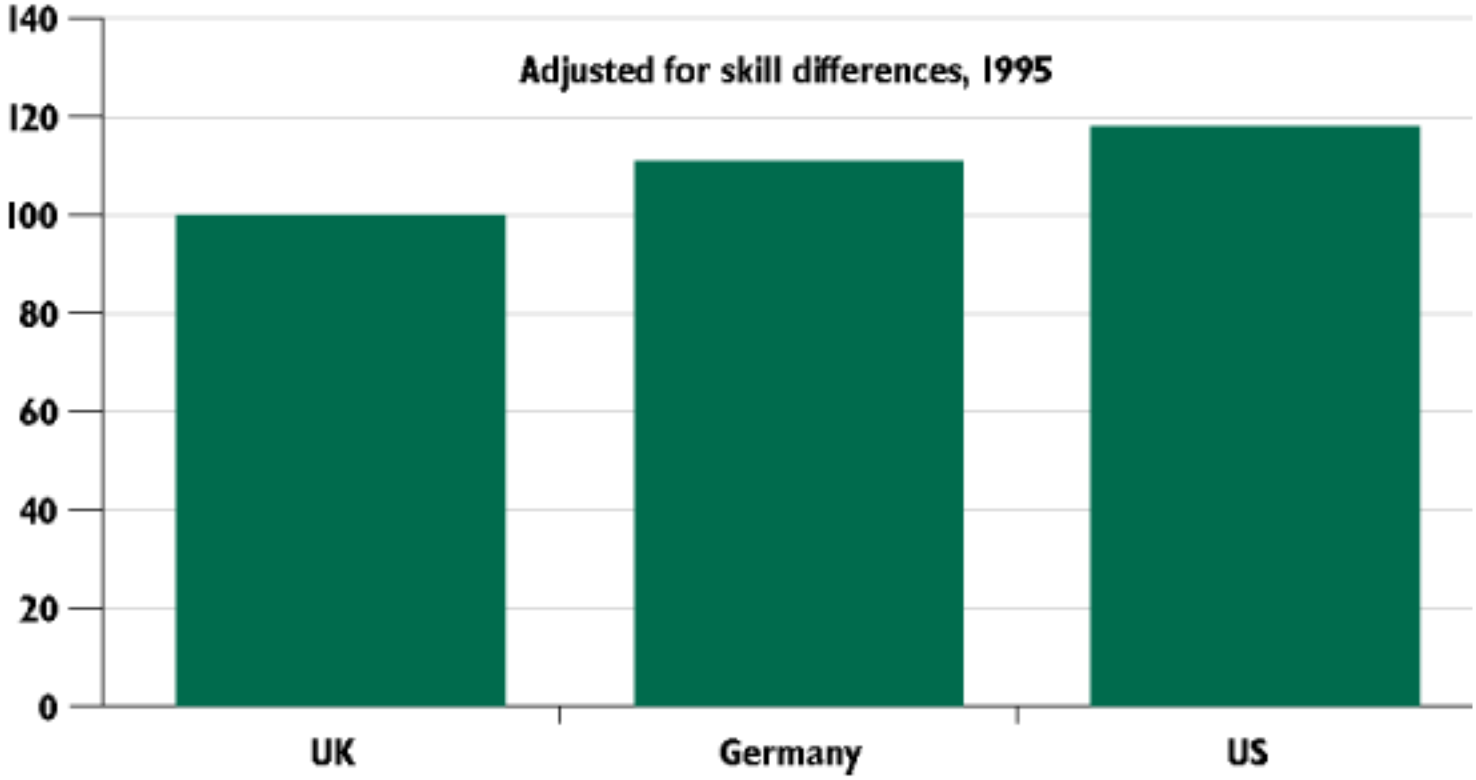
Source: NIESR, UK=100.

Chart 3.3: The skills gap



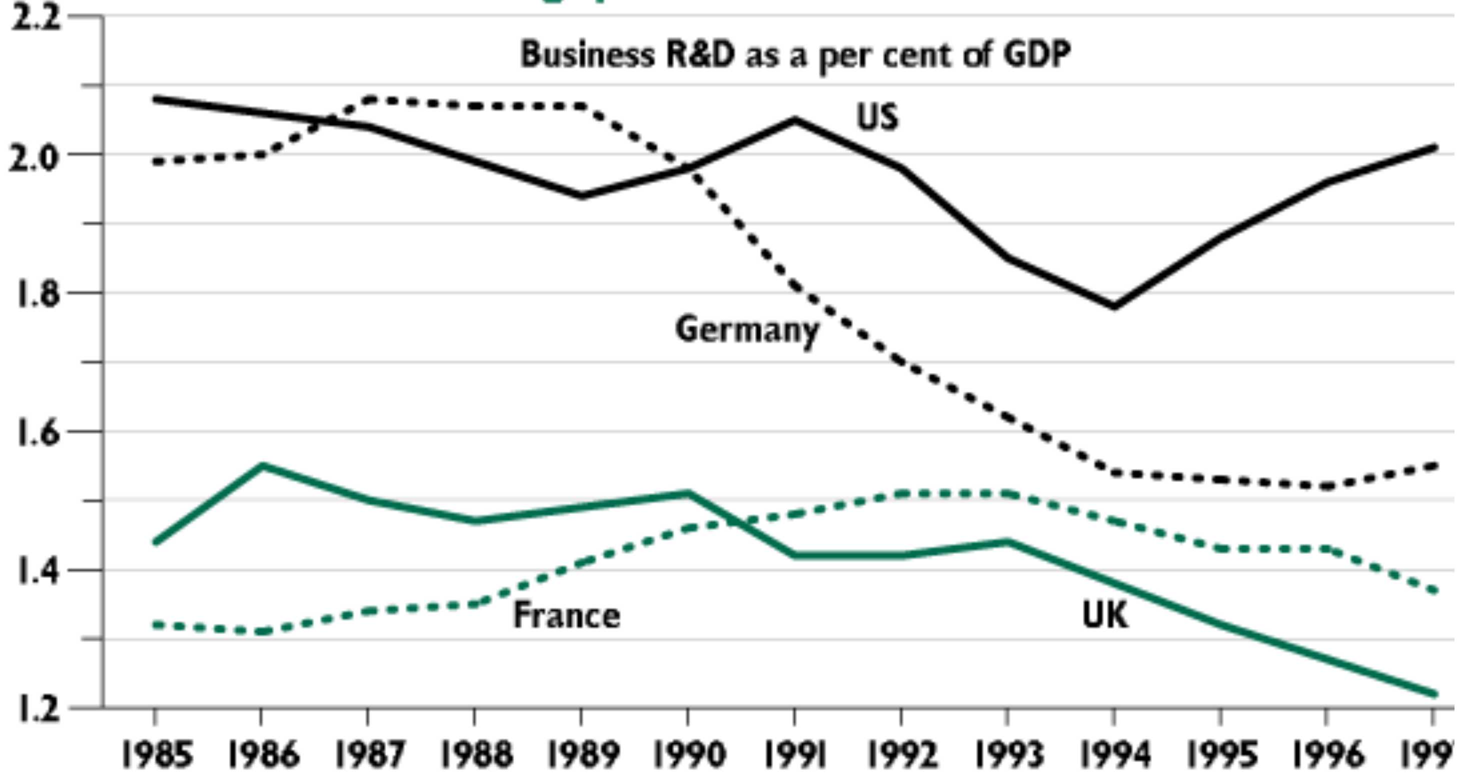
Source: NIESR.

Chart 3.4: Private sector total factor productivity



Source: NIESR, UK=100.

Chart 3.5: The R&D gap



Source: OECD.

Non-employment rates and productivity levels in EU countries, 1997

Source: OECD, DTI.

Chart 4.1: Change in employment relative to change in labour force

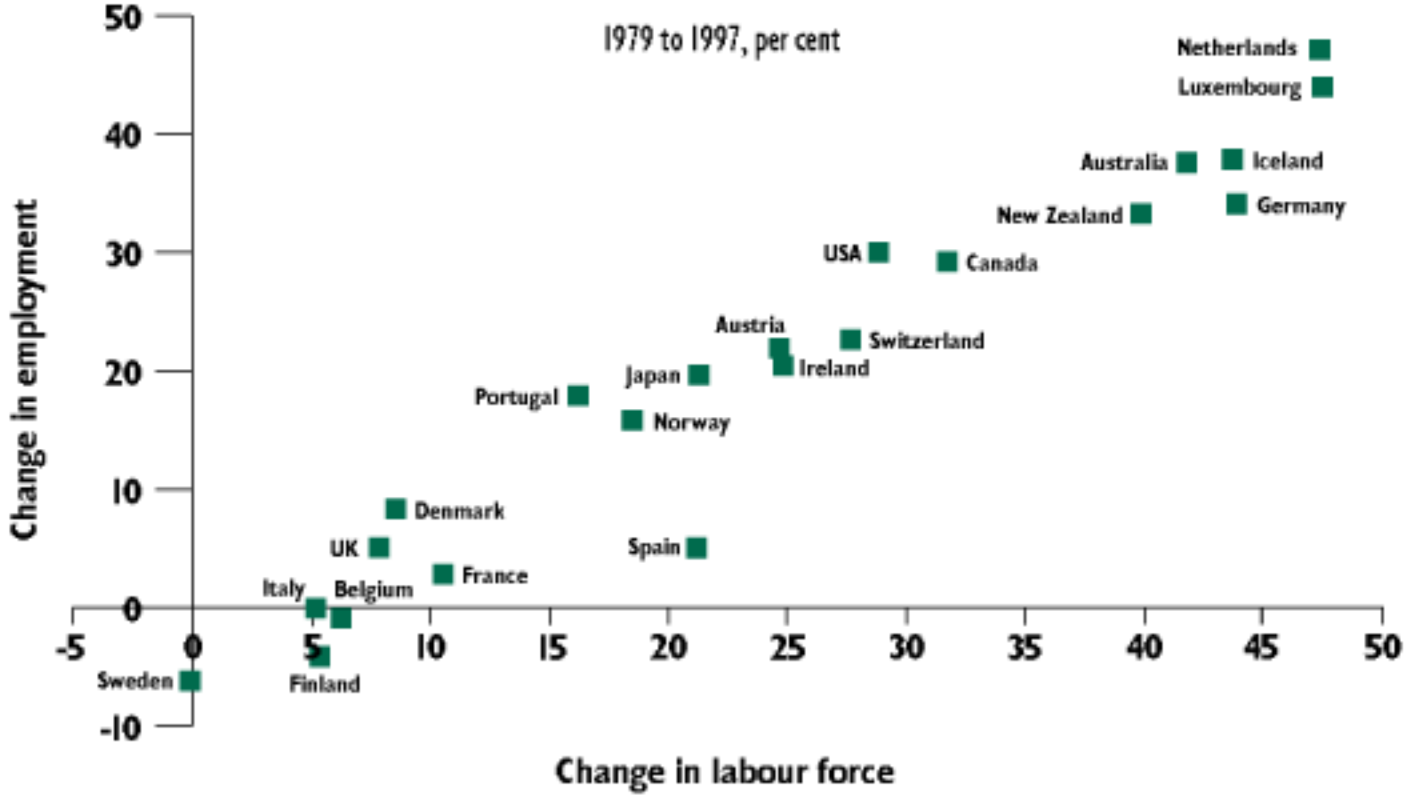


Chart 4.2: Average monthly off-flows from Jobseekers' Allowance

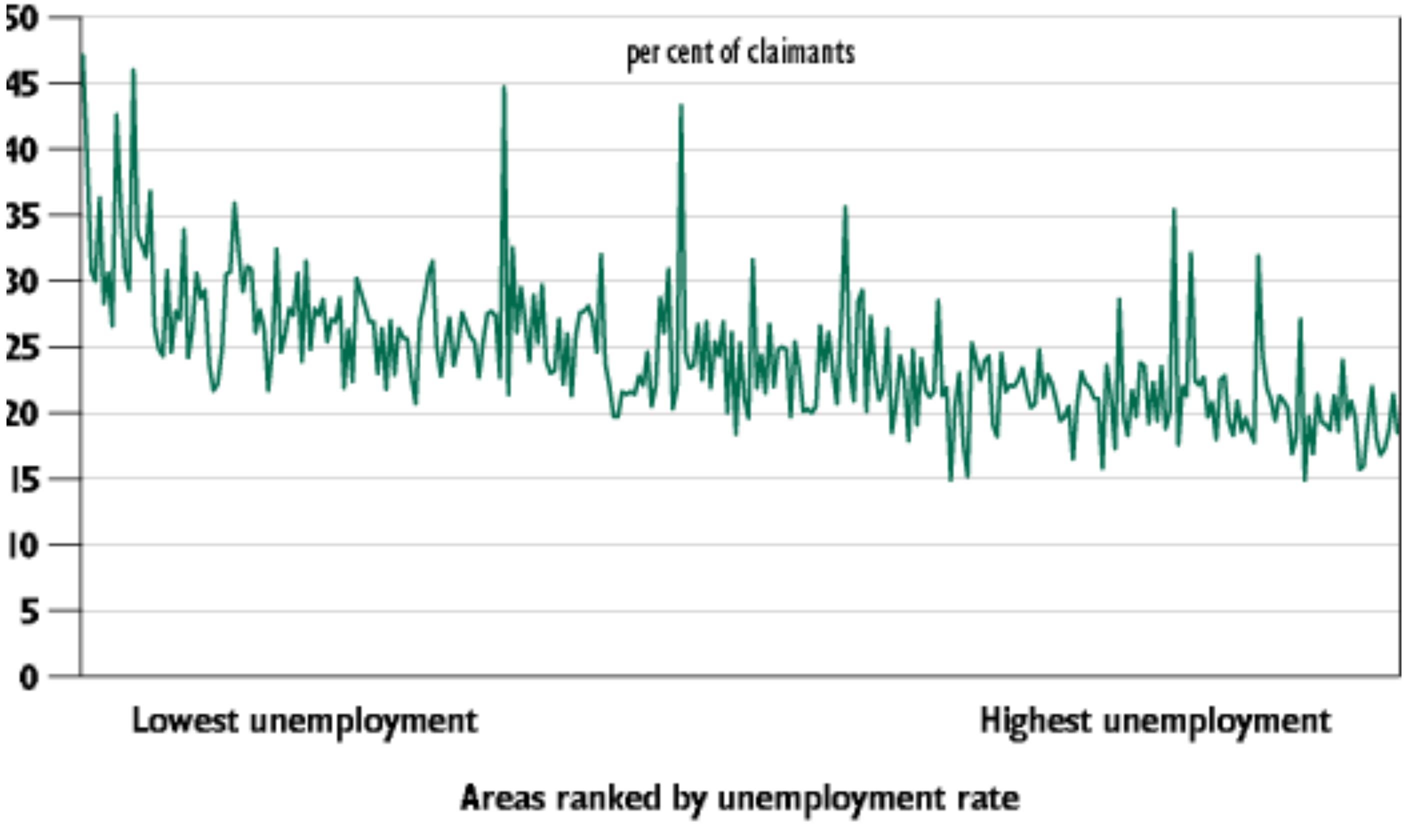
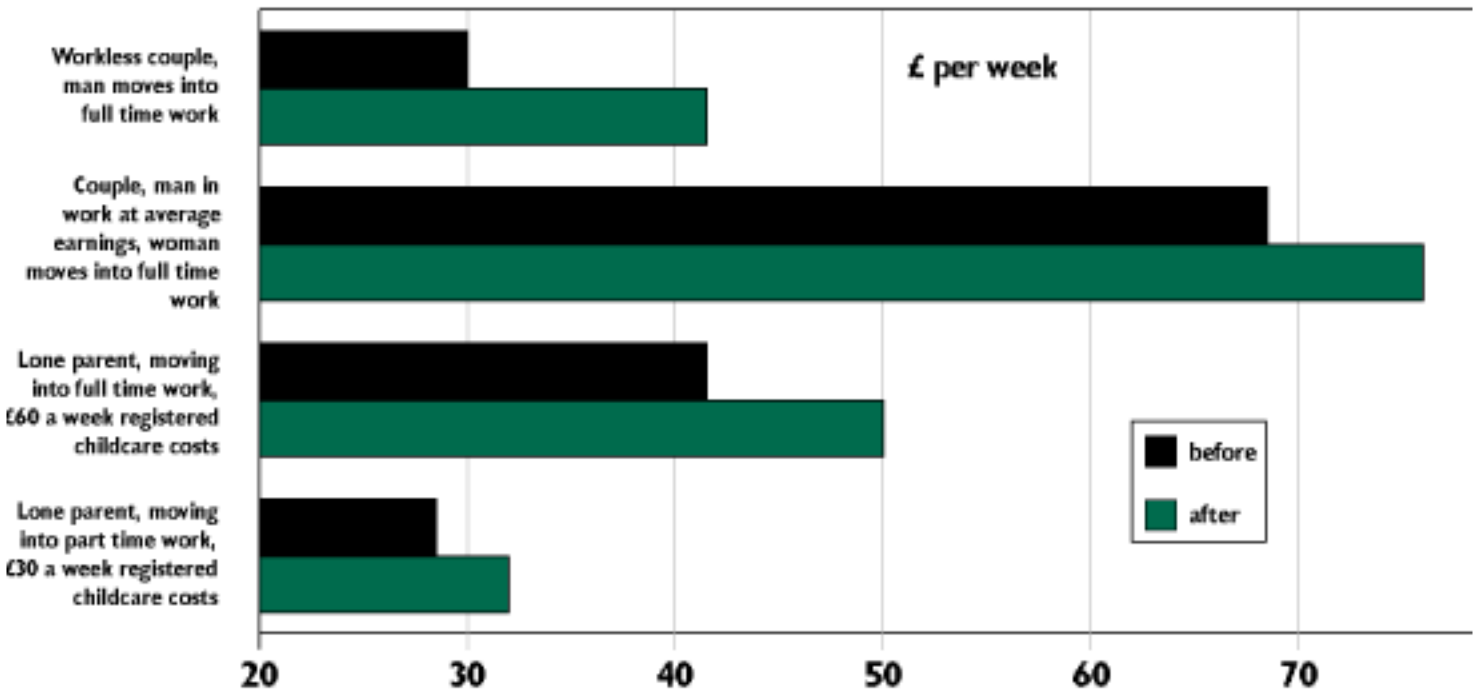


Chart 4.3: The gains to work for different households



The chart assumes that they move into work at typical entry wages for men and women, they live in local authority rent accommodation, have two children under 11 and face a typical rent and council tax. All values are in 1999–2000 levels prices and earnings.

Chart 5.1: Gains for families as a result of children's measures announced in Budgets 98 and 99

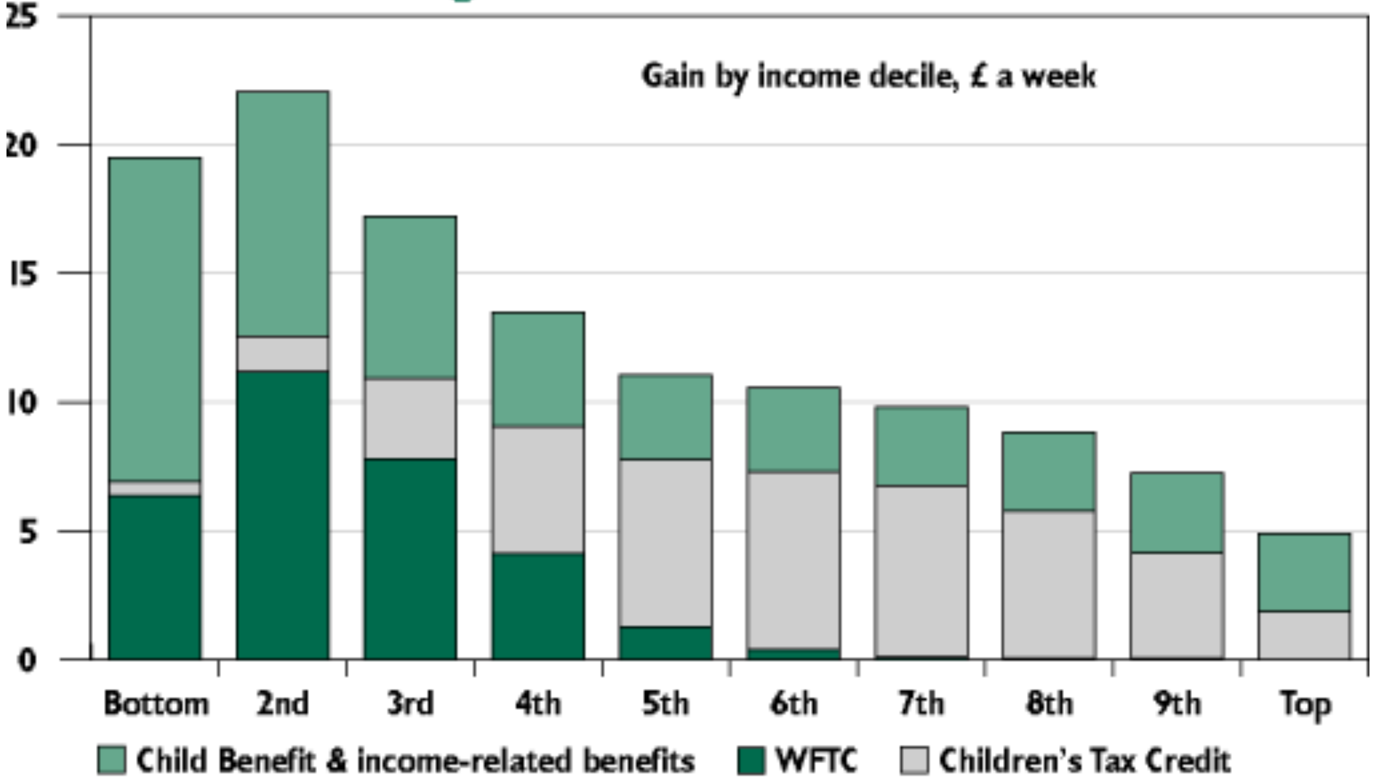


Chart 5.2: £6 billion a year extra on children by 2001

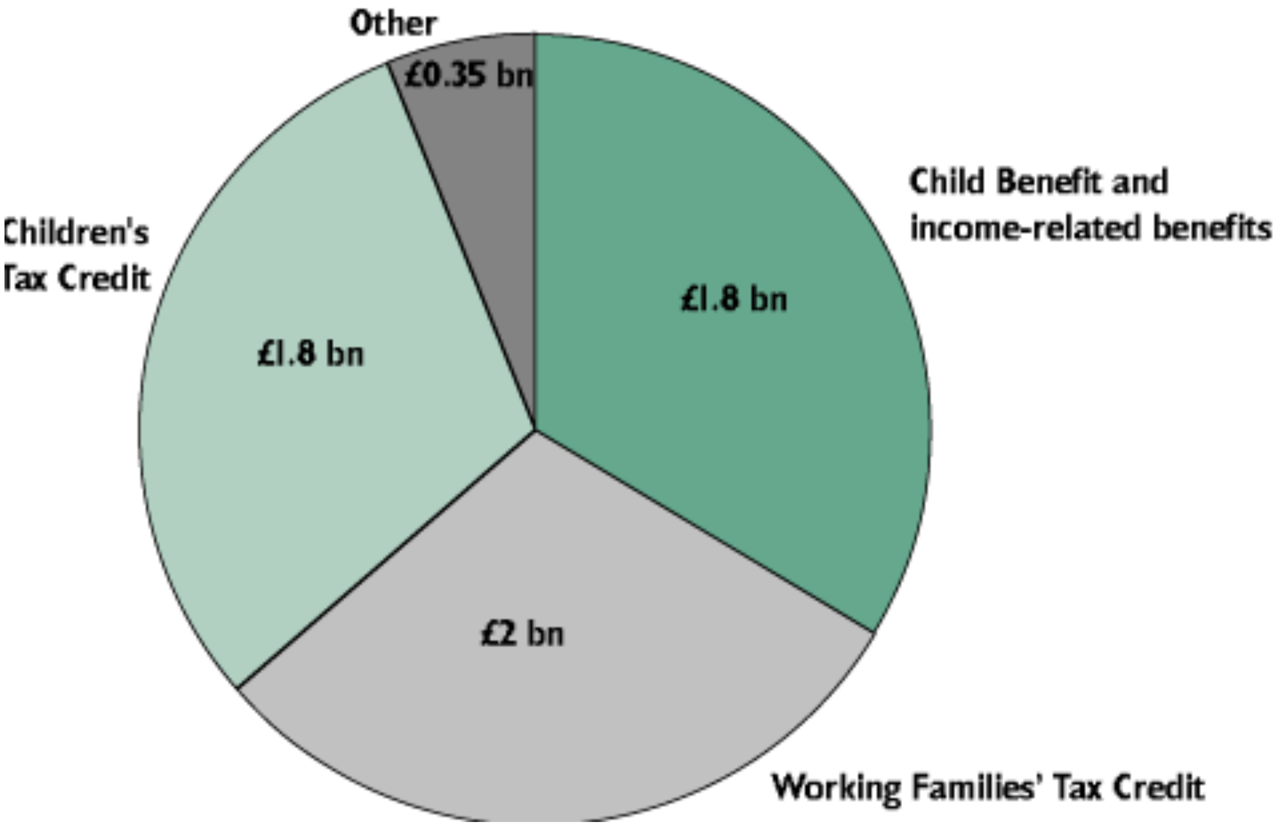
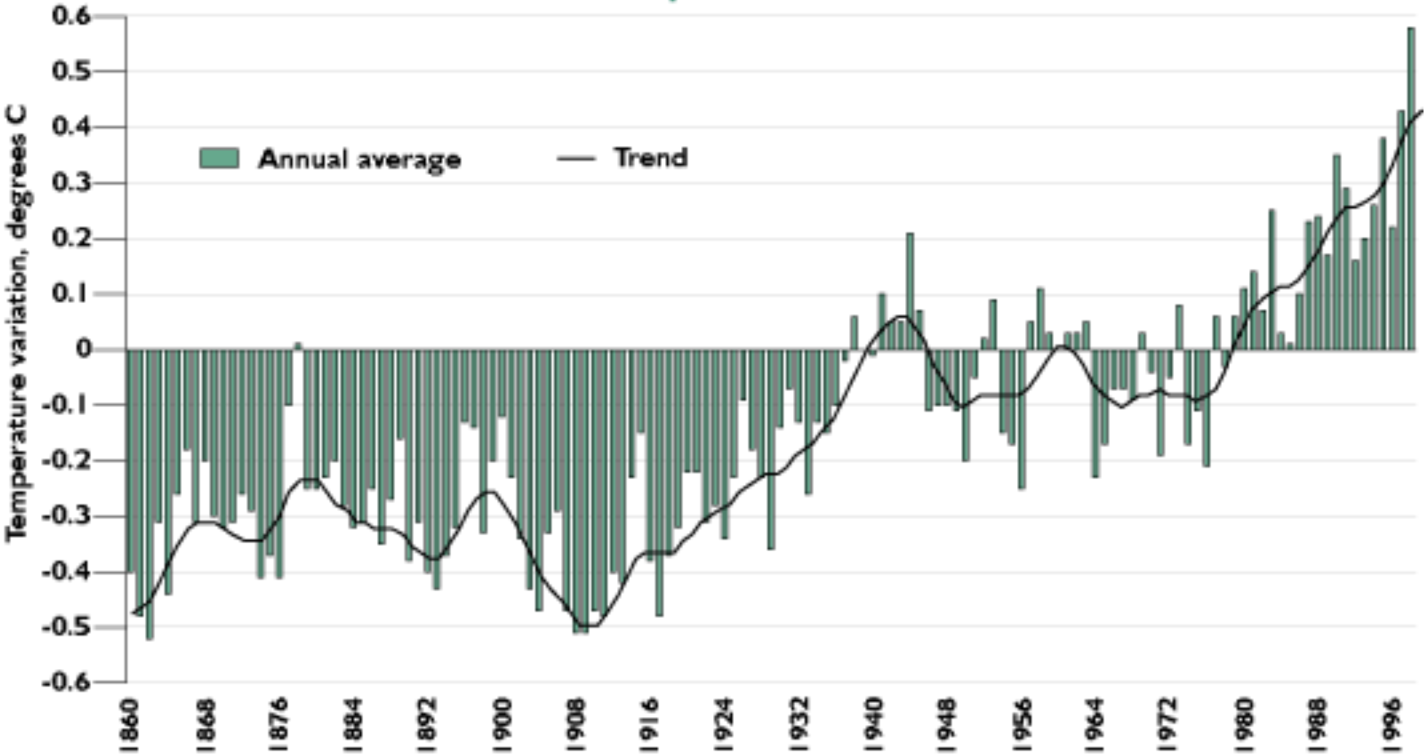


Chart 6.1: Global surface temperature variations[1], 1860-1998



[1] *Compared to a 1961-1990 baseline.*

Business optimism and GDP growth

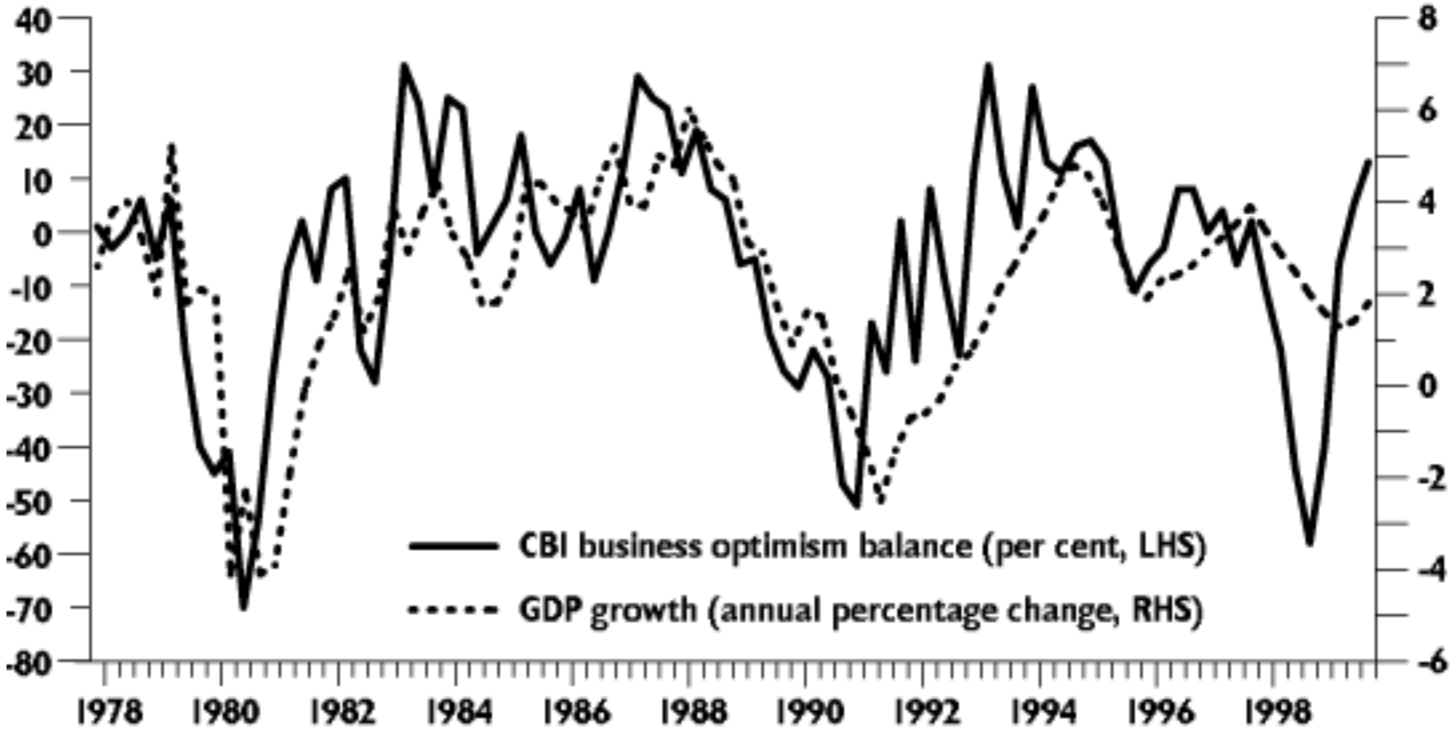
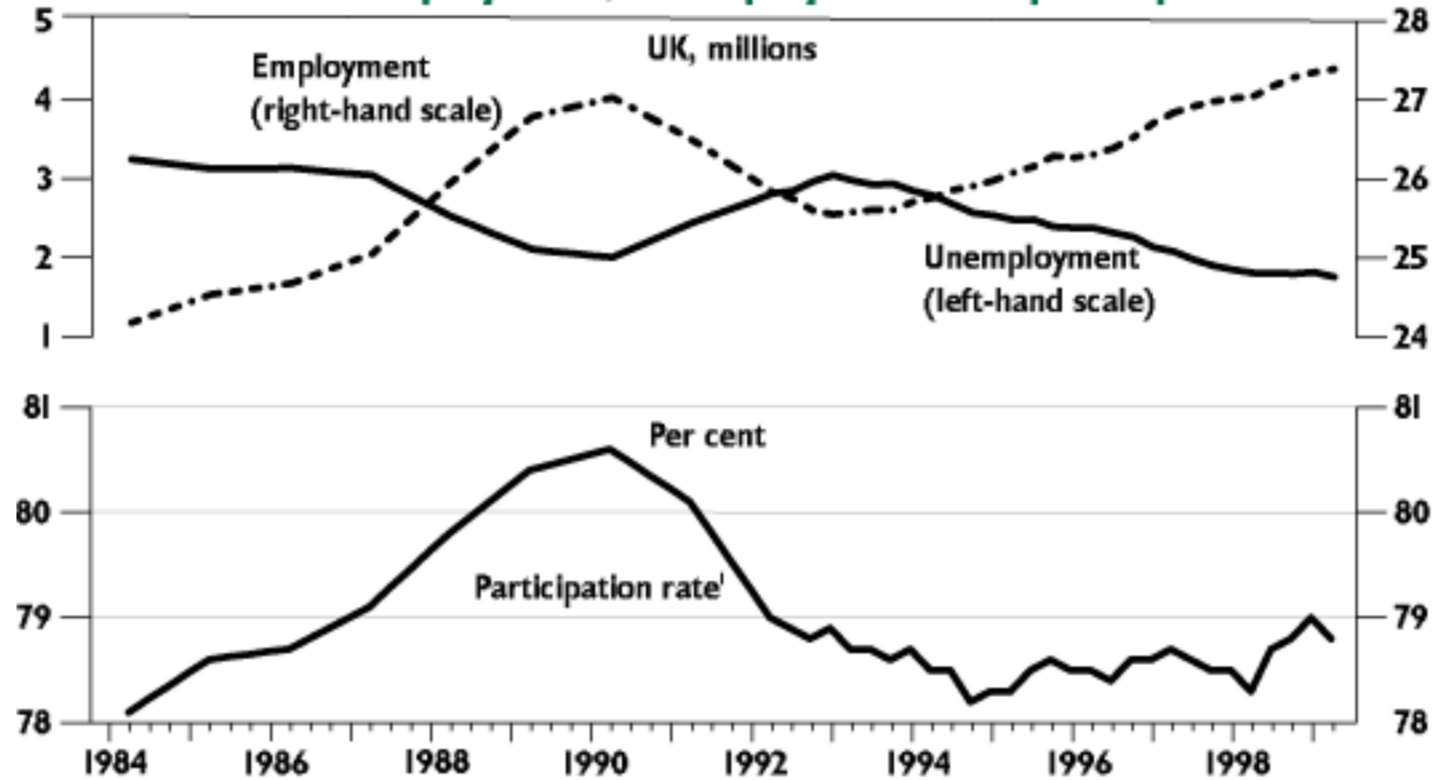
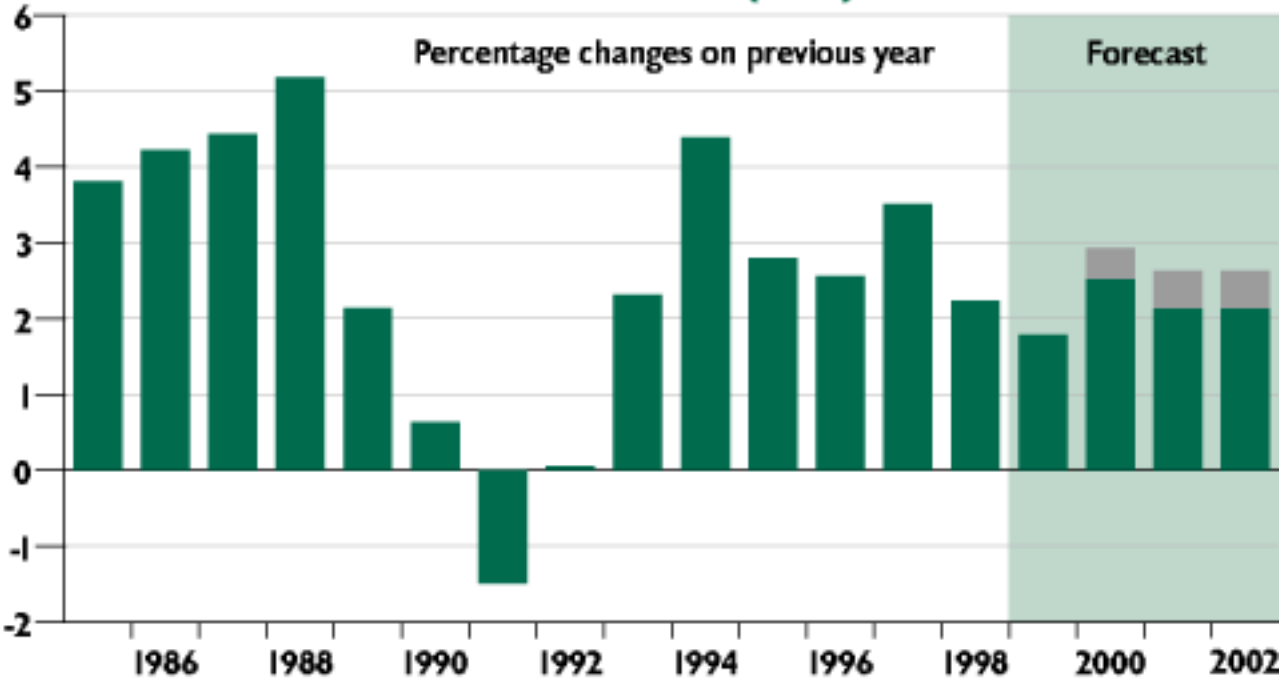


Chart A1: LFS employment, unemployment and participation



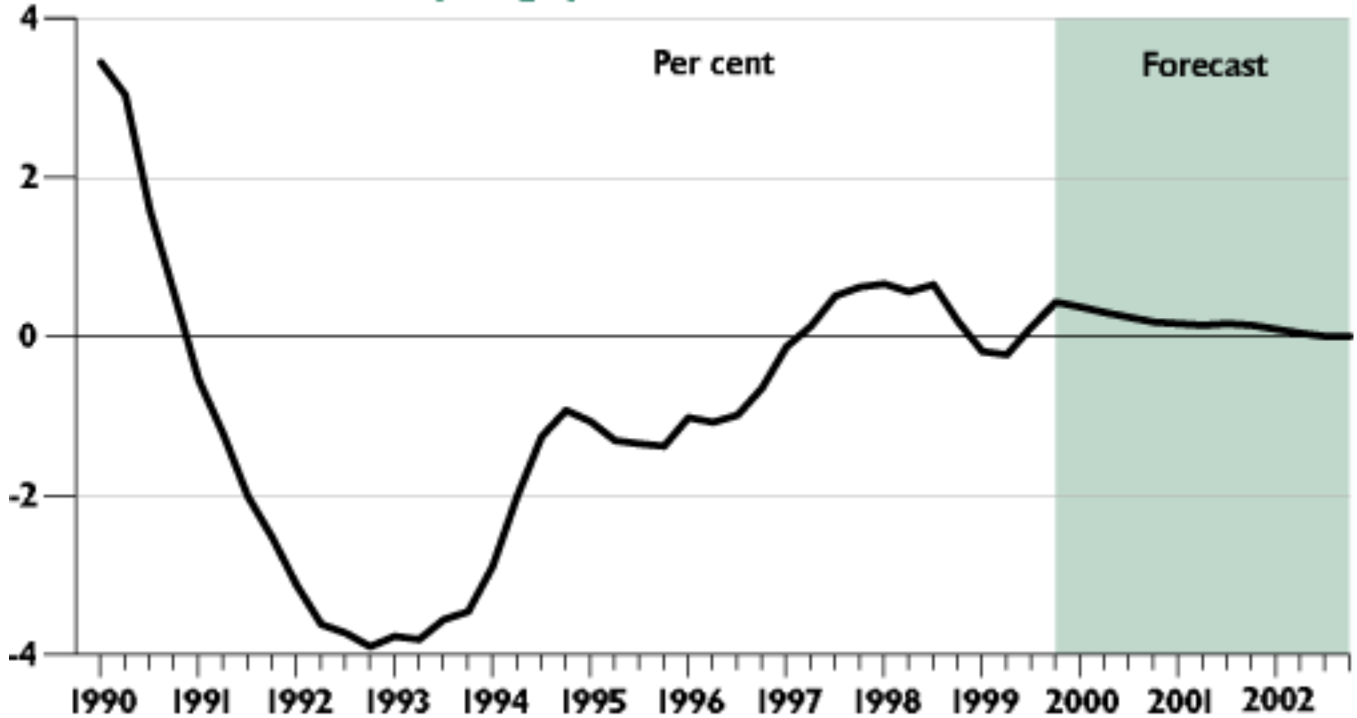
[1]Percentage of the population of working age who are economically active (ie. employed or unemployed).

Chart A2: Gross Domestic Product (GDP)[1]



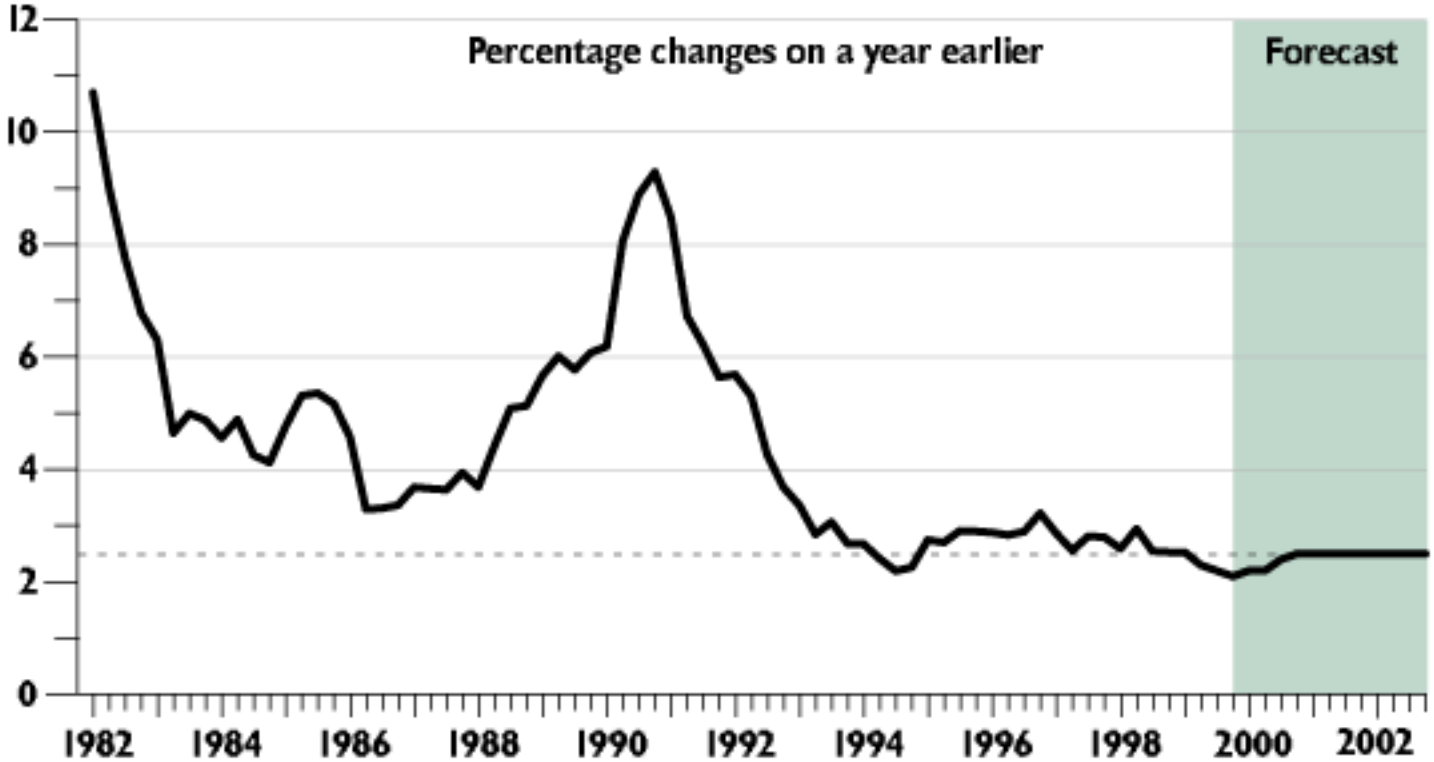
[1] *Shaded areas on bars represent forecast ranges.*

Chart A3: The output gap[1]



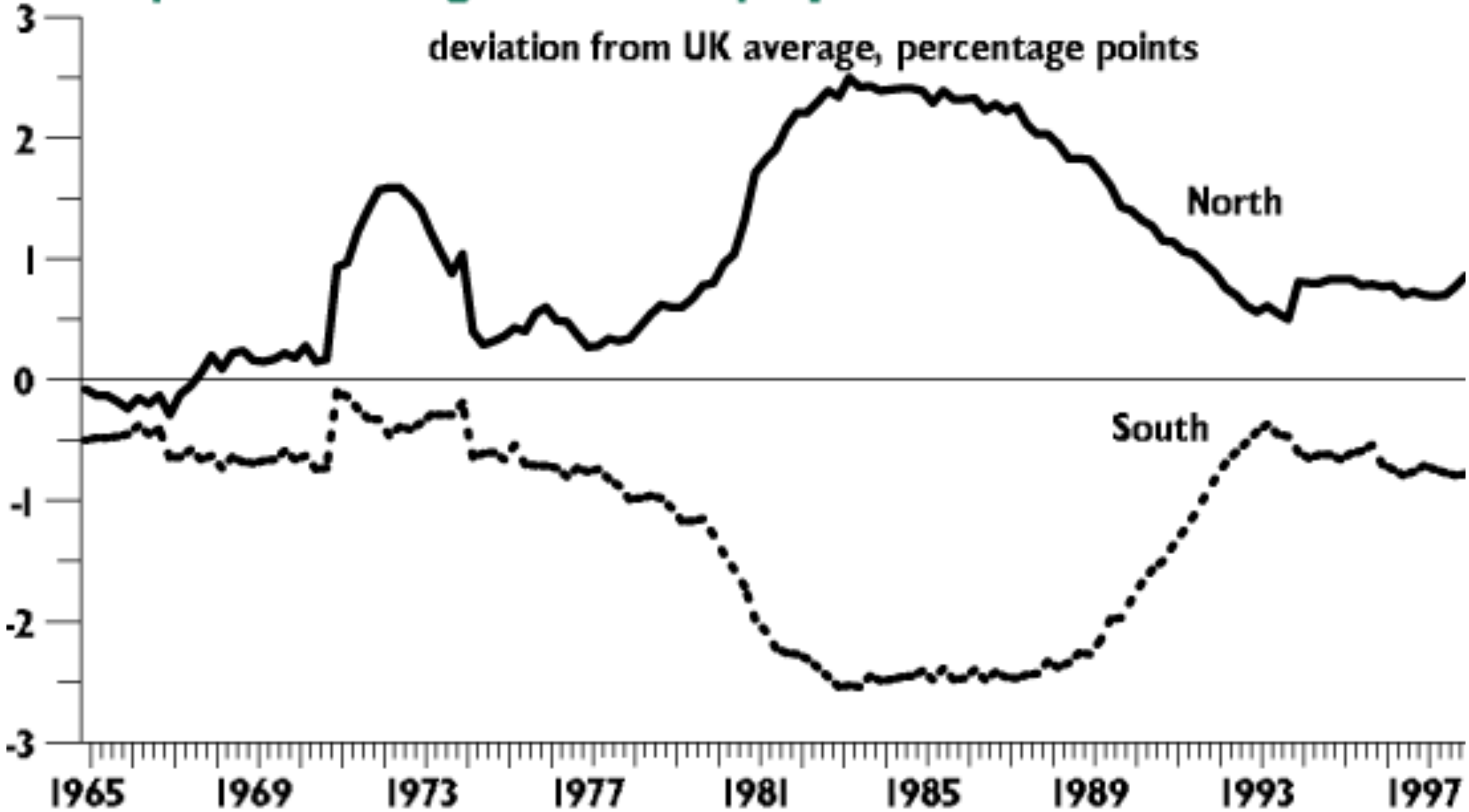
[1]Actual output less trend output as a percent of trend output (non-oil basis).

Chart A4: RPIX[1]

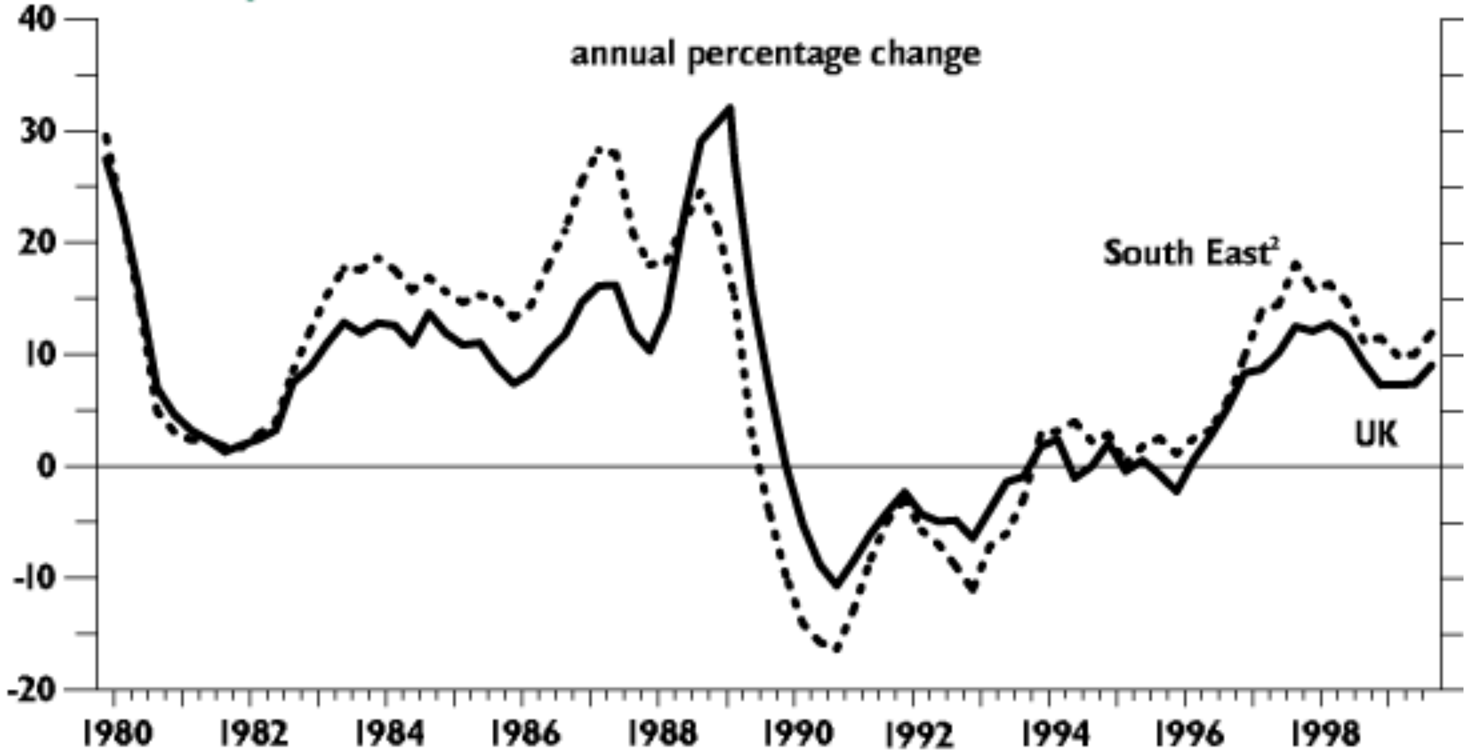


[1]Outturns until 1999Q2; forecasts for every second quarter from 1999Q4 to 2002Q4.

Dispersion in regional unemployment rates



House price inflation[1]

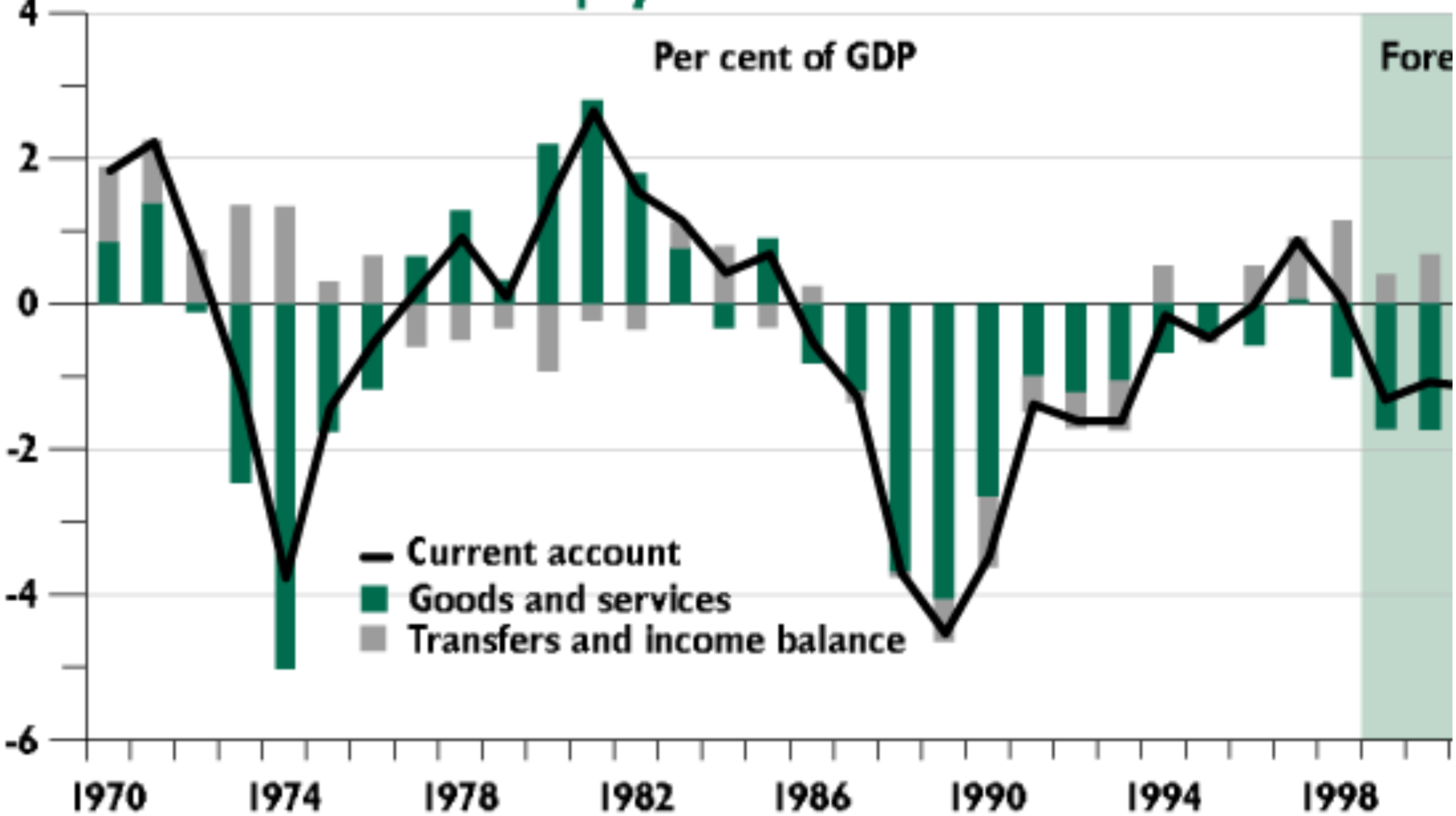


[1] Nationwide index.
[2] Average of London, outer metropolitan and outer South East regions.

Chart A5: Business and non-residential investment ratios

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

Chart A6: Balance of payments current account



A

The Economy continued

Table A8: Summary of economic prospects[1]

Percentage changes on a year earlier unless otherwise stated

	1998	1999	Forecast[2] 2000	2001	2002	Average errors from past forecasts[3]
Output at constant market prices						
Gross domestic product (GDP)	2 1/4	1 3/4	2 1/2 to 3	2 1/4 to 2 3/4	2 1/4 to 2 3/4	1
Manufacturing output	1/4	-1/4	1 1/2 to 2	2 to 2 1/2	2 to 2 1/2	2
Expenditure components of GDP at constant market prices[4]						
Domestic demand	4	3 1/4	2 3/4 to 3	2 1/4 to 2 1/2	2 to 2 1/2	1
Household consumption[5]	3 1/4	4	2 1/2 to 2 3/4	2 to 2 1/2	2 1/4 to 2 3/4	1
General government consumption	1	3 3/4	3	2	1 1/2	1 1/2
Fixed investment	9 3/4	4 1/4	2 1/4 to 2 1/2	2 1/2 to 3	3 1/4 to 3 3/4	2 1/4
Change in inventories[6]	0	-3/4	1/4	0 to 1/4	0	1/4
Export of goods and services	2	2 1/4	6 1/2 to 6 3/4	5 to 5 1/2	5 1/2 to 6	2
Imports of goods and services	8 1/2	6 1/4	6 to 6 1/2	4 1/2 to 5	5 to 5 1/2	2
Balance of payments current account						
£ billion	1/4	-12 1/4	-10 1/4	-11 1/2	-10 3/4	6 1/4
per cent of GDP	0	-1 1/2	-1	-1 1/4	-1	3/4
Inflation						
RPIX (Q4)	2 1/2	2	2 1/2	2 1/2	2 1/2	1
Producer output prices (Q4)[7]	-3/4	3/4	2	2 1/2	2 1/2	1 1/4
GDP deflator at market prices (financial year)	2 1/2	2 1/4	2 1/2	2 1/2	2 1/2	1
Money GDP at market prices (financial year)						
£ billion	851	890	934 to 939	978 to 988	1024 to 1039	11
percentage change	4 1/2	4 1/2	5 to 5 1/2	4 3/4 to 5 1/4	4 3/4 to 5 1/4	1 1/4

[1] *The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 1999, released by the Office for National Statistics on 22 September 1999, and the preliminary GDP estimate for the third quarter*

released on 22 October.

[2] *The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

[3] *Average absolute errors for year-ahead projections made in autumn forecasts over the past ten years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2000.*

[4] *Further detail on the expenditure components of GDP is given in Table A9.*

[5] *Includes households and non-profit institutions serving households.*

[6] *Contribution to GDP growth, percentage points.*

[7] *Excluding excise duties.*

Table A9: Gross domestic product and its components

£ billion at 1995 prices, seasonally adjusted

	Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[2]	GDP a marke price
1998	505·4	142·2	144·2	3·6	795·9	241·1	1037·1	265·3	1·6	773·
1999	525·5	147·5	150·3	1·3	822·5	246·5	1069·0	281·9	0·2	787·
2000	538·3 to 540·4	151·9	153·6 to 154·2	0·4 to 1·0	844·7 to 848·1	262·2 to 263·3	1107·0 to 1111·4	299·1 to 300·3	0·8	807· t 810·
2001	549·0 to 553·9	154·9	157·6 to 159·0	0·6 to 2·0	862·7 to 870·3	275·3 to 277·7	1138·0 to 1148·0	312·9 to 315·6	0·8	824· t 831·
2002	560·8 to 568·6	157·3	162·6 to 164·8	0·4 to 1·7	880·9 to 893·0	290·2 to 294·2	1171·1 to 1187·2	328·5 to 333·0	0·8	841· t 853·
1998 1st half	251·3	70·8	70·4	1·9	394·5	120·3	514·8	130·4	0·7	385·
2nd half	254·1	71·5	73·8	1·8	401·4	120·8	522·2	134·9	0·9	388·
1999 1st half	260·8	73·2	75·0	0·9	408·3	119·4	527·7	137·9	0·6	390·
2nd half	264·7	74·4	75·3	0·4	414·2	127·1	541·3	144·1	0·4	396·

2000 1st half	267·8 to 268·5	75·5	76·3 to 76·5	0·0 to 0·2	420·0 to 421·0	129·7 to 130·0	549·7 to 551·0	147·7 to 148·1	0·4	401· t 402·
2nd half	270·4 to 271·9	76·4	77·3 to 77·7	0·3 to 0·7	424·8 to 427·1	132·5 to 133·2	557·3 to 560·4	151·3 to 152·2	0·4	405· t 407·
2001 1st half	273·1 to 275·1	77·4	78·3 to 78·9	0·0 to 0·6	429·1 to 432·3	135·8 to 136·8	564·9 to 569·1	154·7 to 155·8	0·4	409· t 412·
2nd half	275·9 to 278·8	77·5	79·3 to 80·1	0·6 to 1·4	433·6 to 438·0	139·4 to 140·9	573·0 to 578·9	158·2 to 159·8	0·4	414· t 418·
2002 1st half	278·9 to 282·4	78·1	80·5 to 81·5	0·4 to 1·3	438·1 to 443·5	143·2 to 145·0	581·3 to 588·5	162·2 to 164·2	0·4	418· t 423·
2nd half	281·9 to 286·2	79·3	82·1 to 83·3	0·8 to 0·4	442·8 to 449·5	147·0 to 149·2	589·8 to 598·7	166·3 to 168·8	0·4	423· t 429·
					Percentage changes on previous year[3,4]					
1998	3 1/4	1	9 3/4	0	4	2	3 1/2	8 1/2	1/4	2 1/
1999	4	3 3/4	4 1/4	3/4	3 1/4	2 1/4	3	6 1/4	1/4	1 3/
2000	2 1/2 to 2 3/4	3	2 1/4 to 2 1/2	1/4	2 3/4 to 3	6 1/2 to 6 3/4	3 1/2 to 4	6 to 6 1/2	0	2 1/2 t
2001	2 to 2 1/2	2	2 1/2 to 3	0 to 1/4	2 1/4 to 2 1/2	5 to 5 1/2	2 3/4 to 3 1/4	4 1/2 to 5	0	2 1/4 t 2 3/
2002	2 1/4 to 2 3/4	1 1/2	3 1/4 to 3 3/4	0	2 to 2 1/2	5 1/2 to 6	3 to 3 1/2	5 to 5 1/2	0	2 1/4 t 2 3/

[1] *Includes households and non-profit institutions serving households.*

[2] *Expenditure adjustment.*

[3] *For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.*

[4] *The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*

THE WORLD ECONOMY

Overview

A53 The financial market turmoil of 1997 and 1998 has not turned out to be as damaging to global activity as was initially feared. Strains in world financial markets have subsequently eased, both Brazil and Russia have stabilised, and recovery is taking hold in many of Asia's crisis-hit countries. The geographical balance of economic activity in the industrial countries is improving, as the Eurozone picks up, Japan shows some signs of recovery and the impressive US expansion continues. Overall, prospects for G7 growth have improved since the Budget, although uncertainties remain as to whether adjustment from the present position of uneven growth and balance of payments imbalances will proceed smoothly. Global inflationary pressures remain very subdued.

G7 Activity

A54 G7 growth is expected to pick up from $2^1/_4$ per cent in 1998 to $2^3/_4$ per cent this year, slowing slightly to $2^1/_2$ per cent in 2000. As in recent years, the US has been the main engine of world growth in 1999. However, a more balanced distribution of global output and demand is emerging as the outlook for growth in both the Eurozone and Japan has improved since Budget time. This should reduce the vulnerability of the world economy to any sharp slowdown in the US. There has been no repeat of the world financial market volatility that occurred last autumn.

Table A10: The world economy

			Percentage changes on a year earlier		
			Forecast		
	19981	**1999**	**2000**	**2001**	**2002**
*Major 7 countries*2					
Real GDP	$2^1/_4$	$2^3/_4$	$2^1/_2$	$2^1/_2$	$2^1/_2$
Consumer price inflation3	2	$1^1/_2$	$1^1/_2$	$1^1/_2$	$1^1/_2$
World trade in goods	$4^1/_4$	5	$6^1/_2$	$6^1/_4$	$6^1/_4$
UK export markets4	8	$6^3/_4$	$6^3/_4$	$5^3/_4$	$5^3/_4$

1 *Estimates, except consumer price inflation.*

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

3 *Final quarter of each period. For UK, RPIX.*

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

A55 The improved outlook for the Japanese economy in 1999 reflects a delayed impact from last year's fiscal stimulus and some pick up in private consumption. However, it is still unclear whether the recovery is sustainable and so the outlook remains uncertain. Prospects for the Eurozone have improved over the past six months, mainly due to stronger industrial confidence as global conditions have improved. This recovery should become more broadly based as domestic demand strengthens during 2000.

A56 The strength of domestic demand in the US continued to exceed expectations in the first half of 1999, and was met by a rundown in inventories and a strong rise in imports. The interest rate cuts made last autumn in response to the global financial crisis have been largely reversed, and growth is now expected to slow in 2000.

Recent developments in developing countries

A57 The IMF recently revised up its growth forecasts for newly-industrialised Asia to over $4^1/_2$ per cent this year and next reflecting supportive monetary policy, expansionary fiscal policy and stronger export growth. The region has also benefitted from some return of private capital inflows.

A58 The outlook for other emerging markets is mixed. While Brazil has stabilised faster than expected, much of Latin America is in recession. The recent rise in the oil price has alleviated some severe financing problems in oil-producing countries. Russia and other FSU economies have not experienced as serious a fallout from the Russian crisis as had been feared. Indeed Russian industrial output has recovered strongly through import substitution and the rise in the oil price. The IMF forecast growth in China of around $6^1/_2$ per cent in 1999.

World inflation and commodity prices

A59 Spare capacity at a global level and subdued commodity prices have contributed to historically low G7 consumer price inflation in 1999. However, the decline in commodity prices has now been arrested. Metal prices are increasing and oil prices have almost doubled since the coordinated supply cut by OPEC producers in March. These factors point to a mild pick up in G7 inflation in 2000. But with Japan and many European economies operating at below capacity, and forward-looking monetary policy keeping expectations in check, any increase in inflation is likely to be limited.

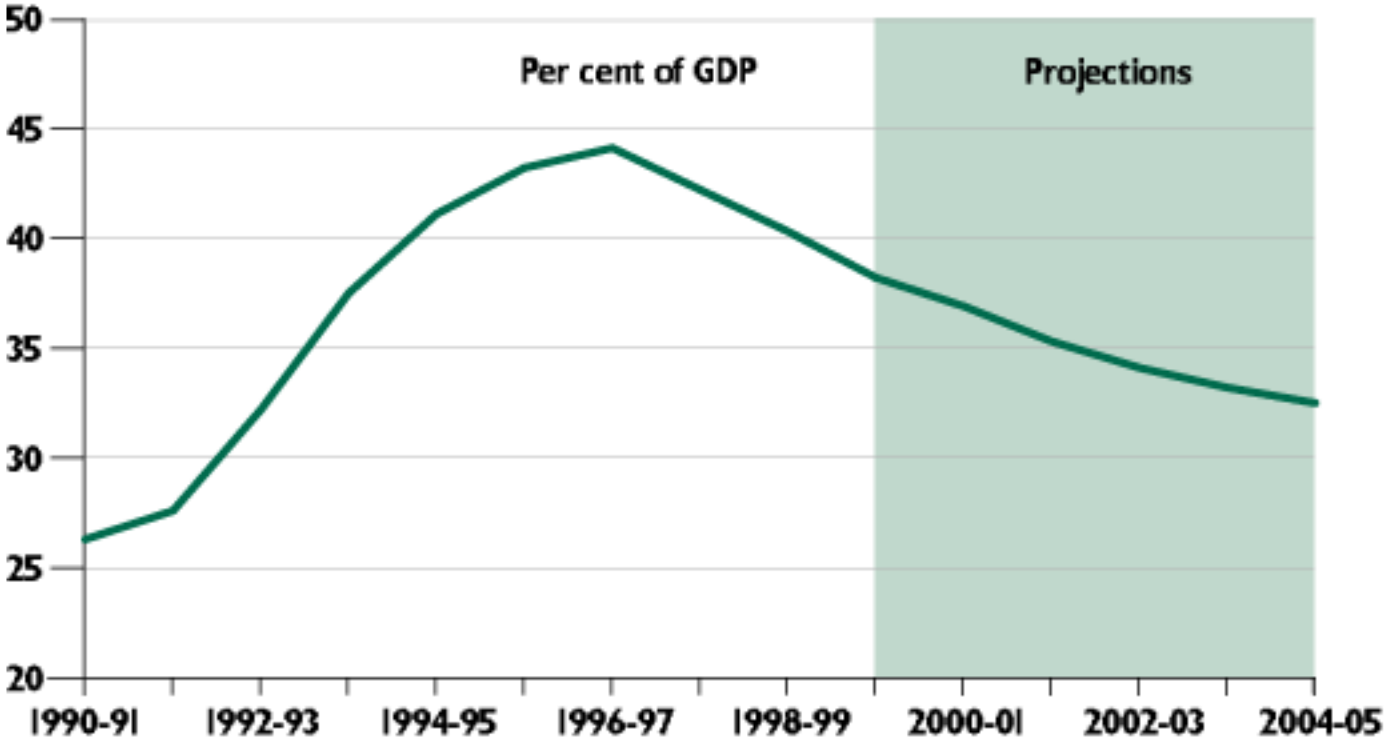
Chart A7: G7 GDP and world trade

World trade

A60 World trade growth is estimated to have picked up to 5 per cent in 1999, primarily due to a rebound in Asian trade. The effect of the slowdown in European trade growth has been offset by a mild upturn in Japan and the US. With further expansion in Asia, combined with growth in Europe and only a minor slowdown in the US, world trade growth is forecast to strengthen to $6^1/_2$ per cent next year.

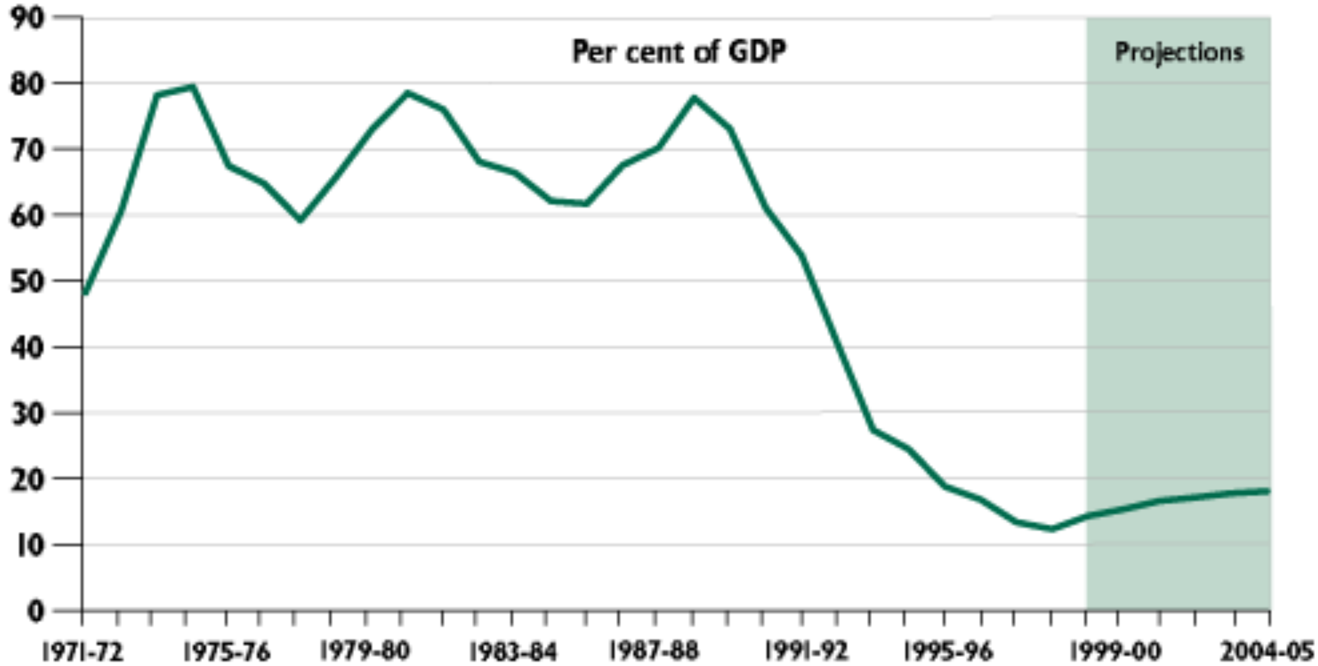
A61 UK export markets are likely to have grown significantly faster than world trade in 1999, due to the UK export sector's relatively high exposure to the fast growing US economy. In 2000, stronger growth in Asia should offset the weaker outlook for the US economy enabling UK export markets to grow at $6^3/_4$ per cent - the same rate as in 1999, and higher than expected at the time of the Budget.

Chart B1: Public sector net debt[1]



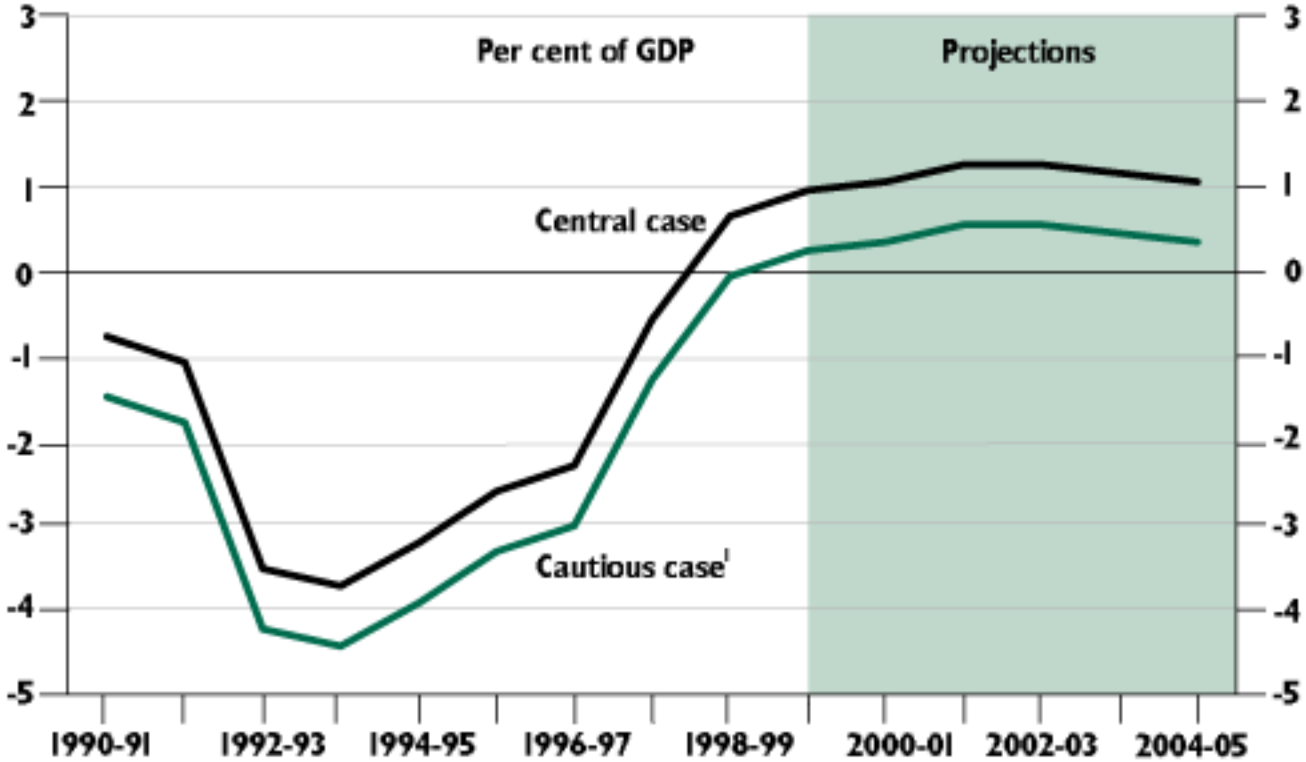
[1] End-March.

Chart B2: Public sector net worth[1]



[1] *End-December.*

Chart B3: Cyclically-adjusted current budget



[1] *Cautious case assumes trend output 1 per cent lower in relation to actual output than in the central case.*

Box B3: The impact of the new system of corporation tax instalments on the timing of tax receipts

The July 1997 and March 1998 Budgets reformed the corporation tax system by abolishing payable tax credits on dividends; abolishing advance corporation tax (ACT); and introducing quarterly instalment corporation tax payments for large companies. The changes were accompanied by reductions in the main rate of corporation tax from 33 per cent to 30 per cent and in the small companies rate from 23 per cent to 20 per cent. These changes seek to raise investment, by removing many of the distortions that encouraged firms to pay out dividends rather than reinvest their profits. The changes also affect the size and timing of tax payments. These effects are described below.

- **Under the previous system, the average date of payment of tax was dependent on the timing of dividend payments and the balance between ACT and mainstream corporation tax. The effect of the new system of quarterly instalment payments is to more closely link corporation tax payments with the profits being made.**
  When the new system is fully implemented in 2003-04, large companies will pay their tax 5 months after the profit is earned. That is on average about 7 months earlier than under the old system.
- **The changes produce a revenue gain to the Exchequer during the transition to instalments as payments are progressively brought forward over a four year period. However, companies will gain by around £1$^{1}/_{2}$ billion a year once the changes are complete because of the cuts in the tax rates and reduced payments by companies with surplus ACT.**

Cyclicality of tax receipts

- **corporation tax accounts for a large part of the cyclicality of tax receipts, reflecting the pro-cyclicality of the profits share of GDP. (See Fiscal Policy: Public Finances and the Cycle, HM Treasury, March 1999);**
- **under the old system, the cycle mostly affected mainstream corporation tax (MCT) payments. Companies tended to smooth their dividend payments, making ACT largely invariant to the cycle. Reflecting the time lags in collecting MCT, the receipts-GDP ratio would tend to rise in the year following above-trend GDP growth;**
- **the greater timeliness of receipts to changes in economic activity under the new system is reflected in the Treasury's ready reckoner that adjusts the public finances for the economic cycle. (See the Fiscal Policy paper referred to above.) By 2003-04, when the adjustment to the new system is complete, a one per cent increase in the output gap would be expected to improve the current budget surplus by 0.5 per cent of GDP in the same year, and by a further 0.2 per cent of GDP a year later. This compares with estimated elasticities of 0.4 and 0.3 respectively, under the old system.**

Table B9: Public sector current receipts

		£ billion	
	Outturn	Estimate	Projection
	1998-99	**1999-00**	**2000-01**
Inland Revenue			
Income tax (gross of tax credits)	88.4	94.0	100.4
Income tax credits	-2.0	-3.3	-5.0
Corporation tax[1]	30.0	33.5	32.5
Windfall tax	2.6		
Petroleum revenue tax	0.5	0.8	0.7
Capital gains tax	2.0	2.4	3.0
Inheritance tax	1.8	2.0	2.2

Stamp duties	4.6	6.1	6.2
Total Inland Revenue (net of tax credits)	**127.9**	**135.5**	**139.7**
Customs and Excise			
Value added tax	52.3	55.7	58.0
Fuel duties	21.6	22.5	23.5
Tobacco duties	8.2	5.7	7.1
Spirits duties	1.6	1.7	1.8
Wine duties	1.5	1.6	1.7
Beer and cider duties	2.8	3.0	3.0
Betting and gaming duties	1.5	1.5	1.5
Air passenger duty	0.8	0.9	1.0
Insurance premium tax	1.2	1.4	1.6
Landfill tax	0.3	0.4	0.4
Customs duties and levies	2.1	2.0	2.0
Total Customs and Excise	**94.0**	**96.4**	**101.7**
Vehicle excise duties	4.6	4.9	5.1
Oil royalties	0.3	0.4	0.4
Business rates[2]	15.3	15.7	16.7
Social security contributions	55.1	56.2	58.9
Council Tax	11.9	12.8	13.7
Other taxes and royalties[3]	8.6	7.5	7.6
Net taxes and social security contributions[4]	**317.8**	**329.3**	**343.9**
Accrual adjustments on taxes	0.3	3.7	2.9
less own resources contribution to EU budget	-6.2	-5.9	-5.4
less PC corporation tax payments	-0.4	-0.4	-0.4
Income tax credits[5]	2.0	3.3	5.0
Interest and dividends	4.2	3.6	4.0
Gross operating surpluses and rent	17.8	18.4	20.1
Current receipts	**335.5**	**352.1**	**370.0**
Memo:			
North Sea revenues[6]	2.5	2.4	3.4
[1]*Includes advance corporation tax (net of repayments):*	*11.0*	*1.5*	*-0.2*

Also includes North Sea corporation tax after ACT set off, and corporation tax on gains.

[2] *Includes district council rates in Northern Ireland.*

[3] *Includes money paid into the National Lottery Distribution Fund.*

[4] *Includes VAT and 'traditional own resources' contributions to EU budget. Net of income tax credits. Cash basis.*

[5] *Excludes Children's Tax Credit, which scores as a tax repayment in the national accounts.*

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

Total taxes

B39 Chart B4 and Table B10 show the tax-GDP ratio, measured as net taxes and social security contributions, as a percentage of GDP. The tax ratio is estimated to fall by nearly $\frac{1}{2}$ percentage point this year to 37 per cent, and to remain close to this level on average over the next five years. The tax burden on a typical family on average earnings with two children will fall in 2001-02 to its lowest level since 1972.

Chart B4: Tax-GDP ratio

Table B10: Net taxes and social security contributions[1]

	Per cent of GDP						
	Outturn[2]	**Estimate**	**Projections**				
	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**
PBR	37.4	37.0	36.8	37.2	37.2	37.0	36.8
Budget 99	37.2	36.6	36.7	37.0	37.0	37.1	

1 *Net of income tax credits; cash basis.*

2 *The 1998-99 figures were estimates in Budget 99.*

PUBLIC EXPENDITURE

Economic assumptions

Table B11: Economic assumptions for public expenditure projections

	Percentage changes on previous year						
	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**
RPIX-PBR	$2\frac{3}{4}$	$2\frac{1}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$
RPIX-Budget 99	$2\frac{3}{4}$	$2\frac{1}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$	
RPI (September[1])-PBR	$3\frac{1}{4}$	1	$3\frac{1}{2}$	$2\frac{1}{2}$	3	$2\frac{1}{2}$	$2\frac{1}{4}$
RPI (September[1])-Budget 99	$3\frac{1}{4}$	$1\frac{1}{4}$	3	$2\frac{3}{4}$			
Rossi[2](September[1])-PBR	$2\frac{1}{4}$	$1\frac{3}{4}$	$1\frac{3}{4}$	2	2	2	2
Rossi[2] (September[1]) -Budget 99		$2\frac{1}{4}$	2	2	2		

1 *Used for projecting social security expenditure over the following financial year.*

2 *RPI excluding housing costs, used for uprating certain social security benefits.*

B40 In addition to the assumptions shown in Table B11, the projections assume that UK claimant unemployment remains flat at the most recent quarterly outturn of 1.23 million. The March 1999 FSBR set out the new NAO-audited assumption for unemployment to be used in public expenditure projections. When the average of independent forecasts of unemployment shows a rise, that will be used for fiscal planning. When it is projected to fall the flat assumption will be used. The average of independent forecasts of unemployment is now slightly below the current level, so the flat assumption has been used.

PROSPECTS

B41 Table B12 shows the projections for public expenditure for the three years, 1999-2000 to 2001-02, covered by the Comprehensive Spending Review. These projections cover the whole public sector, using the aggregate Total Managed

Expenditure (TME). TME is split into Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME).

Table B12: Total Managed Expenditure 1998-99 to 2001-02

							£ billion
	Outturn		Projections		Changes since Budget 99		
	1998-99	**1999-00**	**2000-01**	**2001-02**	**1999-00**	**2000-01**	**2001-02**
Departmental Expenditure Limits	**167.5**	**179.9**	**189.7**	**199.5**	**0.7**	**0.0**	**0.0**
Annually Managed Expenditure							
Social Security Benefits	93.3	97.2	99.0	103.6	-1.9	-2.5	-2.8
Housing Revenue Account subsidies	3.5	3.4	3.3	3.2	0.0	-0.1	-0.3
Common Agricultural Policy	2.7	2.6	2.6	2.7	0.1	-0.1	-0.1
Export Credits Guarantee Department	-0.2	0.8	1.0	0.7	0.3	0.2	-0.1
Net Payment to EC Institutions[1]	3.6	2.7	2.6	2.5	0.0	0.0	-0.4
Self-financing Public Corporations	-0.3	0.2	0.2	-0.1	0.3	0.4	0.2
Locally Financed Expenditure	16.1	17.2	18.0	19.3	0.2	-0.3	-0.5
Net Public Service Pensions	4.7	5.8	5.9	6.0	-0.3	-0.2	-0.2
National Lottery	1.6	2.0	2.5	2.5	-0.6	-0.2	-0.3
Central government gross debt interest	29.3	25.7	28.4	28.1	-0.3	0.7	0.9
Accounting and other adjustments	9.3	9.0	11.8	12.9	-0.2	0.1	0.1
AME Margin	0.0	3.5	3.9	6.4	2.5	1.9	3.4
Annually Managed Expenditure	**163.6**	**170.0**	**179.1**	**187.8**	**0.0**	**0.0**	**0.0**
Total Managed Expenditure	**331.0**	**349.9**	**368.8**	**387.3**	**0.7**	**0.0**	**0.0**
of which:							
Public sector current expenditure	312.5	329.7	346.2	362.2	0.7	0.1	0.2
Public sector net investment	5.0	6.4	8.4	10.4	0.9	0.9	0.8
Public sector depreciation	13.6	13.8	14.2	14.7	-1.0	-1.0	-1.0

[1] *Net payments to EC institutions exclude the UK's contribution to the cost of EC aid to non-Member States (which is attributed to the aid programme). Net payments therefore differ from the UK's net contribution to the EC Budget, latest estimates for which are (in £ billion).*

	1998-99	*1999-00*	*2000-01*	*2001-02*
Figures from 2000-01 are trend estimates.	4.1	3.1	3.3	3.3

B42 With the exception of 1999-2000, DEL is unchanged since Budget 99. The current year DEL total has been increased by the carry-forward from 1998-99 of a £0.7 billion underspend on DEL programmes in that year, in line with the procedure announced in the 1998-99 Public Expenditure Outturn White Paper (Cm 4416). The forecasts of individual AME programmes have been updated since the March Budget. Total AME remains unchanged from the Budget and, in line with the convention adopted in last year's PBR, changes to AME programmes have been offset in the margin. The figures will be reviewed again at the time of the next Budget.

B43 The most significant change since the Budget to the AME programmes is a downward revision to the forecast of social security expenditure. To a large extent this reflects the revised assumption for unemployment, accounting for over £1 billion of the reduction in the current year rising to over £2 billion in future years. Further reductions arise from a re-assessment of future rents, affecting housing benefits, and lower projected disability benefit caseloads.

B44 Debt interest in the current year is expected to be a little lower than forecast in the Budget, reflecting lower borrowing. It is higher in future years, as the NAO-audited assumption for short-term interest rates (based on market expectations) implies higher levels compared to the projections used at Budget time. This has a direct effect on debt interest via new issues of short dated debt, and an indirect effect through the uplift on index-linked gilts.

Chart B5: Total Managed Expenditure

B45 The CSR plans extend only to 2001-02. The spending totals for the last two years of the projection period are illustrative. They assume that real current expenditure continues to grow by $2^{1}/_{4}$ per cent a year and net investment continues to rise as a share of GDP (from 1 per cent in 2001-02 to $1^{1}/_{2}$ per cent in 2003-04).

B46 The main accounting and other adjustments, those items within TME but outside DEL and AME main programmes, are shown in Table B13. The increase in the aggregate adjustments over the three years of the CSR period is largely due to the introduction of the Working Families' Tax Credit in October 1999. This adds over £1 billion to the adjustments in 1999-2000 and about £5 billion in each of the next two years. These adjustments are little changed since the Budget.

Table B13: Accounting and other adjustments

		£ billion		
	1998-99	**1999-00**	**2000-01**	**2001-02**
1 Non-trading capital consumption	7.0	7.1	7.3	7.6
2 VAT refunded on general government expenditure	5.1	5.3	5.5	5.8
3 EC contributions	-6.0	-5.7	-5.6	-5.1
4 Income tax credits	2.0	3.3	5.2	5.4
of which Working Families' Tax Credit and Disabled Persons' Tax Credit:	*0.0*	*1.3*	*4.8*	*5.1*
5 Other programme spending in AME	0.2	0.3	0.4	0.5
6 Adjustments for public corporations	2.8	3.4	3.9	3.9
7 Intra-public sector debt interest	-2.4	-2.0	-1.6	-2.2
8 Financial transactions in DEL and AME	-0.3	-2.3	-2.8	-2.5
9 Other accounting adjustments	0.8	-0.3	-0.4	-0.4
Total	**9.3**	**9.0**	**11.8**	**12.9**

Capital spending

B47 Table B14 gives a breakdown of public sector net investment. The gross investment projections are little changed from the Budget. Small reductions in National Lottery expenditure projections have been offset by increases in the public corporations sector. The net investment totals are about £1 billion higher than at Budget time, because of revisions to depreciation data and projections.

Table B14: Public sector capital expenditure

			£ billion	
	1998-99	**1999-00**	**2000-01**	**2001-02**
CG spending and LA support in DEL	10.7	12.1	14.3	16.5
Locally financed spending	0.8	0.9	0.7	0.7
National Lottery	1.4	1.7	2.1	2.1
Public corporations[1]	4.1	4.7	4.5	4.5
Other capital spending in AME	1.5	0.7	0.8	1.1
Allocation of Reserve and AME margin	0.0	0.2	0.2	0.2
Public sector gross investment[2]	**18.6**	**20.2**	**22.6**	**25.1**
Less depreciation	-13.6	-13.8	-14.2	-14.7
Public sector net investment[2]	**5.0**	**6.4**	**8.4**	**10.4**

Proceeds from the sale of fixed assets[3]	4.3	3.8	3.8	3.8

[1] *Public corporations' capital expenditure is partly within DEL and partly within AME.*

[2] *This and previous lines are all net of sales of fixed assets.*

[3] *Projections of total receipts from the sale of fixed assets by public sector. These receipts are taken into account in arriving at public sector gross and net investment, which are net of sales of fixed assets.*

B48 Table B15 shows receipts from asset and loan sales from 1997-98 to 2001-02, the last three years being projections. Planned sales of fixed assets by central government are set out for each department in their Departmental Investment Strategy and are expected to total £1 billion over the next three years.

Table B15: General Government receipts from sales of assets

	£ billion				
	Outturn			Projections	
	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**
Sales of fixed assets					
Ministry of Defence: sale of married quarters	0.7				
Department of Social Security: PRIME[1] and Newcastle estate	0.1	0.4			
Other Central Government	0.8	1.2	1.0	1.0	1.0
Local Authorities	2.5	2.7	2.8	2.8	2.8
Total sales of fixed assets	**4.1**	**4.3**	**3.8**	**3.8**	**3.8**
Loans and sales of financial assets					
Sale of Housing Corporation and Housing for Wales loan portfolios	0.7				
Sale of student loans portfolio	1.0	1.0			
Other loans and sales of financial assets	0.0	-1.6	-0.1	-1.5	-1.5
Total loans and sales of financial assets	**1.7**	**-0.6**	**-0.1**	**-1.5**	**-1.5**
Total receipts from sales of assets	**5.8**	**3.7**	**3.6**	**2.3**	**2.2**

[1]*Private sector resource initiative for management of the estate.*

B49 The figures for sales of financial assets include proceeds from the sale of British Energy debt and from the Public Private Partnerships for Belfast Port, National Air Traffic Services and the Defence Evaluation and Research Agency.

B50 Table B16 shows a full analysis of public sector receipts and expenditure by economic category with a breakdown between central government, local authorities and public corporations. Table B17 gives a breakdown of Departmental Expenditure Limits.

Table B16: Public sector transactions by sub-sector and economic category

		£ billion				
		1998-99				
		General government				
	Line	**Central government**	**Local authorities**	**Total**	**Public corporations**	**Public sector**
Current receipts						

Taxes on income and wealth	*1*	124.3	0.0	124.3	-0.4	123.9
Taxes on production and imports	*2*	116.9	0.1	117.0	0.0	117.0
Other current taxes	*3*	3.2	12.0	15.2	0.0	15.2
Taxes on capital	*4*	1.8	0.0	1.8	0.0	1.8
Social contributions	*5*	55.0	0.0	55.0	0.0	55.0
Gross operating surplus	*6*	4.0	8.5	12.6	4.5	17.1
Rent and other current transfers	*7*	0.7	0.0	0.7	0.6	1.3
Interest and dividends from private sector and abroad	*8*	3.1	0.8	3.9	0.3	4.2
Interest and dividends from public sector	*9*	6.2	-3.9	2.3	-2.3	0.0
Total current receipts	*10*	**315.3**	**17.5**	**332.9**	**2.7**	**335.5**
Current expenditure						
Current expenditure on goods and services	*11*	95.7	60.2	155.9	0.0	155.9
Subsidies	*12*	3.8	0.8	4.5	0.0	4.5
Net social benefits	*13*	92.9	13.7	106.6	0.0	106.6
Net current grants abroad	*14*	-1.0	0.0	-1.0	0.0	-1.0
Current grants (net) within public sector	*15*	60.8	-60.8	0.0	0.0	0.0
Other current grants	*16*	17.1	0.0	17.1	0.0	17.1
Interest and dividends paid	*17*	29.3	0.5	29.7	-0.5	29.3
Apportionment of DEL reserve and AME margin	*18*	0.0	0.0	0.0	0.0	0.0
Total current expenditure	*19*	**298.6**	**14.3**	**312.9**	**-0.5**	**312.5**
Depreciation	*20*	3.7	6.0	9.7	3.9	13.6
Surplus on current budget	*21*	**13.0**	**-2.8**	**10.2**	**-0.7**	**9.5**
Capital expenditure						
Gross domestic fixed capital formation	*22*	4.5	5.7	10.2	4.1	14.3
Less depreciation	*23*	-3.7	-6.0	-9.7	-3.9	-13.6
Increase in inventories	*24*	0.0	0.0	0.0	0.0	0.1
Capital grants within public sector	*25*	4.3	-3.1	1.2	-1.2	0.0
Capital grants to private sector	*26*	3.7	1.0	4.6	0.0	4.6
Capital grants from private sector	*27*	0.0	-0.4	-0.4	0.0	-0.4
Apportionment of DEL reserve	*28*	0.0	0.0	0.0	0.0	0.0
Net capital expenditure	*29*	**8.8**	**-2.8**	**6.0**	**-1.0**	**5.0**
Public sector net borrowing	*30*	**-4.2**	**-0.1**	**-4.2**	**-0.3**	**-4.5**

Table B16: Public sector transactions by sub-sector and economic category

£ billion
1999-00

	General Government					
Line	**General government**	**Local authorities**	**Total**	**Public corporations**	**Public sector**	
						Current receipts
1	130.9	0.0	130.9	-0.4	130.5	Taxes on income and wealth
2	123.9	0.1	124.0	0.0	124.0	Taxes on production and imports

3	3.3	12.8	16.1	0.0	16.1	Other current taxes
4	2.0	0.0	2.0	0.0	2.0	Taxes on capital
5	56.6	0.0	56.6	0.0	56.6	Social contributions
6	4.5	8.7	13.1	4.3	17.5	Gross operating surplus
7	1.3	0.0	1.3	0.6	1.9	Rent and other current transfers
8	2.7	0.7	3.4	0.2	3.6	Interest and dividends from private sector and abroad
9	6.0	-3.8	2.2	-2.2	0.0	Interest and dividends from public sector
10	**331.1**	**18.4**	**349.5**	**2.6**	**352.1**	**Total current receipts**
						Current expenditure
11	98.7	63.8	162.5	0.0	162.5	Current expenditure on goods and services
12	3.6	0.8	4.4	0.0	4.4	Subsidies
13	98.5	13.4	111.8	0.0	111.8	Net social benefits
14	-1.1	0.0	-1.1	0.0	-1.1	Net current grants abroad
15	63.5	-63.5	0.0	0.0	0.0	Current grants (net) within public sector
16	20.9	0.0	20.9	0.0	20.9	Other current grants
17	25.7	0.4	26.1	-0.3	25.8	Interest and dividends paid
18	5.3	0.0	5.3	0.0	5.3	Apportionment of DEL reserve and AME margin
19	**315.0**	**14.9**	**329.9**	**-0.3**	**329.7**	**Total current expenditure**
20	3.9	6.2	10.0	3.8	13.8	Depreciation
21	**12.2**	**-2.7**	**9.5**	**-1.0**	**8.5**	**Surplus on current budget**
						Capital expenditure
22	5.0	5.9	10.9	4.6	15.5	Gross domestic fixed capital formation
23	-3.9	-6.2	-10.0	-3.8	-13.8	*Less* depreciation
24	0.0	0.0	0.0	0.1	0.1	Increase in inventories
25	4.4	-3.1	1.3	-1.3	0.0	Capital grants (net) within public sector
26	3.9	1.2	5.1	0.0	5.1	Capital grants to private sector
27	0.0	-0.6	-0.6	0.0	-0.6	Capital grants from private sector
28	0.2	0.0	0.2	0.0	0.2	Apportionment of DEL reserve
29	**9.6**	**-2.8**	**6.8**	**-0.4**	**6.4**	**Net capital expenditure**
30	**-2.6**	**-0.1**	**-2.7**	**0.5**	**-2.1**	**Public sector net borrowing**

Table B17: Departmental Expenditure Limits - Current and Capital Budgets

	£ billion				
	Outturns			Plans	
	1997-98	**1998-99**	**1999-00**	**2000-01**	**2001-02**
Current Budget					
Education and Employment	14.0	13.5	14.5	15.8	16.8
Health	35.1	37.5	39.9	42.7	45.5
of which: NHS	*34.5*	*36.8*	*39.3*	*42.1*	*44.8*
DETR - Main programmes	4.1	4.1	4.4	4.6	4.8
DETR - Local Government and Regional Policy	31.1	32.4	33.9	35.4	36.9

Home Office	6.2	6.5	7.4	7.4	7.6
Legal Departments[1]	2.6	2.6	2.7	2.7	2.6
Defence	20.1	20.9	20.8	21.3	21.4
Foreign and Commonwealth Office	1.0	1.0	1.0	1.1	1.1
International Development	1.9	2.1	2.0	2.5	2.7
Trade and Industry[2]	2.7	2.6	2.9	3.2	3.1
Agriculture, Fisheries and Food[3]	1.4	1.2	1.1	1.0	1.0
Culture, Media and Sport	0.8	0.8	0.9	0.9	1.0
Social Security (administration)	3.2	3.3	3.0	3.1	3.2
Scotland[1,4]	11.5	11.7	12.2	12.8	13.3
Wales[4]	5.6	5.9	6.3	6.7	7.0
Northern Ireland[4]	4.9	5.1	5.3	5.4	5.5
Chancellor's Departments	2.7	2.8	3.3	3.4	3.4
Cabinet Office	0.8	1.1	1.2	1.1	1.1
Welfare to Work[5]	0.0	0.3	1.0	1.0	0.9
Invest to Save Budget				0.0	0.1
Capital Modernisation Fund					
Reserve[6]			1.8	1.6	2.2
Total Current Budget	**149.6**	**155.3**	**165.7**	**173.9**	**181.3**
Capital Budget					
Education and Employment	0.7	0.8	1.2	1.7	2.1
Health	0.2	-0.1	0.5	0.5	0.6
of which: NHS[7]	*0.1*	*-0.2*	*0.4*	*0.5*	*0.6*
DETR - Main programmes	5.5	5.0	5.3	5.9	7.1
DETR - Local Government and					
Regional Policy	0.3	0.4	0.3	0.1	0.0
Home Office	0.5	0.4	0.4	0.4	0.5
Legal Departments[1]	0.1	0.1	0.1	0.1	0.1
Defence	0.9	1.6	1.5	1.5	1.5
Foreign and Commonwealth Office	0.1	0.1	0.1	0.1	0.1
International Development	0.2	0.2	0.3	0.3	0.4
Trade and Industry[2]	0.4	0.3	0.4	0.5	0.5
Agriculture, Fisheries and Food[3]	0.3	0.1	0.2	0.2	0.2
Culture, Media and Sport	0.1	0.1	0.1	0.1	0.1
Social Security (administration)	0.0	-0.3	0.1	0.1	0.1
Scotland[1,4]	1.4	1.6	1.7	1.8	2.0
Wales[4]	0.9	0.8	0.8	0.8	0.8
Northern Ireland[4]	0.5	0.5	0.5	0.6	0.7
Chancellor's Departments	0.2	0.1	0.2	-0.1	0.1
Cabinet Office	0.2	0.2	0.3	0.2	0.2
Welfare to Work[5]	0.1	0.3	0.3	0.3	0.3
Invest to Save Budget				0.0	0.0

Capital Modernisation Fund			0.0	0.5	0.7
Reserve[6]			0.2	0.2	0.2
Total Capital Budget	**12.6**	**12.2**	**14.2**	**15.8**	**18.2**
Departmental Expenditure Limits	**162.2**	**167.5**	**179.9**	**189.7**	**199.5**
Total education spending	37.4	38.3	41.3	44.8	48.0

[1] *The Crown Office is included in the Lord Chancellor's Department figures up to 1998-99, and in the Scotland figures from 1999-2000, reflecting a machinery of government change. See Chapter 22 of the CSR White Paper for further details.*

[2] *Includes the capital expenditure of the Export Credits Guarantee Department.*

[3] *Includes spending on BSE related programmes.*

[4] *For Scotland and Wales, the split between current and capital budgets is decided by by the respective Executives, for Northern Ireland it is currently a matter for the Secretary of State (and in due course for the devolved executive).*

[5] *Expenditure financed by the Windfall Tax.*

[6] *Reserve has been arbitrarily apportioned between current and capital, with 10% allocated to capital.*

[7] *Excludes the element of NHS trust capital expenditure which is funded through charges to health purchasers. Plans for total net capital spending on health are £1.5 billion in 1999-2000, £1.8 billion in 2000-01 and £2.1 billion in 2001-02.*

B51 Table B18 presents projections of the net cash requirement by sector, giving details of the various financial transactions that do not affect net borrowing (the change in the sector's net financial indebtedness) but do affect its financing requirement.

Table B18: Net cash requirement[1]

	£ billion							
	1998-99				**1999-2000**			
	General government				General government			
	Central government	Local authorities	Public corporations	Public sector	Central government	Local authorities	Public corporations	Public sector
Public sector net borrowing	**-4.2**	**-0.1**	**-0.3**	**-4.5**	**-2.6**	**-0.1**	**0.5**	**-2.1**
Financial transactions								
Net lending to private sector and abroad	0.2	-0.1	0.1	0.1	0.8	-0.1	0.0	0.7
Cash expenditure on company securities (including privatisation proceeds)	0.2	0.0	0.2	0.4	-0.6	0.0	0.0	-0.6
Accruals adjustments on receipts	0.4	0.1	-0.1	0.3	3.7	0.0	0.7	4.4
Other accruals adjustments	-2.4	0.0	0.0	-2.4	-1.3	0.0	0.0	-1.3
Miscellaneous financial transactions	-0.3	-0.4	-0.3	-1.0	-0.2	0.0	-0.8	-0.9
Public sector net cash requirement	*-6.2*[2]	*-0.5*	*-0.4*	*-7.0*	*-0.2*[2]	*-0.2*	*0.5*	*0.1*

[1] *The figures in this table include the windfall tax and associated spending. Excluding windfall tax receipts and associated spending, the public sector cash requirement was -£5.0 billion (-0.6 per cent of GDP) for 1998-99 and is projected to be -£1.3 billion (-0.1 per cent of GDP) for 1999-2000. It is projected at - £1 billion (-0.1 per cent of GDP) for 2000-01 and for 2001-02.*

[2] *Own account.*

Financing policy

B52 The 1999-2000 Debt Management Report, published in March, set out how the Government intended to finance its net cash requirement in 1999-2000. The outturn for the 1998-99 central government net cash requirement announced on 20 April 1999 reduced the financing requirement by £1.7 billion, to £19.3 billion. In accordance with the plans set out in the Debt Management Report, this change was absorbed by a reduction in the planned net issuance of Treasury bills, and planned gilt sales remained unchanged at £17.3 billion. Table B19 updates the financing arithmetic to allow for the latest forecast of the central government net cash requirement for 1999-2000.

B53 The reduction to the forecast of the net cash requirement now reduces the financing requirement further, to £14.2 billion. This is expected to be met from a net contribution from National Savings which is now forecast to be -£0.9 billion, and an increase in the level of short-term debt of £0.8 billion, with gross gilt sales required of £14.2 billion.

Table B19: Financing requirement forecast

	1999-2000		
	March 1999 Original Remit	**Revised remit April 1999**[1]	**November 1999 Pre-Budget Report**
£ billion			
Central government net cash requirement	**6.2**	**6.2**	**1.1**
Expected net financing of official reserves[2]	2.4	2.3	2.3
Expected gilt redemptions	14.8	14.9	14.9
Under/overfinancing from 1998-99	-2.3	-4.1	-4.1
Financing requirement	**21.0**	**19.3**	**14.2**
Less assumed net National Savings contribution	0.1	0.1	-0.9
Less increase in T-bills and other short-term debt[3]	3.6	1.9	0.8
Gross gilts sales requirement	**17.3**	**17.3**	**14.2**
Gilt sales to date (April-October 1999)			11.0
of which			
Short conventionals (3-7 years)			2.4
Medium conventionals (7-15 years)			2.8
Long conventionals (>15 years)			3.5
Index-linked			2.4
Further planned gilt sales			
Long conventionals			2.3 to 2.7
Index-linked[4]			0.5 to 0.9
Total planned gilt sales			13.8 to 14.6

Note: Figures may not sum due to rounding.

[1] *Remit revised following outturn of the 1998-99 central government net cash requirement.*

[2] *The reserves require financing in 1999-2000 to replace Euro3.5 billion of Euro Treasury bills. Future refinancing estimated as current exchange rate.*

[3] *This increase less the 1998-99 overfinancing shows the increase in the stock of T-bills and other short term debt during 1999-2000 in advance of the DMO taking over responsibility for cash management.*

[4] *Includes flexibility to tap if necessary.*

B54 Gilt sales to end-October were £11.0 billion, of which index-linked issuance was £2.4 billion. The DMO have already announced, on 30 September, that they will hold an auction of long-dated gilts on 24 November. The further planned gilt sales include £2.3 billion to £2.7 billion (cash) from that forthcoming auction of long gilts. (The DMO will announce the actual amount to be auctioned on 16 November, in accordance with the usual auction timetable). The Government does not intend to auction further conventional gilts in 1999-2000. In the Debt Management Report, the Government gave a lower limit of £2.5 billion for sales of index-linked gilts. The Government therefore intends to proceed with the index-linked auction scheduled for 26 January. The further planned gilt sales include £0.5 billion to £0.9 billion further index-linked gilt issuance, which includes flexibility for issuance through taps, if that was to be necessary.

B55 The financing plans assume an increase in the level of short-term debt of £0.8 billion. This is only an assumption for planning purposes. Should gilt sales differ from the gilt sales requirement, there would be an offsetting further change in short-term debt. An increase in short-term debt of £0.8 billion would be consistent with end-year levels of Ways and Means of £17 billion, and an outstanding stock of Treasury bills of about £7 billion. These are the planned levels at which Ways and Means will be frozen, when the DMO cash management operations are fully up and running, and the assumed level of Treasury bills at the start of the DMO cash management operations in April 2000. However these levels are assumed here only for planning purposes. The level of Treasury bill issuance at the end of March 2000 will still partly need to reflect the Bank of England's requirements for their money market operations.

B56 These financing plans are also based on a forecast of the central government net cash requirement. To the extent that the final outturn for this net cash requirement is different from forecast, such differences in outturn will also be reflected in the final change in short-term debt, since the change in short-term debt necessarily balances the government's final cash position.

B57 Tables B20 and B21 set out historical data for the main fiscal aggregates.

Table B20: Historical series of public sector balances, receipts and debt

	Per cent of GDP								
	Public sector current budget[1]	**Public sector net borrowing[1]**	**Public sector net cash requirement[1]**	**General government net borrowing[2]**	**Net taxes and social security contributions**	**Public sector current receipts**	**Public sector net debt[3]**	**General government gross debt[4]**	**Public sector net worth[5]**
1970-71	7.0	-0.5	1.3	-2.0		42.7	69.6	77.7	41.7
1971-72	4.5	1.1	1.5	-0.7		41.1	65.2	74.8	48.1
1972-73	2.1	2.9	3.8	2.3		38.5	58.5	67.6	60.0
1973-74	1.0	4.5	5.9	4.1		39.7	58.4	65.9	76.8
1974-75	-0.6	6.3	9.1	4.0		42.2	52.4	60.5	78.0
1975-76	-1.4	7.1	9.4	4.8		42.7	54.2	59.5	66.5
1976-77	-1.0	5.7	6.5	4.3		43.0	52.6	58.9	63.9
1977-78	-1.1	4.3	3.7	3.5		41.3	49.2	57.5	58.6

1978-79	-2.2	4.8	5.2	4.0	33.3	40.1	47.3	56.1	64.9
1979-80	-1.5	3.9	4.8	2.8	34.0	40.8	44.1	52.0	71.8
1980-81	-2.7	4.6	5.3	3.7	35.8	42.6	46.2	53.6	77.1
1981-82	-1.1	2.2	3.5	3.2	38.7	45.9	46.4	51.8	74.7
1982-83	-1.4	3.0	3.2	3.2	39.0	45.4	44.9	50.5	67.1
1983-84	-1.9	3.8	3.2	3.8	38.3	44.5	45.2	50.6	65.5
1984-85	-2.5	4.2	3.2	3.8	38.9	43.8	45.4	50.5	61.4
1985-86	-1.0	2.4	1.6	2.6	38.1	43.2	43.6	49.6	61.0
1986-87	-1.4	2.1	1.0	2.4	37.7	41.8	41.2	48.8	66.6
1987-88	-0.3	1.0	-0.7	1.3	37.6	41.0	36.9	46.6	69.1
1988-89	1.8	-1.4	-3.0	-1.0	36.8	40.6	30.7	40.6	82.4
1989-90	1.6	-0.3	-1.3	0.2	36.3	39.9	27.9	35.6	74.5
1990-91	0.8	0.7	-0.1	1.3	36.3	39.0	26.3	33.3	62.8
1991-92	-1.7	3.6	2.4	3.5	35.3	38.8	27.6	34.6	55.3
1992-93	-5.7	7.8	5.9	7.6	34.0	36.5	32.2	40.5	42.4
1993-94	-6.2	7.8	7.2	7.8	33.3	35.9	37.5	46.1	30.2
1994-95	-4.8	6.3	5.3	6.6	34.3	36.9	41.1	49.5	29.7
1995-96	-3.5	4.9	4.4	5.1	35.3	37.9	43.2	52.2	21.6
1996-97	-2.9	3.6	3.0	3.8	35.3	37.6	44.1	52.3	17.8
1997-98	-0.6	1.2	0.4	0.9	36.5	38.7	42.2	49.4	14.7
1998-99	0.8	-0.3	-0.6	-0.5	37.4	39.4	40.3	47.0	13.7
1999-00	1.1	-0.4	-0.1	-0.3	37.0	39.6	38.2	44.9	15.6

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

[2] *UK national accounts definition (ESA95).*

[3] *At end-March, GDP centred on end-March.*

4 *Expressed as a ratio to money GDP (ESA95).*

5 *At end-December; GDP centred on end-December.*

Table B21: Historical series of government expenditure

	£ billion (1998-99 prices)				Per cent of GDP			
	Public sector current expenditure	Public sector net capital expenditure	General government expenditure	Total Managed Expenditure	Public sector current expenditure	Public sector net capital expenditure	General government expenditure	Total Managed Expenditure
1970-71	143.5	29.0	183.3	188.6	32.1	6.4	41.0	42.2
1971-72	150.1	25.2	188.6	192.2	32.9	5.5	41.3	42.2
1972-73	157.6	24.5	196.7	199.8	32.7	5.0	40.8	41.4
1973-74	173.5	27.5	211.8	220.9	34.7	5.5	42.3	44.1
1974-75	192.0	28.8	238.0	242.1	38.4	5.8	47.6	48.5
1975-76	196.3	28.5	238.1	246.2	39.7	5.7	48.1	49.8
1976-77	202.0	23.4	232.1	247.7	39.7	4.6	45.6	48.7
1977-78	198.8	16.4	221.2	237.4	38.1	3.1	42.4	45.5
1978-79	204.7	14.3	231.7	241.8	38.0	2.7	43.0	45.0
1979-80	210.9	13.6	237.9	247.4	38.1	2.4	43.0	44.8
1980-81	217.7	10.6	245.4	252.1	40.8	2.0	46.0	47.3
1981-82	226.9	5.9	248.8	256.4	42.6	1.1	46.7	48.1
1982-83	232.7	9.2	254.7	264.8	42.6	1.6	46.6	48.5
1983-84	239.5	10.9	257.6	273.3	42.3	1.9	45.5	48.3
1984-85	245.9	9.6	262.9	277.4	42.5	1.6	45.5	48.0
1985-86	246.6	8.0	261.8	274.3	41.0	1.3	43.5	45.5
1986-87	250.5	5.0	261.3	275.6	40.0	0.8	41.6	43.9
1987-88	253.8	5.0	262.5	277.0	38.5	0.7	39.8	42.0
1988-89	247.7	2.9	255.8	269.7	36.0	0.4	37.2	39.2

1989-90	248.9	9.2	268.0	277.1	35.6	1.3	38.3	39.6
1990-91	250.3	10.5	268.8	277.4	35.8	1.5	38.5	39.7
1991-92	265.3	13.3	281.4	292.6	38.4	1.9	40.8	42.4
1992-93	279.3	14.6	297.3	307.0	40.3	2.1	42.8	44.3
1993-94	287.8	12.0	306.4	312.7	40.3	1.7	42.9	43.8
1994-95	298.0	11.3	314.7	322.6	40.0	1.5	42.2	43.2
1995-96	311.3	10.5	331.0	336.2	39.6	1.3	42.1	42.8
1996-97	313.5	5.4	325.5	333.0	38.8	0.7	40.3	41.2
1997-98	312.7	4.9	326.6	330.9	37.4	0.6	39.1	39.6
1998-99	312.5	5.0	327.7	331.0	36.7	0.6	38.5	38.9
1999-00	*321.6*	*6.2*	*340.8*	*341.4*	*37.0*	*0.7*	*39.2*	*39.3*

Chart A7: G7 GDP and world trade

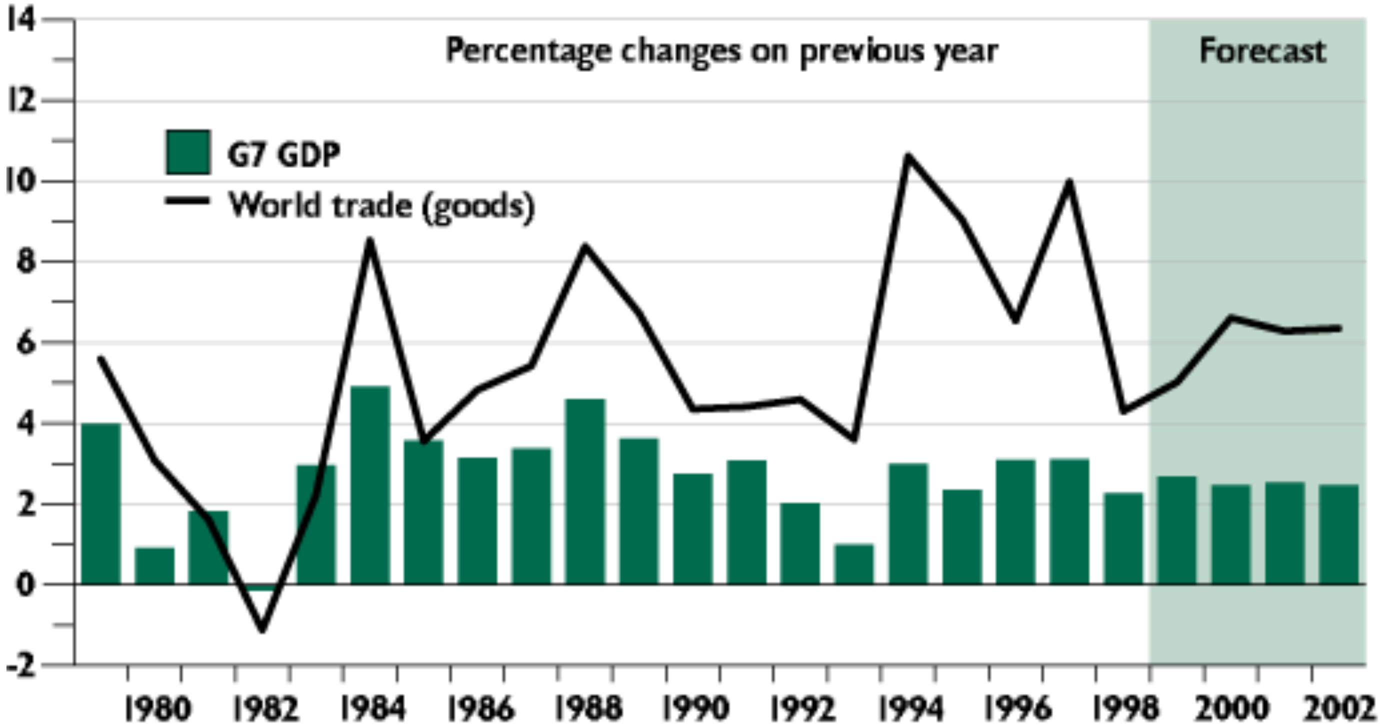
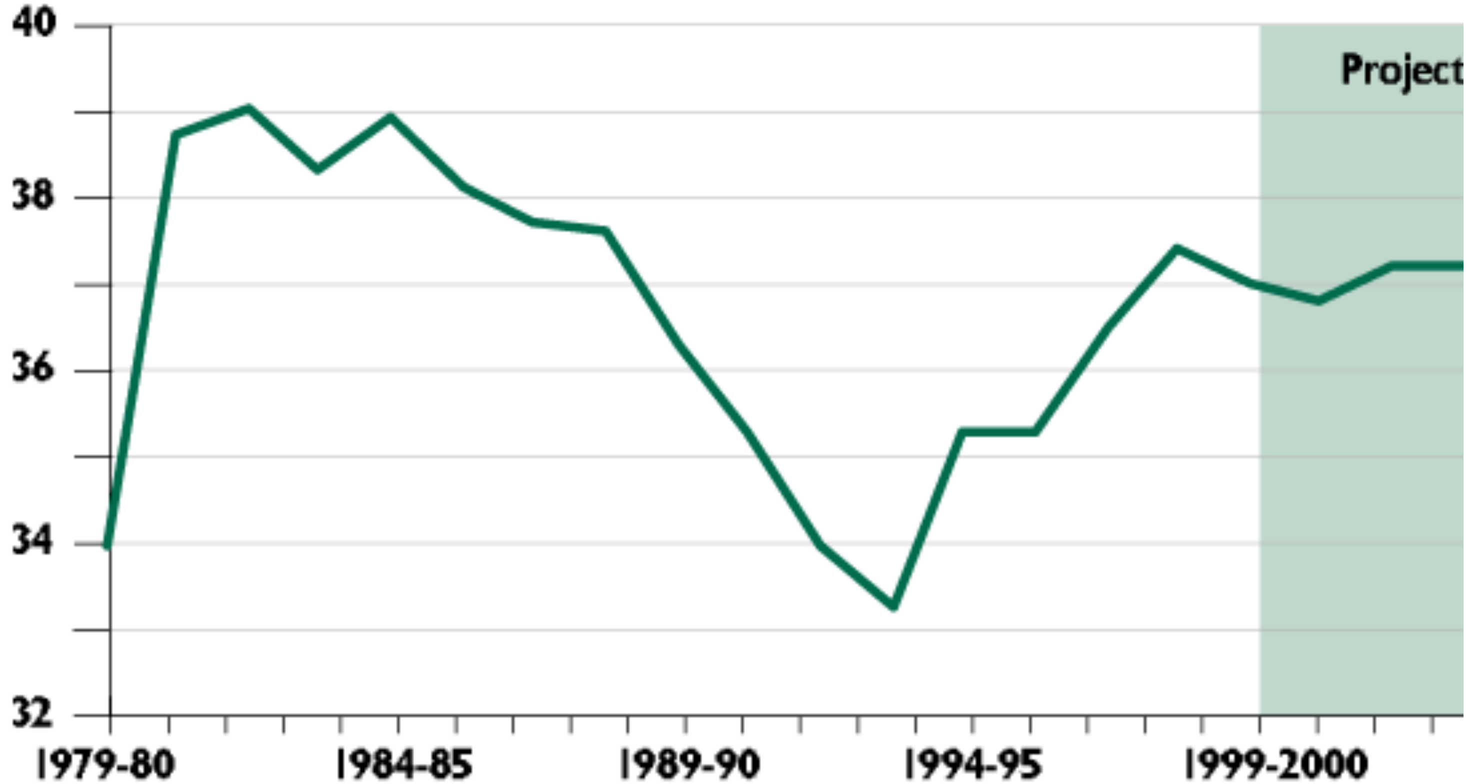


Chart B4: Tax-GDP ratio[1]



[1] Net taxes and social security contributions as defined in Table B10.

Chart B5: Total Managed Expenditure